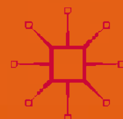
INTERNATIONAL ASPECTS OF THE US TAXATION SYSTEM

FELIX I. LESSAMBO



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Writing a book is always a challenge. But writing a book on international aspects of the US tax system geared to MBA, MST students, and professionals, is an especially daring intellectual exercise for two reasons: the difficulty in choosing appropriate topics to cover and the complexity of each subject chosen.

First and foremost, I would like to thank my wife, Aline, for standing beside me while writing this book and throughout my entire career. I would also like to express my gratitude to those who motivated me all along the project, knowing my dedication to the subject, and who believed in my ability to complete this project: James Thompson, Fouad Sayegh, and Brice Thionnet.

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List of Abbreviations

APA	Advance Pricing Agreement
BEPS	Base Erosion and Profit Shifting
CEN	Capital Export Neutrality
CFC	Controlled Foreign Companies
CIN	Capital Import Neutrality
DFTC	Commodity Futures Trading Commission
COFLA	Consolidated Overall Foreign Loss Account
CON	Capital Ownership Neutrality
CSLI	Consolidated Separate Limitation Income (CSLI) or consolidated separate
CSLL	Consolidated Separate Loss Limitation Loss
DCC	Domestically Controlled Corporation
DEA	Dividend Equivalent Amount
DISC	Domestic International Sales Corporations
ECEP	Effectively Connected Earnings and Profits
ECTI	Effectively Connected Taxable Income
EIN	Employer Identification Number
EJMMA	Education Jobs and Medicaid Assistance Act
EOI	Exchange of Information
ETR	Effective Tax Rate
EU	European Union
FATCA	Foreign Account Tax Compliance Act
FC	Foreign Corporation
FCDC	Foreign Controlled-Domestic Corporation
FDAP	Fixed, Determinable, Annual or Periodic (income)
FFI	Foreign Financial Institution
FIRPTA	Foreign Investment in Real Property Tax Act

FOGEI	Foreign Oil and Gas Extraction Income
FORI	Foreign Oil Related Income
FSC	Foreign Sales Corporations
FY	Fiscal Year
GLAM	Generic Legal Advice Memorandum
HIRE	Hiring Incentives to Restore Employment Act
IC	Inverted Corporation
IGAs	Intergovernmental Agreements
IRC	Internal Revenue Code
IRS	Internal Revenue Service
ISDA	International Swaps and Derivatives Association
LB&I	Large Business & International
LoB	Limitation-on-Benefits
MAP	Mutual Agreement Procedure
MAPS	Managed Account Product Structure
NFFE	Non-Financial Foreign Entity
NOLs	Net Operating Losses
NON	National Ownership Neutrality
NN	National Neutrality
NOPA	Notice of Proposed Adjustment
ODL	Overall Domestic Loss
OECD	Organisation for Economic Co-operation and Development
OFL	Overall Foreign Loss
OID	Original Issue Discount
OTC	Over-The Counter
PE	Permanent Establishment
QEA	Qualified Export Assets
QER	Qualified Export Receipt
QI	Qualified Intermediary
REIT	Real Estate Investment Trust
REMIC	Real Estate Mortgage Investment Conduit
TEFRA	Tax Equity and Fiscal Responsibility Act
TIN	Tax Identification Number
TPA	Transfer Pricing Operations
TRA	Tax Reform Act
USNE	US Net Equity
USP	United States Parent
USRPHC	US Real Property Holding Corporation
WQI	Withholding Qualified Intermediary

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CHAPTER 1

Overview

1.1 Introduction

International taxation is one of the most complex, if not the most complex, component of the Internal Revenue Code (IRC). Inception of International Tax, the US Congress faced a challenge in enacting specific provisions that deal with or cover the two aspect of the US Aspect of international tax: the inbound and the outbound. Inept tax policies in place since the 1980s, aggravated by the Bush Tax reforms of 2004–2005, put US multinational companies out of sync with the rest of the world. The 1986 Tax Reform Act was governed by the principle of tax neutrality. Thus, the burden on lobbyists was to demonstrate how their proposals would not lose many supports or how they could be paid for by other revenues.[1] Since then tax policy debates have been hijacked into an examination of how well tax systems and particular taxes meet the criteria of equity, efficiency, and simplicity. The debate is led by two opposing groups: liberals and conservatives. Liberals see tax policy as a tool for economic distribution. Their approach has been to raise taxes on the wealthy in order to sustain expensive government programmes. In contrast, conservatives advocate for economic growth, lower taxation, and public sector spending cuts. They see consumption as an unstoppable engine of economic growth.[2]

Curiously, each side claims to be 100 % correct, while the right approach lies in between. Therefore, the US international tax provisions from the IRC is out of step with the way global business is conducted. Most of the provisions still in effect have been in place since the 1930s. Subsequent

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tax reforms have worsened or at least perverted the underlying principles that sustained the International Aspects of the IRC. The 1986 Tax Act favors foreign investment in the USA in several ways. Unless a substantial and well-thought-out overall tax reform is conducted by experts in the field, incremental changes could aggravate the complexity of the system to render it incomprehensible to all except lobbyists.

1.2 A Worldwide vs. Territorial Tax Regime

The USA is among only a handful of countries, and the only one in the Group of Seven (the Group of Seven is an informal bloc of industrialized democracies which includes: the US, Canada, France, Germany, Italy, Japan, and the UK), that taxes companies on worldwide earnings rather than the earnings in their home domiciles. That is, in a worldwide system, a country taxes a corporation's total income, whether generated within its boundaries or outside its boundaries. A worldwide tax regime often provides tax credits for the foreign taxes already paid. In a territorial system, a country taxes only the income that the corporation generates in that country, leaving other countries to tax the income generated within their boundaries. However, the worldwide tax system allows indefinite deferral of US tax on earnings reported in foreign countries and a tax credit for foreign taxes paid. That feature alone does not make the US tax system a case apart. Many other countries use a so-called "territorial tax system" with "territorial" reach beyond their borders to prevent abuse in ways that the US system does not. Many territorial systems have hybrid systems, under which the countries can tax substantial portions of the overseas profits of their multinationals on a worldwide basis.[3] For example, Japan taxes resident companies on foreign-source income at the full Japanese rates if they are paying an effective rate of less than 20 % in the foreign jurisdiction. Further, the Organisation for Economic Co-operation and Development (OECD) is even calling for its member countries to review the "fundamentals" of their predominantly territorial tax systems.[4]

The US tax regime is often criticized as having among the top rates in the world. Though true, the argument lacks consistency as rates alone do not depict the true reality. Comparisons are often made between corporate tax rates in the United States and those found elsewhere in the world. Such a short-cut analysis is especially frequent among non-economist tax scholars who tend mainly to consider countries' "statutory rates." Economists, however, generally prefer to compare "effective tax rates" when making international comparisons. The reason is that, as every country has its own

tax system, the statutory tax rate is just one component of each system and does not tell all the story.[5] For example, some countries may have higher or lower rates, allow for faster capital recovery (i.e., deprecation), or offer corporate tax credits not offered by other countries. Effective tax rates attempt to account for all the system differences and are more indicative of the tax burden in each country.

Though the statutory corporate income tax rate is 35 %, the effective tax of US corporations has been estimated at less than half that much, at 13 %, reduced through a variety of mechanisms, including tax provisions that permit multinational corporations to defer US tax on active business earnings of their offshore subsidiaries until those earnings are brought back to the USA.[6] Although the USA has one of the highest statutory tax rates, a study by Avi-Yonah and Lahav comparing US-based multinationals with the 100 largest EU multinationals concludes that the effective US tax rate is the same or lower than effective EU tax rates despite the USA having a corporate statutory tax rate 10 percentage points higher than the average EU corporate statutory tax rate.[7] The main finding was that the EU tax base is broader than the US tax base. Despite the evidence, several lawmakers still cling to their hypothetical "pure territorial tax system" which exists nowhere in the world. The mere fact that, among OECD nations, 26 have territorial systems—including Australia, Canada, France, Germany, Japan, Spain, and the United Kingdom—does not justify the USA shifting from the predominantly "worldwide tax system" to a territorial tax system.[8]

1.3 US Taxation of Individuals and Corporations

Today, corporate tax accounts for 8.9 % of federal tax revenue, whereas individual and payroll taxes generate 41.5 % and 40 % respectively, of federal revenue.[9] The decline in corporate tax revenues is due in part to more corporate income being reported abroad in low-tax jurisdictions such as Ireland, Bermuda, and the Cayman Islands.[10]

1.4 Reforming the US Tax System

1.4.1 Broadening the Tax Base

The USA needs to increase the amount of income subject to tax. This can be done by eliminating some loopholes and corporate expenditures such as the deductibility of interest which is not an expenditure.

1.4.2 *Integration of the Corporate and Individual Tax Systems*

One integration approach would be to eliminate corporate tax and allocate earnings directly to shareholders in a manner similar to which partnerships and S corporations allocate income to their partners and shareholders. In effect, C corporations, partnerships, and S corporations would be treated identically for tax purposes, with all being treated as pass-throughs.[11]

1.4.3 *Taxing Certain Large Pass-throughs*

Taxing large pass-throughs as corporations would also allow for lower tax rates as it would broaden the corporate tax base. Lower tax rates combined with a reduction in business tax disparity could improve business tax equity and the allocation of resources relative to current policy.

Depending on how "large" pass-throughs were identified, a relatively small percentage of businesses currently structured as pass-throughs could be affected by the corporate tax under certain reforms.[12]

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CHAPTER 2

The Underlying Principles of the US Tax System

2.1 Introduction

In his seminal book *Inquiry into the Wealth of Nations*, Adam Smith laid out four principles that tax systems should follow: equality, clear and plain rules, convenience, and efficiency. To some extent, US tax policy borrows from these principles. The policies underlying the US taxation of international taxation were conceived in the early years of the twentieth century, a time when a few nations were engaged in global trade or exchange and did not anticipate a worldwide economic integration. Thus, our international tax law reflects an old consensus reached by the SDN (Societe des Nations) 80 years ago, as to the appropriate divisions of the income tax base among nations.[1]

A modern reconsideration of these policies is urgently needed. Put differently, the USA's international tax policy relates to old-world concepts which are biased and without relevancy to our modern way of conducting business or trade.

2.2 The Core Principles

Three core economic doctrines underlie the economic efficiency of US international taxation: (i) tax neutrality, (ii) tax equity, (iii) fairness, and (iv) administrability or simplicity.

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2.2.1 Tax Neutrality

Efficiency or tax neutrality looks at potential distortions in economic activity that result from the corporate tax system or specific provisions within that system.[2] International tax policy seeks to assure or provide several types of neutrality: (i) capital export neutrality (CEN), (ii) capital import neutrality (CIN), and (iii) national neutrality (NN).

2.2.1.1 Capital Export Neutrality

Capital export neutrality is based on the idea that capital should be taxed at the same rate whether utilized in the home country or in the host country. That is, an investor decision to invest at home (domestically) or abroad shall not be affected by taxation, as the tax incidence will be the same. CEN identifies conditions whereby investment is allocated efficiently. It assesses efficiency from the perspective of the home country. CEN is satisfied as long as the rate of tax on exported capital is the home country's rate. A tax system which satisfies CEN is deemed to enhance world welfare.[3] CEN is thought to support either a purely residence-based system or worldwide source-based taxation with an unlimited foreign tax credit.[4]

2.2.1.2 Capital Import Neutrality

Capital import neutrality, on the other hand, relies upon the ideal that capital should be taxed at the same rate, which is the rate imposed on domestic capital in the capital-importing nation. CIN is about savings.[5] It aims to promote the efficient allocation of capital worldwide.[6] However, for any given tax system to satisfy CIN, it is also necessary that individual income taxes be harmonized, since CIN requires that the combined tax burden on saving and investment in each location not differ between or among investors.[7]

CIN principles assume that capital income is fully taxed by the host country in the same fashion as domestic capital.

2.2.1.3 National Neutrality

National neutrality is based upon the idea that, if both the home and the host countries tax capital, the same capital will be taxed twice, leading to a double or multiple taxation. Thus, to avoid such a double taxation, the home country shall defer in part to the host country by providing a deduction against income for the foreign taxes paid.

Besides these three doctrines, three new "neutralities" have emerged as tools for assessing the efficiency of the US international tax system:

(i) capital ownership neutrality (CON), (ii) national ownership neutrality (NON), and (iii) Market neutrality (MN).

2.2.1.4 Capital Ownership Neutrality

A given tax system satisfies CON if it does not distort ownership patterns. It demands that taxation should not influence the real ownership of assets. CON assumes that the function of foreign direct investment is simply to reassign asset ownership among domestic and foreign investors. Thus, if the productivity of capital depends on the identities of its owners, then the efficient allocation of capital is one that maximizes output given the stocks of capital in each country. Such a system is deemed to promote efficiency if it encourages the most productive ownership of assets within the set of feasible investors.

2.2.1.5 National Ownership Neutrality

A tax system is deemed to satisfy NON if it exempts foreign income from taxation. The key difference between CEN and NN is the treatment of foreign taxes.

2.2.1.6 Market Neutrality

Market neutrality is based on the idea that if two firms compete with each other in the same market, they should face the same overall effective tax rates on their investments.[8]

2.2.2 Tax Equity

Equity evaluates how the corporate tax burden is distributed across individuals. Generally, it is believed that the corporate income tax contributes to the overall progressivity of the US tax system.[9]

Historically, US tax policy holds the principles of vertical and horizontal equity. Vertical equity holds that taxpayers with greater income and wealth should contribute more; whereas horizontal equity relies upon the idea that taxpayers in a similar income and wealth position should be taxed similarly. However, changes in the IRC have nullified these principles. The various loopholes granted to diverse taxpayer groups, the grant of deductions and special treatment have rendered the "equities" unreachable. For instance, while the nominal US corporate tax rate is 35 %, some multinational companies manage to substantially lower their tax burden: General Electric's global effective tax rate for 2010 was 7.4 %, Pfizer's was 11.9 %, Cisco came in at 17.5 %.[10]

2.2.2.1 Vertical Equity

Vertical equity means that people with higher incomes and/or capital should be required to pay more tax. The purpose of vertical equity is to tax in a more progressive way. It goes by the principle that people with more ability to pay should pay more. The point of vertical equity is to redistribute wealth in society more fairly.

The vertical equity of the US system is controversial, especially since the Bush administration's tax cuts of 2001 and 2003, which critics have criticized as primarily benefiting the wealthy. However, that results from the fact that the wealthy bear most of the tax burden, and the cuts were roughly constant across income categories in terms of percentages of tax paid. It has to be borne in mind, though, that the distribution of income in the United States has become increasingly unequal over a 30-year period.[11]

Example
An example of vertical equity is the progressive federal income tax system in the United States. As a person earns more money they have to pay a higher percentage of their income in taxes. Those with low incomes pay lower percentages of their income in tax, or perhaps pay no tax at all.

2.2.2.2 Horizontal Equity

The concept of horizontal equity plays an important role in the evaluation of tax policy. For example, treating taxpayers with equal incomes equally was one of the central organizing principles of the landmark reform of the federal income tax encapsulated in the Tax Reform Act of 1986.

Contrary to vertical equity, horizontal equity holds that similarly situated taxpayers should receive similar tax treatment—that is, taxpayers who earn the same amount of income or capital should be accorded equal treatment.

Horizontal equity is hard to achieve in a tax system with loopholes, deductions, and incentives because the presence of any tax break means that similar individuals do not pay the same rate. For example, by allowing mortgage payments to be deducted from income tax, governments create a difference in tax payments between two tax filers who may otherwise be considered economically similar.

Horizontal equity protects taxpayers against arbitrary discrimination and also seems consistent with basic principles of equal worth. Some might also argue that horizontal equity comports with the principle of "equal protection under law" set forth in the US Constitution.

Three terms are used in measuring horizontal equity:

1. Regressive tax systems require that low- and middle-income families pay a higher share of their income in taxes than upper-income families. Sales taxes, excise taxes, and property taxes tend to be regressive.
2. Proportional or flat tax systems take the same share of income from all families.
3. Progressive tax systems require upper-income families to pay more of their incomes in taxes than those with lower incomes. Personal income taxes are usually progressive.

Example
Horizontal equity means that we apply the exact same policy to people in the same situation. For example, if two people both earn $25,000 per year they should both pay the same amount of tax. This means that if we have horizontal equity, we try to make sure that we do not make decisions based on non-income characteristics such as ethnicity, gender, weight, sexual orientation, or job status.

2.2.3 Fairness

A fair tax system asks citizens to contribute to the cost of government services according to their ability to pay. Fairness is an important goal for policymakers, for several reasons, among others to encourage a sentiment of belonging to the same nation. To be fair or at least perceived as such, each social group pays its burden pro rata to the income earned. That is no longer the case in the USA where middle- and low-income families are required to pay a much greater share of their incomes in taxes than the wealthy.

The wealthiest 1 % of Americans retained more income than the poorest 40 % put together, and the best-off 20 % of Americans make more than the remaining 80 % combined. The richest 1 % of families in the United States saw their average pre-tax income rise by 281 % in the 21 years from 1979

to 2007—that is in "constant dollars" (meaning it's adjusted for inflation)! Meanwhile, middle-income earnings grew by 25 % over this period, and the poorest 20 % saw their real pre-tax incomes grow by just 16 %.[12]

While the rich have seen their incomes rise substantially faster than others, federal taxes on the wealthy have declined—resulting in an overall tax system that is much less progressive than previous systems. In 2009, the wealthiest 1 % of Americans paid 30.8 % of their income in combined federal, state, and local taxes, down sharply from 37.1 % before the George W. Bush administration. By comparison, the other 99 % of Americans paid, on average, 28.2 % of their income in total taxes—almost as much as the wealthiest taxpayers.

That is not to say that the tax revenue should be confined to the "affluent"; rather, the tax policy should be designed in such a way that it includes the largest possible proportion of the population. Around 60–70 % should be elevated to middle-class status. In the USA today, inequality among citizens in the distribution of income, wealth, and opportunity has reached a point where it has become unsupportable.

Equity considerations demand that affluent taxpayers contribute a larger share of government spending. However, fortunately or unfortunately, affluent taxpayers have greater incentives to mitigate or even avoid their fair share of taxes by either reducing their earnings through tax schemes, masquerades with the assistance of tax lawyers or CPAs (Certified Public Accountant). These distortions imply a basic trade-off between equity and aggregate efficiency.[13] Some economists believe that, in an efficient income tax system, earnings distortions vanish over time.[14]

Fairness is achieved either through CEN or through CIN.

2.2.4 Tax Simplicity/Administrability

Simplicity is an important tax policy goal. Complicated tax rules make the tax system difficult for citizens to understand. Complexity also makes it harder for governments to monitor and enforce tax collections, and makes it easier for lawmakers to enact (and to conceal) targeted tax breaks benefitting particular groups. A tax system full of loopholes gives those who can afford clever accountants an advantage over those who must wade through the tax code on their own. But beware—tax changes described as "simplification" measures are often nothing of the kind. Anti-tax advocates

frequently seek to "simplify" the income tax by eliminating the graduated rate structure and instituting a flat-rate tax. This is a red herring: a graduated tax system is no more complicated than a flat-rate tax.

2.2.5 Adequacy

An adequate tax system raises enough funds to sustain the level of public services demanded by citizens and policymakers.[15] At the end of the day, adequacy is what separates successful tax systems from unsuccessful tax systems. Of course, at any given time, the primary concern for state lawmakers is short-term adequacy—making sure there's enough revenue to fund public services in the upcoming fiscal year. But it's equally vital for good-government advocates and lawmakers to seek strategies that will achieve long-term adequacy, balancing budgets not only this year and next but five years and ten years down the road.

Two factors that contribute to the adequacy of a tax are its stability and its elasticity. A stable tax is one that grows at a predictable pace. Predictable growth makes it easier for lawmakers to put together budgets that match anticipated revenues to anticipated spending. But stability by itself is not enough to achieve adequacy in the long run.

For example, property taxes grow predictably but tend to grow more slowly than the cost of the services that state and local governments provide. Elasticity is a measure of whether the growth in a specific tax keeps up with the economy—an important consideration because the cost of providing public services usually grows at least as fast as the economy. An elastic tax is one for which tax revenue grows faster than the economy over the long run. There is some inherent tension between the goals of elasticity and stability. Elastic taxes, like personal income tax, are more likely to ensure adequate revenues in the long run, but may fluctuate more from year to year. Academic research has shown that the long-term growth of personal income tax is substantially greater than that of sales tax, even though income tax is more volatile in the short run. This makes it vital for these taxes to be accompanied by prudent fiscal management to smooth out the ups and downs associated with normal economic cycles (for instance, by creating and maintaining a "rainy day fund"—see Chapter 9 for more details). Prudently managed, income taxes will likely provide a more sustainable funding source over the long run than is possible with

sales or property taxes. Stable taxes, like property tax, will grow predictably, but the slower growth rate of these taxes may mean that in the long run tax hikes will probably be necessary to fund services at the same level.

2.3 The Inefficiency of the Aforementioned Principles

Taken singly, none of the neutralities, or equities aforementioned can support or underlie US international tax policy. They conflict with one another, and often an equilibrium needs to be reached between more than one neutrality to support a change or modification in the US tax rules. For instance, a tax system cannot simultaneously satisfy both CEN and CIN unless tax rates on capital are harmonized across jurisdictions.

2.3.1 Capital Export Neutrality

Desai and Hines criticize CEN as assuming that foreign firms do not respond to changes induced by home-country taxation.[16]

Graetz criticizes CEN for, among other issues, failing to consider the reasons for foreign direct investment,[17] such as economies of scale or scope that allow successful businesses to exploit opportunities worldwide rather than just domestically.

There are some benefits to US firms operating abroad relative to their counterpart operating only within the US tax boundaries.[18] Internalization reduces the tax burden as different countries have different rates of corporate, individual, and sale taxes. Such a reduction in tax cost gives US firms operating abroad in low or no tax jurisdictions beneficial cash flows, which in turn enables them to finance projects necessary for the development of the firm without interest payments that come with loans or borrowings. Moreover, internationalization facilitates cross-border transactions, bringing firms products close to their customers. Finally, internalization enables US firms to take advantage of economies of scale and scope on a regional or global basis.

The reason why internalization creates benefits that are unavailable (or less available) to open market transactions is that the goals of the trading partners change; this change not only makes a big difference in firm behaviors, but also has different legal implications for multinational enterprises (MNEs) and domestic firms.

2.3.2 Capital Import Neutrality

There are two alternative and different interpretations of CIN, and the failure of commentators to be clear about which interpretation they have in mind when they use the term CIN has been the source of much confusion.[19] It is not always easy to understand when an author is referring to CIN as a trade-off between consumption and saving or ownership neutrality.

2.3.3 Vertical and Horizontal

The principle of horizontal equity has been fiercely criticized by some economists. Kaplow, for instance, states that horizontal equity is inconsistent with the principle of welfare maximization.[20] He argues that welfare should be the preeminent tax policy objective, and that horizontal equity can conflict with that aim. Other critics, such as Murphy and Nagel, reject the principle of horizontal equity on the basis that the justice of a system of taxation cannot be determined apart from an overall evaluation of the justice of society as a whole.[21]

In the same vein, critics of vertical equity allege that arbitrary distinctions among taxpayers render vertical equity impossible to attain.[22]

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CHAPTER 3

Inbound Taxation

3.1 Introduction

The United States remains an attractive investment location for worldwide businesses. According to a US Department of Commerce report, the United States has been the world's largest recipient of foreign direct investment (FDI) since 2006. Inbound foreign direct investment has long played an important role in the US economy. The bulk of this investment comes from Japan, Canada, Australia, and the European Union (EU), which together accounts for more than 80 % of FDI in the USA.

3.2 History of Income Tax

3.2.1 Individual Tax

The origin of the income tax on individuals is generally cited as the passage of the 16th Amendment, passed by Congress on July 2, 1909, and ratified on February 3, 1913. The first attempt to introduce the income tax dates back to the American Civil War, when Congress passed the Revenue Act of 1861 which included a tax on personal incomes to help pay for war expenses. The tax was repealed ten years later. However, in 1894 Congress enacted a flat-rate rederal income tax, which was held unconstitutional by the US Supreme Court the following year because it was a direct tax not apportioned according to the population of each state.

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The 16th amendment, ratified in 1913, removed this objection by allowing the federal government to tax the income of individuals without regard to the population of each state.

3.2.2 *Corporate Tax*

A federal tax on corporate income has been imposed at the corporation level since 1909. The principle of taxing corporations as entities separate from their owners was established by the Revenue Act of 1894. The 1894 Act was ruled unconstitutional, but when a constitutional way of taxing corporate income was enacted in 1909, the same principle prevailed.

3.3 Forms of Enterprise and Their Tax Implications

Legal forms of business organization may include a branch, partnership, limited liability company, corporation, and trust. Treasury regulations generally allow many business entities to classify themselves as a corporation, partnership or entity separate from their parent. Each choice has its own implications, complications, and criteria. The various ownership structures also have financing, legal liability, and growth flexibility issues. Typical business models include a representative office, branch office, or wholly owned subsidiary.

3.3.1 *Representative Office*

A representative office is the easiest option for a company starting to do business in the USA and is especially appropriate in the very early stages of the corporation's business presence in the USA. As for any business organizational structure, the choice of a representative should be periodically reviewed in line with the business's strategies and goals.

3.3.2 *Branch*

A branch is a mere extension of the activities of the parent entity. Formation of a branch is not a taxable event for US federal tax purposes. A branch choice may be appropriate for activities such as advertising and promotional activities, market research, and the purchase of goods on behalf of the headquarters office. Such an extension will constitute a presence

in the US for which the branch will be required to account for, and file US tax on the profits of the branch. Generally, the branch is subject to a corporate tax rate of up to 35 %. In addition, any remittance of post-tax profits by the branch to the head office is subject to branch remittance tax of 30 %. However, US tax treaties typically reduce branch remittance tax. Transactions between a US branch and its foreign parent are generally disregarded and the US branch is not subject to entity-level taxation. The foreign parent would be subject to US taxation on its ECI (Effectively Connected Income) with US trade or business and must file a tax return to claim deductions and credits, thereto.

If, by inadvertence, the foreign parent of a US branch fails to file its US tax return, the foreign corporation would be subject to tax on gross, not net, income. A branch is often preferable to a subsidiary if US activities do not rise to level of US ToB (Trade or Business) or are unlikely to trigger a permanent establishment in the USA.

A branch structure is suitable when the foreign investor anticipates incurring losses in the near future or repatriating profits on a current basis. The US branch's trading losses can be offset against the home office's trading profits. In a reverse situation, where the branch is profitable, the parent company may also be subject to tax in the home country on the US profits. Further, a foreign investor considering a branch structure needs also to assess the effect of US Branch Profit Tax (BPT). US BPT was intended to create a parity between foreign corporations investing in the US through domestic corporations and foreign corporations investing in the US through branches.

There are two levels of tax for foreign corporations investing in the USA through domestic subsidiaries: (1) the domestic subsidiary is subject to US tax on its worldwide income and (2) the foreign corporation is subject to US withholding tax on dividends.

In general, there is no branch profits for the taxable year in which the branch completely terminates all its US trade or business activities, if the requirements under the regulations are satisfied.

3.3.3 Corporation (Subsidiary)

In a subsidiary structure, the inbound company incorporates a wholly owned subsidiary in the USA, making it a separate legal identity distinct from the parent company. A subsidiary is preferable to a US branch if US activities rise to level of a US ToB or PE, and so avoid exposure to the US BPT. Generally, at the formation stage, the subsidiary is eligible for

non-recognition treatment under Internal Revenue Code (IRC) § 351(a). US Sub takes carryover basis in the transferred property if the transfer qualifies for the non-recognition treatment provided under IRC section 362(a). The profits earned by the US subsidiary would be liable to tax in the US at up to 35 %. Further, the repatriation of profits (dividend distribution) by the US subsidiary to the parent is subject to a withholding tax of 30 %. However, US tax treaties typically reduce the dividend withholding tax.

Corporations in the USA are established in accordance with the law of the state in which the business is incorporated. Although the corporate laws of most states are similar, certain states (e.g., Delaware) are more flexible than others. A corporation generally comes into legal existence as soon as its certificate of incorporation is filed with the secretary of state's office in the state of incorporation.

Generally, most states do not prescribe a minimum or maximum number of shareholders. Further, there are generally no minimum capitalization requirements, except for corporations engaged in banking, insurance, or related activities. Most states require subscribed capital to be fully paid in before authorized shares are issued. A subsidiary can terminate its activities through sale of the assets or through liquidation.

- Sale

A sale of stock of US subsidiary is generally not taxable in US unless the stock is a US real property interest ("USRPI").

- Liquidation

A US subsidiary generally recognizes gain on the distribution of property in liquidation pursuant to IRC § 367(e)(2). However, an exception is available for assets used in a US trade or business for 10 years if certain requirements are met. § 1.367(e)-2(b)(2)(i)(A)-(C) (Table 3.1).

3.3.4 Partnerships

The partnership form is probably the most common type of business organization involving more than one owner. There are generally no formal requirements to be met at the time of set-up because the partnership's existence is based on the business relationship of the participants and their carrying on a business as co-owners with the intention of making a profit.

Table 3.1 Taxable income and tax rates

Taxable income	*Tax rates (%)*
Not over $50,000	15
Over $ 50,000 but not over $ 75,000	25
Over $ 75,000 but not over $ 100,000	34
Over $ 100,000 but not over $ 335,000	39
Over $ 335,000 but not over $ 10,000,000	34
Over $ 10,0000,000 but not over $ 15,000,000	35
Over $ 15,0000,000 but not over $ 18,333,333	38
Over $ 18,333,333	35

Generally there is no US tax on partners' contribution of property (§ 721). Also, according to Internal Revenue Service (IRS) § 722, foreign investors generally take exchange basis in partnership interest. Finally, a partnership generally takes carryover basis in US ToB contributed property pursuant to IRC § 723.

Distributions from partnership partner is generally not taxable to the partner to the extent the distribution does not exceed the partner's basis in his partnership interest subject to US ToB interest, various exceptions. See, e.g., §§ 731, 733, 704(c)(1)(B), 737, 751(b).

Likewise, a partnership can be terminated through sale or liquidation.

- Sale

Under Revenue Ruling 91-32, a foreign partner's gain from the disposition of a partnership that engages in a US ToB may be sourced to the United States as ECI to the extent attributable to assets of the partnership used in a US ToB. The holding in Revenue Ruling 91-32 has been criticized on the grounds that the disposition of a partnership interest is generally treated as a disposition of an interest in an entity, not the underlying assets. Under § 741, the sale of a partnership interest is generally treated as a sale or exchange of a capital asset (subject to § 751).

- Liquidation

A partnership's liquidation is generally not taxable.

3.3.5 Some Special Investment Structures

3.3.5.1 Joint ventures

Joint ventures are any combination of two or more enterprises associated for the purpose of accomplishing a single business objective. For legal and tax purposes, if two unrelated incorporated or unincorporated businesses agree to conduct business as a non-corporate joint venture, the venture is normally considered a partnership, limited in scope or duration. Corporate joint ventures consist of two entities that form a corporation to carry out a specific business objective.

3.3.5.2 Holding companies

As an inbound company, you may want to invest directly in the USA or you may choose to make step-down investments there using tax-friendly intermediary jurisdictions. These intermediary holding companies help to plan the effective utilization of the various streams of income (from the step-down operating companies) either for future investments or for further expansion. Key holding company jurisdictions may include the Netherlands, Belgium, Luxembourg, and the UK, among others.

3.3.5.3 Real estate REITs and REMICs

There are a number of ways to invest in US real estate. Foreign investors are able to invest directly or indirectly in US real estate. Among the indirect instruments are Real Estate Investment Trusts (REITs), which result when investors provide a specified amount of money that is pooled to purchase the real property, or Real Estate Mortgage Investment Conduits (REMICs) wherein money is pooled to buy mortgage securities.

REITs are specialized investments that pool the money of many investors to purchase real estate assets, primarily properties. REITs can focus on one property type, such as an office, or include many different kinds of property in a single portfolio. REITs can also vary in terms of their geographic focus—they can be regional, national, or global in scope.

REITs and REMICs are generally not taxed on their real estate-related income or capital gain. Taxation usually occurs at the investor level. The special rule under the REIT aims to prevent a disparity between the taxation of direct real estate investments and real estate investments made

through REIT conduits. The special rule, however, permits portfolio investors in a REIT to be eligible for the 15-% maximum rate of withholding tax on dividends from the REIT.

REMICs are a popular US tax vehicle that hold a fixed pool of real estate loans and issue debt securities with serial maturities and differing seniority and rates of return (referred to as "regular interests") backed by those loans.[1] A REMIC is not subject to US income tax. Instead, holders of a REMIC's "residual interests" include in income their share of the REMIC's net taxable income or loss each year. Although cash flow from the REMIC's mortgage assets is used almost exclusively to service payment obligations with respect to regular interests it has issued, ordinarily there is a mismatch in the tax character of payments received and payments made.[2]

For example, in a REMIC's early years, payments of taxable interest received with respect to mortgage assets might be used to make nondeductible payments of principal with respect to a shorter-maturity regular interest. In such a case, the holder of a residual interest could have "phantom income," or taxable income without accompanying distributions of cash. This situation reverses in the REMIC's later years, when cash received from mortgage assets consists largely of non-taxable repayments of principal but the payments with respect to outstanding regular interests consist primarily of deductible payments of interest.

3.4 Financing US Investments

Inbound US transactions can be financed through debt or equity. In general, interest on debt incurred by a US corporation is deductible. The debt vs. equity debate in the related party context has been a contentious one. Substance over form is frequently raised by the IRS in the context of distinguishing between debt and equity for tax purposes. There is no bright-line test in the Internal Revenue Code (IRC) or in case law to distinguish debt from equity, but IRC Section 385 (thin capitalization rules) states that the following factors will be considered, although no single factor is controlling:

1. Whether there is a written, unconditional promise to pay on demand, or on a specified date, a sum certain in money in return for an adequate consideration, and to pay interest.

2. Whether there is subordination to or preference over any indebtedness of the corporation.
3. The ratio of debt to equity of the corporation.
4. Whether there is convertibility into the stock of the corporation.
5. The relationship between holdings of stock in the corporation and holdings of the interest in question.

Even if an instrument is considered debt under the rules of IRC Section 385 and associated case law, the deduction of associated interest may still be limited. Under IRC Section 482 (arm's-length transfer pricing), the IRS has the authority to reallocate deductions, including interest deductions, between related parties to reflect the arm's-length standard.

Finally, the US federal income tax provisions under IRC Section 267(a)(3) (Matching Rule) and IRC Section 163(j) (Earnings Stripping Rule) must be satisfied before the interest expense realized by the US subsidiary can be deducted.

- Applying IRC Section 267 generally defers the deductibility of interest until such time as it is actually paid, as opposed to merely accrued.
- Earning stripping.

Earnings stripping refers to the payment of excessive deductible interest by a US corporation to a related person when such interest is tax exempt (or partially tax exempt) in the hands of the related person. Although payments of other deductible amounts by a US corporation to tax-exempt or partially exempt related parties also provide an opportunity to shift income out of a US corporation, the use of related-party debt is arguably the most readily available method of shifting income out of US corporations.

Section 163(j) was added to the IRC by the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) to prevent erosion of the US tax base by means of excessive deductions for interest paid by a taxable corporation to a tax-exempt (or partially tax-exempt) related person. 5 Section 163(j) applies where a corporation's debt-to-equity ratio exceeds 1.5 to 1 and its net interest expense exceeds 50% of its adjusted taxable income (generally computed by adding back net interest expense, depreciation, amortization, depletion, and the net operating loss deduction). If the corporation exceeds these thresholds, no deduction is allowed for interest in excess of the 50% limit that is paid to a related party and that is not subject to US income tax. Interest is treated as not subject to US

income tax to the extent an applicable income tax treaty reduces the US income tax on such interest. Disallowed interest amounts may be carried forward indefinitely. In addition, the excess of the 50% limit over a corporation's net interest expense for the year (if any) may be carried forward three years. Special rules also apply in the case of interest paid or accrued to a partnership. For the purposes of these rules, all members of the same affiliated group of corporations are treated as one taxpayer.

Put differently, IRC Section 163(j) is directed at taxpayers that have very high interest expense relative to cash flow.

3.5 Other Potential Corporate Tax Liabilities

3.5.1 State and Local Tax

One misconception of inbound companies coming to the USA is that doing business in the country is the same as doing business in the 50 individual states; this is not so. The objective of most states is to tax the income of residents, both individuals and entities conducting business within their boundaries. The rates vary from one state to another and Delaware, as we have seen, is the most friendly state among the 50 states. Many US indirect taxes are imposed at the state and local level (e.g., gross receipts, franchise, real property, and business personal property taxes). Further, many state and local jurisdictions provide tax credits and incentive opportunities for business investment within the jurisdiction (e.g., jobs credits, training credits, and negotiated incentives).

States with jurisdiction to impose an income-based tax upon a multistate corporation or a group of corporations must first determine the state's taxable base—the total taxable income under state law—and then determine the state's share of that income—the state's apportioned taxable income. The state taxable income for a corporation or group of related corporations is dependent upon the computational rules and methods that each state applies. Although states vary in the methods permitted or required to file an income tax return, the general methods are separate return, nexus combination, unitary combined reporting, and consolidated reporting. Each state and local tax advisor will help determine which method applies to any given inbound entity. State tax rates vary from 0 % to 12 %. However, state income tax paid is deductible for federal tax purposes. Although state income taxes are generally based upon federal income tax concepts, the underlying rules vary from state to state.

In general, states may choose whether to conform to the federal IRC. Some states opt for “fixed” conformity, which means that they follow the IRC as of a certain date. Other states practice “rolling” conformity, automatically updating their reference to the IRC on a continual basis and thus conforming to the most recent version of the IRC.

As a general rule, states are not party to tax treaties between the USA and foreign nations. That means that a foreign corporation may be subject to state tax even though it is not subject to US federal tax pursuant to a tax treaty. Take, for example, a foreign corporation (FC) eligible for US treaty benefits. The FC stores inventory on consignment in a state, accepts sales orders in its home country and fills the US sales from the stock of consigned goods. In keeping with the treaty, the FC’s US activities may not rise to the level of a permanent establishment, so the FC may not be subject to US federal income tax. However, depending upon the state, there may be income or other state tax ramifications. Since there are 50 states with different rules, business leaders should consult the relevant state and local tax professionals to discuss the tax ramifications of any activity in a particular locale.

3.5.2 Transfer Pricing and Documentation

Transfer pricing is a complex yet interesting challenge for multinational companies (MNCs), which must establish appropriate prices at which goods, services, financial instruments, and even intellectual property are transferred among their affiliated companies. These pricing practices are subject to complex, changing regulations that affect the subsidiaries, supply chains, and competitive strategy.

Pricing decisions determine where profit will be recognized. Consequently, this is an issue of great concern for national and state governments because the distribution of profits has a direct impact on the collection of tax revenues. Over the past several years, the need for—and importance of—contemporaneous transfer pricing documentation has increased considerably, due not only to the process itself but also to the growing trend among taxing authorities worldwide to share information.

Treasury regulations require that taxpayers prepare 10 principal documents, along with any background or supporting materials, at the time the relevant tax return is filed (contemporaneous).

These required documents are:

- An overview of the company’s business, including economic and legal factors that affect the pricing of its products or services.

- A description of the company's organizational structure, including all related parties whose activities are relevant to transfer pricing.
- Any document explicitly required by the regulations under Section 482 (e.g., documentation of non-routine risks and cost-sharing agreements).
- A description of the transfer pricing method and the reason such a method was selected.
- A description of the alternative methods that were considered and an explanation of why they were not selected.
- A description of the controlled transactions (including terms of sale) and any internal data used to analyze them.
- A description of the comparables used, how comparability was evaluated, and what adjustments were made.
- An explanation of the economic analysis and projections relied upon in developing the method.
- A description or summary of any relevant data that the company obtains after the end of the year and before filing a tax return.
- An index of principal and background documents.

3.5.3 Sales and Use Taxes

There is no federal sales tax or value-added tax in the USA. However, most states and many municipalities levy sales taxes. Combined rates, including local rates, can range as high as 11 %. These sales taxes are usually assessed on the final consumer purchase, with wholesale transactions remaining tax exempt.

As a general rule, all sales of tangible personal property occurring within a state's borders are subject to sales tax unless specifically exempted by statute. Sales of services and intangible property (e.g., software) can also be subject to sales tax, though this varies from state to state. It is the seller's responsibility to collect and remit sales tax, typically passing the cost on to the consumer.

Use taxes are a tax on the use, storage, or consumption of tangible personal property by a business itself, within a state's borders. Use taxes are effectively a complement to sales tax.

3.5.4 Human Capital and Personal Tax

Human capital is an area that can become quite challenging for an inbound company, especially if the home country headquarters is left to deal with the diverse and often complex requirements of federal and multistate

taxing jurisdictions. Many businesses coming to the USA decide to outsource some or all of their human resource management activities such as payroll and benefits administration since these areas require considerable local knowledge. The taxation of foreign nationals working in the USA depends on the residency status of the individual. Generally, foreign nationals may be considered resident aliens if they are lawful permanent residents (green card holders) or if their physical presence in the United States lasts long enough under a substantial presence test. Under the substantial presence test, a foreign national is deemed to be a US resident if the individual fulfills two conditions.

The first is simply that the individual is present in the USA for at least 31 days during the current year. The second condition, the "183-day rule," is somewhat more complex. To meet the 183-day rule to the individual must have been present for at least 183 days during a consecutive three-year test period that includes the current year, using the following formula: 100 % of current year days, 33.33 % of the first preceding year and 16.67 % of the second preceding year. Using this formula, being in the USA an average of 122 days during each of three consecutive years causes a foreign national to be considered a US resident under the substantial presence test.

3.5.5 Social Security Tax

Under the Federal Insurance Contributions Act (FICA), social tax is imposed on wages or salaries received by individual employees to fund retirement benefits paid by the federal government. The FICA tax has two components: (i) social security tax (old age, survivors, and disability insurance), and (ii) Medicare tax (hospital insurance). For 2010, the social tax of 15.3 %, which includes a 12.4 % old-age, survivors, and disability tax and a 2.9 % Medicare tax, is imposed on the first $106,800 of annual employment income. However, no limit applies to the amount of wages subject to the Medicare portion of the social tax. Half the tax is withheld from the employee's wages and half is paid by the employer. In 2016, the social security tax rate is 6.2 % each for the employee and the employer, unchanged from 2015. During 2011, there was a one-year temporary two % reduction in the employee portion of the old-age, survivors and disability tax. FICA tax is imposed on compensation for services performed in the United States, regardless of the citizenship or residence of the employee or employer. So unless there is a specific exception in place, non-resident alien employees who perform services in the United States are subject to FICA tax. The employer must match the employee's portion for the

two components of FICA. It should be noted that a spouse employed by another spouse is subject to FICA, while children under the age of 18, employed in an unincorporated trade or business of a parent, are exempt.

3.5.6 Federal Unemployment Tax

Federal unemployment tax (FUTA) is imposed on the wage payments that employers make to their employees for the services performed within the USA regardless of the citizenship or residency of the employer or employee. The purpose of FUTA is to enable states to collect funds needed to administer unemployment benefits to their residents. The 2012 tax rate was 6.2 % on the first $7,000 of wages of each employee. Before July 1, 2011, a 0.2 % surcharge on the FUTA tax rate was also imposed. The federal government allows credit tor FUTA paid to the state government. Self-employed individuals are not subject to FUTA tax.

3.5.7 Franchise Tax and Occupational Fees

Most states levy a franchise tax on corporations based on their capitalization either with or without the inclusion of long-term indebtedness. Likewise, most states levy occupational fees on a variety of trades or business, such as fees to practice legal, medical, and architectural professions.

3.5.8 Employer Reporting and Withholding

An employer, whether US or foreign, is responsible for withholding and remitting US income and social taxes from the wages of resident and non-resident alien employees. The employer is also responsible for reporting the compensation income of its employees working in the USA. When a foreign employer does not have a US employer identification number, the reporting and withholding responsibilities are often handled by a US affiliate of the foreign employer.

Notes

1. US Congress (2007): Report to Congress on Earnings Stripping, Transfer Pricing and US Income Tax Treaties, p. 76.
2. US Congress (2007): Report to Congress on Earnings Stripping, Transfer Pricing and US Income Tax Treaties, p. 76.

CHAPTER 4

The Split of Tax Jurisdiction: The Source Rules

4.1 Introduction

The idea that income has a locatable source seems to be generally taken for granted, but the source of income is not a well-defined economic idea.[1] There has never been a comprehensive rationale for the source rules that now exist, either in the United States or elsewhere; and it is difficult, if not impossible, to articulate generally valid and neutral principles for assigning a geographical source to income. The process seems, however, to require a balancing of the strength of conflicting claims and considerations as they apply to particular types of income.

The US approach to defining source rules includes three different approaches: (i) a systematic approach, which defines the source of income in statutory rules; (ii) a courts' case-by-case approach where the rules are established by the courts; and (iii) an administrative determination by the Internal Revenue Service (the IRS).

4.2 Statutory Rules

The Internal Revenue Code (IRC) Sections 861 through 863, and 865 provide rules for some items of income. However, the list is not intended to be all inclusive.

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4.2.1 Interest

Interest is derived from US sources if it is paid by the United States or any agency or instrumentality thereof, a state or any political subdivision thereof, or the District of Columbia. Interest is also derived from US sources if it is paid by a resident or a domestic corporation on a bond, note, or other interest-bearing obligation. Special rules apply to treat as foreign source certain amounts paid on deposits with foreign commercial banking branches of US corporations or partnerships and certain other amounts paid by foreign branches of domestic financial institutions. Interest paid by the US branch of a foreign corporation is also treated as US-source income.

4.2.1.1 Exceptions: 4

(i) Earning Stripping Rules under Section 163 (j).

Section 163 (j) was first enacted in 1989 in response to congressional concerns over earnings stripping. Congress believed it was "appropriate to limit the deduction for interest that a taxable person pays or accrues to a tax-exempt entity whose economic interests coincide with those of the payor. To allow an unlimited deduction for such interest permits significant erosion of the tax base."

In 1993, the earnings stripping rules were amended so that they applied to interest paid on unrelated party loans if guaranteed by a related party under certain circumstances. Congress made this change because it was concerned about the distinction made under the existing earnings stripping rules between the situation in which unrelated creditors all lend to the parent of a group, which in turn lends to the US subsidiary, and the situation in which the creditors lend directly to the US subsidiary with a guarantee from the parent. The existing rules applied to the first situation but not the second situation, even though the "same 'excess' interest deductions, and the same resultant 'shifting' of net income out of US taxing jurisdiction, is obtainable through borrowing by US corporations on [the parent's] credit."

In 2006, the earnings stripping rules were modified to apply to corporate owners of partnership interests. Specifically, the modifications provided that for purposes of applying the earnings stripping rules when a corporation owns an interest in a partnership, (1) the corporation's share of partnership liabilities is treated as liabilities of the corporation, and (2)

the corporation's distributive share of interest income and interest expense of the partnership is treated as interest income or interest expense, respectively, of the corporation. Treasury was also granted expanded regulatory authority to reallocate shares of partnership debt, or distributive shares of the partnership's interest income or interest expense.

The US Jobs Creation Act of 2004 required the Secretary of the Treasury to submit a report to Congress by June 30, 2005, examining the effectiveness of the earnings stripping provisions of present law, including specific recommendations as to how to improve the provisions of the Internal Revenue Code (IRC) applicable to earnings stripping. The Treasury Department submitted its report to Congress on November 28, 2007. In summary, the report concludes that "[t]here is strong evidence that [inverted corporations] are stripping a significant amount of earnings out of their US operations and, consequently, it would appear that Section 163(j) is ineffective in preventing them from engaging in earnings stripping." The report also concludes, however, that the evidence that foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive, and that it is not possible to determine with precision whether Section 163 (j) is effective generally in preventing earnings stripping by foreign-controlled domestic corporations.

However, a taxpayer can still avoid the effects of IRC Section 163 (j) by (i) reducing the US subsidiary's debt-to-equity ratio below 1.5 to 1; (ii) increasing the US subsidiary's "adjusted taxable income" without increasing taxable income; or (iii) allowing US subsidiary to buy assets rather than leasing them.

(ii) Interest paid by US branch of foreign corporation treated as US source.

Interest paid or credited on deposits with a branch outside the United States (as defined in Section 7701(a)(9)) of a domestic corporation or of a domestic partnership is treated as income from sources without the United States if, at the time of payment or crediting, such branch is engaged in the commercial banking business. For the purposes of applying this paragraph, it is immaterial (i) whether the domestic corporation or domestic partnership is carrying on a banking business in the United States, (ii) whether the recipient of the interest is a citizen or resident of the United States, a foreign corporation, or a foreign partnership, (iii) whether the interest is effectively connected with the conduct of a trade or business in

the United States by the recipient, or (iv) whether the deposits with the branch located outside the United States are payable in the currency of a foreign country. Notwithstanding the provisions of § 1.863–6, interest to which this paragraph applies is treated as income from sources within the foreign country, in possession of the United States, or other territory in which the branch is located. Put differently, interest paid by a US branch of a foreign corporation would not be deemed a US source if such branch is engaged in the commercial banking business.[2]

(iii) Interest paid by a foreign branch of a US corporation is treated as a foreign source.[3]

Interest on deposits with a foreign branch of a domestic corporation or a domestic partnership if such branch is engaged in the commercial banking business would not be treated as income from sources within the United States.

(iv) 80/20 Rules.

Certain interest received from a US corporation that earned 80 % or more of its active business income from foreign sources over the prior three-year period is treated as foreign-source income. The Education Jobs and Medicaid Assistance Act of 2010 Act has amended IRC Section 861 to repeal the rule that treats as foreign source all or a portion of any interest paid by a resident alien individual or domestic corporation that meets the 80/20 test. The Act also amends Section 871 to repeal the rule that exempts from US withholding tax all or a portion of any dividends paid by a domestic corporation that meets the 80/20 test. These amendments are effective for taxable years beginning after December 31, 2010. The repeal of the interest rules, however, does not apply to payments of interest to persons not related to the 80/20 company on obligations issued before the date of enactment.

4.2.2 Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.[4] Thus, dividends paid by a domestic corporation are generally treated as entirely US-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source

income. Under a special rule, dividends from certain foreign corporations that conduct US businesses are treated in part as US-source income.

However, if 25 % or more of a foreign corporation's gross income for the three tax years immediately preceding the current tax year was effectively connected with the conduct of a US trade or business, a special rule applies. The US portion of gross income is equal to the proportion of gross income effectively connected with the conduct of a US trade or business for the immediately preceding three-year period.

4.2.3 Rents and Royalties

Rental income is sourced by reference to the location or place of use of the leased property. The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or from any interest in such property) is US-source income, regardless of whether the property is real or personal, intangible or tangible.

- Royalties are sourced in the place of use of (or the place of privilege to use) the property for which the royalties are paid. This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises. See Revenue Ruling 68-443 re trademark licensing income—place of initial sale of trademarked goods not relevant for determining sourcing of royalty income. Holding is that royalty is foreign source because the product's ultimate use outside the USA—i.e. foreign trademarks.
- Income from rents are sourced where the property is used.

4.2.4 Income from Sales of Personal Property

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller.[5] However, several exceptions apply to the general rule: income from sales of property by non-residents is treated as US-source income. A non-resident's gain on the sale of inventory property may be treated as US-source income if title to the property passes in the United States or if the sale is attributable to an office or other fixed place of business maintained by the non-resident in the United States. If the inventory property is manufactured in the United

States by the person that sells the property, a portion of the income from the sale of such property in all events is treated as US source income. A non-resident's gain on the sale of depreciable property is treated as US-source income to the extent of prior US depreciation deductions. Payments received on sales of intangible property are sourced in the same manner as royalties to the extent the payments are contingent on the productivity, use, or disposition of the intangible property.

- Inventory.

Sales are sourced under two theories: (i) the place where the negotiation occurs or (ii) the place where title passes. Under IRC §§ 861(a)(6) & 865 sale of purchased inventory is sourced in the country where the sale takes place. The sale is deemed to take place when title passes.[6] When the seller produces the property the income must be apportioned between the country of production and the country of sale.[7] The seller must source the gross income under a 50/50 allocation method (see next slide) unless another method is elected. Other methods are independent factory price and separate books and records.

- Non-inventory personal property is deemed sold at the residence location.[8]

4.2.5 Sale of Real Property

As a general rule, gain on sale of real property is sources according to the situs (location) of the property.[9] Income from the sale of personal property by a US resident is sourced in the United States. If the seller is a non-resident the income is sourced outside the United States.

4.2.6 Depreciable Assets

The host country normally allows the taxpayer depreciation deductions to allow for the portion of the asset used up, but if all that is allowed is economic depreciation, then the normal return on the investor's capital is fully subject to host-country taxation. Accelerated depreciation (in excess of economic depreciation) allowed by the host country works as a partial relinquishment of the host's traditional source tax base.

4.2.7 Personal Services Income

Compensation for labor or personal services is generally sourced to the place of performance. Thus, compensation for labor or personal services performed in the United States generally is treated as US-source income. However, if a non-resident alien individual performs personal services for a foreign employer, and the individual's total compensation for the services and period in the United States are minimal ($3,000 or less in total compensation and 90 days or fewer of physical presence in a year), the income is be considered as source within the United States. Compensation for services performed both within and without the United States is allocated between US and foreign source.

4.2.8 Intangible Property

Intangible property is treated in the same way as tangible property, that is, where intangibles are leased or sold for an amount contingent on productivity and use, royalties are sourced where used or, indirectly, according to the residence of the lessee-purchaser.

4.2.9 Insurance Income

Underwriting income from issuing insurance or annuity contracts generally is treated as US-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States. In 2009 the IRS considered the source of a foreign corporation's income from the proceeds of a life insurance contract covering the life of a US resident.[10]

In one of the fact patterns that the IRS addressed, B, a foreign corporation not engaged in a US trade or business, purchased from A, a US citizen and resident, a life insurance contract on the life of A for $20,000 with the intent of making a profit. The contract was originally issued by IC, a domestic corporation, to A in 2001. B made regular premium payments after buying the contract.

A died in 2009, and IC paid $100,000 to B under the life insurance contract. B had paid monthly premiums totaling $9000 to keep the contract in force. The IRS concluded that B must recognize $71,000 of income ($100,000 of proceeds less the $20,000 purchase price and $9,000 in premium payments) and that this amount was fixed or determinable annual or periodical income subject to US withholding tax because it was US source.

4.2.10 International Transportation Income

Generally, income from furnishing transportation that begins and ends in the United States is US-source income.[11] Fifty % of other income attributable to transportation which begins or ends in the United States is treated as US-source income.

4.2.11 International Communication Income

Income derived from international communications activity (international communications income) by a United States person is one half from sources within the United States and one half from sources without the United States.[12] Likewise, international communications income derived by a controlled foreign company (CFC) within the meaning of Section 957 is one half from sources within the United States and one half from sources without the United States. International communications income derived by a foreign person, other than a CFC, that is attributable to an office or other fixed place of business of the foreign person in the United States is from sources within the United States. Finally, international communications income derived by a foreign person (other than a CFC) engaged in a trade or business within the United States is income from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

4.2.12 Income from Space or Ocean Activities or International Communications

In the case of a foreign person, generally no income from a space or ocean activity is treated as US-source income. The same holds true for international communications income unless the foreign person maintains an office or other fixed place of business in the United States, in which case the income attributable to such fixed place of business is treated as US-source income.

4.2.13 Amounts Received with Respect to Guarantees of Indebtedness

Amounts received from a non-corporate resident or from a domestic corporation for the provision of a guarantee of indebtedness of such persons

are income from US sources, whether received directly or indirectly. The scope of the provision includes payments that are made indirectly for the provision of a guarantee. For example, the provision treats as income from US sources a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, say, additional interest charged on the indebtedness. In this situation, the domestic subsidiary has paid the guarantee fee as an economic matter through higher interest costs, and the provision treats the additional interest payments made by the subsidiary as indirect payments of the guarantee fee and, therefore, as US source.

Such US-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person which is effectively connected with conduct of a US trade or business. Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign-source income if they are not from sources within the United States under Section 861(a)(9). Non-business income received by foreign persons from US sources is generally subject to tax on a gross basis at a rate of 30 %, which is collected by withholding at the source of the payment.

4.2.14 Social Security Benefits

Social security benefits paid by a US employer for services rendered in the USA are sourced in the USA.[13] However, if a non-resident alien receives pension payments from a US employer for services rendered both within and outside the USA, the payments must be allocated the payments between the USA and the other country.

Revenue Ruling 79-388, 1979-2 C.B. 270 involved an alien who initially worked for a foreign branch of a US corporation and later on transferred to the US office. Upon retirement, he returned to his native country and began receiving pension payments from the employer.

The ruling held that US source income included the portion of each pension payment that represented contributions with respect to services rendered in the United States and all earnings of the pension plan. The portion of each pension payment that represented services outside the United States was foreign-source income. The same principles were

applied in Revenue Ruling 79-389, 1979-2 C.B. 281, which dealt with a US citizen computing foreign-source income for purposes of determining the foreign tax credit.

Example
Margaret, a non-resident alien, receives $15,000 in pension payments during the tax year. Of these payments, $5,000 is attributable to earnings of the pension plan and is US-source income. The remaining $10,000 represents the employer's contributions to the plan for Margaret's services. Of the employer's contributions, 60 % was for her service in a foreign country. Accordingly, 60 % of the $10,000, or $6,000, is non-US-source income. The remaining $4,000 is US-source income. Margaret must report $9,000 ($5,000 + $4,000) of income subject to US income tax.

4.2.15 Foreign Exchange Income

The source of foreign currency gain/loss is generally determined by reference to the residence of the taxpayer deriving income.[14] The gain/loss is generally ordinary income or expense.

4.3 Non-statutory Source Rules: Court Determination

When an item of income is not classified within the confines of the statutory scheme or by regulation, courts source the item by comparison and analogy with classes of income specified within the statutes.

4.3.1 Banking and Financial Services

- In Bank of America (BofA), an Edge Act Corporation, the issue was whether the three commissions (acceptance, confirmation, and negotiation) received by BofA from its international banking business from Germany, France, Guatemala, and Singapore were income sourced in the United States or outside.
- The government took the position that the plaintiff was paid by the opening banks for services. If so, personal services are sourced under Sections 861(a)(3) and 862(a)(3) where those services are performed.

The government contended that the plaintiff performed the services relevant to the commissions at its offices in the United States.
- BofA, on the other hand, contends it is not being paid for personal services but instead for something similar to a loan (the use of its credit). Thus, plaintiff claims its income may be sourced by analogy to interest.
- The trial judge found neither the plaintiff's nor the government's analysis adequate. He found the substance of the transaction to be the plaintiff's promise to pay regardless of any change in circumstances, i.e., the assumption of risk of the foreign bank's default. Since the foreign bank and the risks associated with it are located abroad, the trial judge found the commissions to be foreign source.
- The US Court of Claims disagreed with the parties' characterization of the three commissions as well with the trial judge's determination. It proceeded to dissect each commission separately in order to find its core feature, which then revealed analogies.
- As to the acceptance commission, the US Court of Claims found that what occurred was similar to a loan transaction. That is because, according to the US Court of Claims' construction, the plaintiff assumes the credit risk of the foreign bank and assures the draftholder of its payment, and that the acceptance commissions cover the cost to the plaintiff of credit administration and credit risk. The closest analogy the Court may come up with was 'interest'.
- The closest analogy the Court of Claims found was that confirmation commssion is similar to interests payment.
- Finally, turning to the negotiation commissions, the Court held that since the negotiation commissions charged with advised letters of credit were clearly being charged for personal services, therefore, the negotiation commission should be sourced as personal services.

4.3.2 Endorsement Agreement

The US Tax Court has held that the characterization of a taxpayer's endorsement fees and bonuses depends on whether the sponsors primarily paid for the taxpayer's services, for the use of the taxpayer's name and likeness, or for both. The Court must determine the intent of the sponsors and of the taxpayer from the entire record, including the terms of the specific endorsement agreement. That is, the endorsement agreement is

not a single item of income, but a compound item, which includes royalties and compensation for services.

In the case of *Sergio Garcia v CIR*, the Tax Court elaborated its analysis as to the determination of the split between the royalty income and the compensation for services. The relevant facts under that case are as follows:

- On October 8, 2002, Sergio Garcia, a Spanish professional golfer and a resident of Switzerland, entered into a seven-year endorsement agreement with TaylorMade, whereby Sergio Garcia allowed TaylorMade Golf Co. to use his image, name, and voice (image rights) in advertising and marketing campaigns worldwide. Sergio Garcia also agreed to perform personal services for TaylorMade including using TaylorMade's products in all his golf play, posing and acting for advertisements, and making personal appearances for the company. The endorsement agreement was a "head to toe" deal.
- In return for his services and use of his image rights, TaylorMade agreed to pay Sergio Garcia certain compensation. Sergio Garcia and TaylorMade allocated 85 % of the paid compensation to royalties (for use of his image rights) and 15 % to personal services.
- Sergio Garcia established Even Part, LLC, in the State of Delaware, which would receive the royalty payments and then pay a portion of the royalty payments (attributable to use of the image rights in the United States) to a second LLC that Sergio Garcia established in Switzerland, LongDrive.
- The result was that Sergio Garcia paid no US tax on the royalty payments, but did pay US tax on the US-source personal service payments.
- The petitioner's base remuneration for years 2003 through 2005 was $7 million, after which time his base remuneration depended on his average world ranking at the end of the year, from a high of $9 million for a 1st place rank to a low of $3 million should he be ranked 21st or lower. The petitioner's base remuneration for years 2004 through 2009 could also be calculated under an alternative method (more favourable to petitioner) if TaylorMade's products sold well during the years 2003 through 2009. He could also earn bonuses for each Major tournament he won while using the products which he was required to endorse.
- The original endorsement agreement did not specify the percentage of the remuneration attributable to petitioner's personal services and the percentage attributable to his image rights.

- On August 21, 2003, the endorsement agreement was amended. The amended endorsement agreement reduced petitioner's 2003 base remuneration to $4 million (from $7 million). It also reduced base remuneration (including petitioner's base pay under the alternative method involving TaylorMade sales, which remained at $7 million) by one-seventh for each later year in which petitioner failed to use a Maxfli ball for the entirety of the year in all golfing activities.
- On each of his Forms 1040-NR, US Non-resident Alien Income Tax Return, for 2003 and 2004 Sergio Garcia reported a portion of the personal service payments as his US-source income effectively connected with the conduct of a trade or business within the United States. He did not report any of the royalty payments made to Even Par. Even Par filed tax returns as a partnership, reporting only gross royalty income and matching royalty expenses (which it deducted from the gross royalty income, leaving no taxable income). Even Par's returns stated that the royalty payments were taxable only under Swiss law.
- The IRS" disputed the 85–15 % allocation between royalty and personal service payments, arguing for a larger portion attributable to Sergio Garcia's personal services. The IRS also claimed that we should find the US-source royalty payments were made directly to Sergio Garcia and disregard the form of the transaction involving EP (EP LLC (corporation in the state of delaware)), LD (Corporation established in Switzerland) and TC (Tax Court). The IRS additionally claimed that such royalty income (as well as all US-source personal service income) should be taxable to Sergio Garcia in the United States and not exempted from US taxation under the Convention between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income (Swiss Tax Treaty).That despite the existence of the double tax treaty between the US and Switzerland, all income at issue was taxable to the United states.
- Sergio Garcia claimed that(i) the TC should respect the 85–15 % allocation in the first amended endorsement agreement as the product of an arm's length negotiation between two unrelated parties with adverse tax interests; (ii) the 85–15 % allocation between royalty and personal service payments understated, if anything, the royalty allocation; (iii) that only the personal service income attributable to

his wearing TaylorMade products while playing golf is taxable in the United States and that the royalty income as well as the personal service income attributable to his other personal services is taxable only in Switzerland.

- The Tax Court after listening to expert testimonies, held(i) that the income Sergio Garcia received from TaylorMade for use of his image rights was royalty income not taxable in the United States by virtue of Article 21(1) of the tax treaty between the US and Switzerland; (ii) that the compensation Sergio Garcia received for services performed under the endorsement contract was source into the United States; (iii) that the endorsement agreement should be allocated 65 % to royalties and 35 % to personal services.

4.4 Non-Statutory Rules: IRS Determination

4.4.1 Scholarships, Prices, and Award

Under Treasury Regulation 1.863-1(d), the source of income from scholarships, fellowships, grants, prizes, and awards is determined by the status of the payor rather than the recipient. However, if a US person awards a scholarship to a foreign person for study outside the USA, the payment is regarded as foreign-source income.

4.4.2 Alimony

While alimony is not among the categories of income for which a statutory source-of-income rule is available, the rules that are set forth in the Internal Revenue Code show, for the most part, that Congress thought of the “source” of an item of income in terms of the place where the income was “produced.”

4.4.3 Estate

Thus, the residence of the estate should control the determination of the geographic source of periodic alimony payments just as it controls the source of income paid on an interest-bearing obligation. Periodic payments made by the United States ancillary administrator of the non-resident alien estate to the decedent’s former wife, a non-resident alien, are not from sources within the United States and, therefore, are not subject to the withholding of tax at the source under Section 1441 of the

Code. The relevant facts under Revenue Ruling 69-108,[15] 1969-1 CB, 192 are as follows:

- Decedent, a citizen of the United States, was a resident and domiciliary of a foreign country at the time of his death. Approximately one half of the assets of his estate were located outside the United States. The decedent's sister was appointed sole executrix of her deceased brother's estate in accordance with foreign law, and she is administering the foreign assets. The United States assets are being administered by an ancillary administrator in the United States. The estate is a non-resident alien estate for Federal income tax purposes but is subject to federal tax on income from sources within the United States in the same manner as a non-resident alien individual.

Under the terms of a settlement agreement, entered into by the decedent during his lifetime with his former wife, and incident to their divorce, the non-resident alien estate is required to pay to the former wife, a non-resident alien, a certain amount annually for 20 years for her support and maintenance. The ancillary administrator located in the United States was authorized by the court to pay the annual instalments to the former wife in accordance with the settlement agreement, less the amount, if any, required to be withheld for income tax purposes. These amounts qualify as periodic payments within the meaning of Section 71(a) of the Revenue Ruling 69-108 sourced the payments to the estate of the decedent paying the alimony; not to ancillary estate in USA.

4.4.4 Computer Programs

Section 1.861-18 requires that transactions involving computer software be classified in four categories describes in 1.861-18 (b)(1) and provides specifics rules.[16] In general, a transaction involving the transfer of a computer program, or the provision of services or of know-how with respect to a computer program (collectively, a transfer of a computer program), is treated as being solely one of the following category:

(i) A transfer of a copyright right in the computer program.

A transfer of a computer program is classified as a transfer of a copyright right if, as a result of the transaction, a person acquires any one or more of the following rights:[17]

- The right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;
- The right to prepare derivative computer programs based upon the copyrighted computer program;
- The right to make a public performance of the computer program; or
- The right to publicly display the computer program.

The determination of whether a transfer of a copyright right is a sale or exchange of property is made on the basis of whether, taking into account all facts and circumstances, there has been a transfer of all substantial rights in the copyright. A transaction that does not constitute a sale or exchange because not all substantial rights have been transferred will be classified as a license generating royalty income. For this purpose, the principles of Sections 1222 and 1235 may be applied. Income derived from the sale or exchange of a copyright right will be sourced under Section 865(a), (c), (d), (e), or (h), as appropriate. Income derived from the licensing of a copyright right will be sourced under Section 861(a)(4) or 862(a)(4), as appropriate.

(ii) A transfer of a copy of the computer program (a copyrighted article).

A copyrighted article includes a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk, or in the main memory or hard drive of a computer, or in any other medium.

The determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership have been transferred. A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease generating rental income. Income from transactions that are classified as sales or exchanges of copyrighted articles will be sourced under Sections 861(a)(6), 862(a)(6), 863, 865(a), (b), (c), or (e), as appropriate. Income derived from the leasing of a copyrighted article will be sourced under Section 861(a)(4) or Section 862(a)(4), as appropriate.

(iii) The provision of services for the development or modification of the computer program.

The determination of whether a transaction involving a newly developed or modified computer program is treated as either the provision of services or another transaction under the transfer of computer program regulations is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties.

(iv) The provision of know-how relating to computer programming techniques.

The provision of information with respect to a computer program will be treated as the provision of know-how for purposes of this section only if the information is:

1. Information relating to computer programming techniques;
2. Furnished under conditions preventing unauthorized disclosure, specifically contracted for between the parties; and
3. Considered property subject to trade secret protection.

Any transaction involving computer programs which consists of more than one of the aforementioned transactions will be treated as separate transactions,[18] with the appropriate provisions of this section being applied to each such transaction. However, any transaction that is de minimis, taking into account the overall transaction and the surrounding facts and circumstances, will not be treated as a separate transaction, but as part of another transaction.

It should be noticed that neither the form adopted by the parties to a transaction, nor the classification of the transaction under copyright law is determinative.[19] Therefore, for example, if there is a transfer of a computer program on a single disk for a one-time payment with restrictions on transfer and reverse engineering, which the parties characterize as a license (including, but not limited to, agreements commonly referred to as shrink-wrap licenses), application of the rules of Section 1.861-18 (c) and (f) may nevertheless result in the transaction being classified as the sale of a copyrighted article. Further, the means of transfer will not be taken into account.[20]

4.5 Source Rule for Deductions

Deductions and losses must generally be allocated and apportioned to the appropriate items of income, which then determines which sources of income are offset by the deductions or losses. Any deduction or loss that cannot be allocated, with sufficient amount of certainty, to a specific source of income must then be ratably apportioned among all income, between US and foreign-sourced income. Deductions or losses must be allocated to one of the gross income classes already; and the remainder is then allocated and apportioned ratably. However, there are four specific situations:

(i) Interest expenses on a loan: since money is fungible, interest expense is generally allocated and apportioned according to the assets earning US and foreign-sourced income, regardless of how loan proceeds were used. Interest expenses must be allocated and apportioned on the basis of assets, either their fair market value or their tax book value. If fair market value is chosen, then the company must continue with that election every year.

Example

- Ally Inc., a US corporation, earns all its income through the sale of wigs.
- Most sales occur in the USA, but some income is derived through a branch office located in Paris.
- In 2014, Ally Inc. had deductible interest expense of $50,000.
- Ally Inc. assets producing US-source income had a tax basis of $ 250,000 and a FMV (Fair Market Value) of $400,000.
- Assets producing foreign-source income had a tax basis of $100,000 and a FMV of $ 200,000

Question: Compute Ally Inc. deductible expenses in 2014 using (i) the tax book method; (ii) the book value method.

Solution:

(i) If Ally Inc. chooses the tax book value
$ 50,000 × 250,000/350,000 = $ 35,714.28 (interest expenses allocated to the USA).
$ 50,000 × 100,000/350,000 = $ 14,285.72 (interest expenses allocated to Paris).

(ii) If Ally Inc. uses the book value method
$50,000 × 400,000/600,000 = $ 33,333.33 (interest expense allocable to the USA).
$50,000 × 200,000/600,000 = $ 16,666.67 (interest expense allocable to the Paris branch).

(ii) Treasury Regulation1.861-10T (b) provides special rules for the direct allocation of interest expense to the income generated by certain assets that are subject to qualified nonrecourse indebtedness.

The term "qualified nonrecourse indebtedness" means any borrowing that is not excluded by paragraph (b)(4) of this section if:

- The borrowing is specifically incurred for the purpose of purchasing, constructing, or improving identified property that is either depreciable tangible personal property or real property with a useful life of more than one year or for the purpose of purchasing amortizable intangible personal property with a useful life of more than one year;
- The proceeds are actually applied to purchase, construct, or improve the identified property;
- Except as provided in paragraph (b)(7)(ii) (relating to certain third party guarantees in leveraged lease transactions), the creditor can look only to the identified property (or any lease or other interest therein) as security for payment of the principal and interest on the loan and, thus, cannot look to any other property, the borrower, or any third party with respect to repayment of principal or interest on the loan;
- The cash flow from the property is reasonably expected to be sufficient in the first year of ownership as well as in each subsequent year of ownership to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payments of interest and original issue discount and periodic payments of principal in each such year; and

- There are restrictions in the loan agreement on the disposal or use of the property consistent with the assumptions described in subdivisions (iii) and (iv) of this paragraph (b)(2).

In this case, the deduction for interest will be considered directly allocable solely to the gross income which the property acquired, constructed, or improved with the proceeds of the indebtedness generates, has generated, or could reasonably be expected to generate.

However, the term “qualified non-recourse indebtedness” does not include any transaction that:

- Lacks economic significance;
- Involves cross collateralization, or credit enhancement;
- The purchase of inventory;
- the purchase of any financial asset including stock in a corporation, an interest in a partnership or a trust, or the debt obligation of any obligor;
- Involves interest expense that constitutes qualified residence interest as defined in Section 163(h)(3).

(iii) Treasury Regulation 1.861-10T(c) describes the direct allocation of interest expense to income generated by certain assets that are acquired in integrated financial transaction.

Interest expense incurred on funds borrowed in connection with an integrated financial transaction is directly allocated to the income generated by the investment funded with the borrowed amounts. The term “integrated financial transaction” refers to any transaction in which the taxpayer (i) incurs indebtedness for the purpose of making an identified term investment, (ii) identifies the indebtedness as incurred for such purpose at the time the indebtedness is incurred, and (iii) makes the identified term investment within ten business days after incurring the indebtedness.

(iv) certain related controlled foreign corporation indebtedness. For taxable years beginning after 1987, if a United States shareholder has incurred substantially disproportionate indebtedness in relation to the indebtedness of its related controlled foreign corporations so that such corporations have excess related person indebtedness , the third party interest expense of the related United States shareholder

(excluding amounts allocated under paragraphs (b) and (c) in an amount equal to the interest income received on such excess related person indebtedness) shall be allocated to gross income in the various separate limitation categories described in Section 904(d)(1).

4.5.1 Source Rule Deduction for Research and Development

Though we often use together the term "research and development (R&D)," the two activities are distinguishable. Research activities refer to planned search or critical investigation aimed at discovery of new knowledge, while development activities, on the other hand, consist of the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use.

R&D expenses can be relatively minor, or they can easily run into billions of dollars for large corporations. R&D expenses are usually the highest for industrial, technological, healthcare, and pharmaceutical firms. Some companies reinvest a significant portion of their profits back into R&D, as they see this as an investment in their continued growth.

When a multinational company with activities abroad is engaged in R&D projects, the parent (let us assume from the USA) can decide to bear the costs with some foreign entities and share the proceeds, if any, among the entities involved in the R&D. The split of the proceeds that derived from shared R&D can be complex. The IRC through Section 862 and the regulations thereof provides some specifics.

Ordinarily, a taxpayer's research and experimental expenditures may be divided between the relevant product categories. Where research and experimentation is conducted with respect to more than one product category, the taxpayer may aggregate the categories for purposes of allocation and apportionment; however, the taxpayer may not subdivide the categories. Where research and experimentation is not clearly identified with any product category (or categories), it will be considered conducted with respect to all the taxpayer's product categories. A taxpayer determines the relevant product categories by reference to the three-digit classification of the Standard Industrial Classification Manual (SIC code).[21] Where research and experimentation is undertaken solely to meet legal requirements imposed by a political entity with respect to improvement or marketing of specific products or processes, and the results cannot reasonably

be expected to generate amounts of gross income (beyond de minimis amounts) outside a single geographic source, the deduction for such research and experimentation is considered definitely related and therefore allocable only to the grouping (or groupings) of gross income within that geographic source as a class (and apportioned, if necessary, between such groupings as set forth in paragraphs (c) and (d) of this section).[22] The remaining R&D expenses are allocated under two distinct methods: the sale method and the gross profit method.

4.5.1.1 The sale method

If the taxpayer apportions on the sales method, an amount equal to 50 % of such deduction for research and experimentation is apportioned exclusively to the statutory grouping of gross income or the residual grouping of gross income, as the case may be, arising from the geographic source where the research and experimental activities which account for more than 50 % of the amount of such deduction were performed.[23]

4.5.1.2 The gross profit method

If the taxpayer apportions on the optional gross income methods under paragraph an amount equal to 25 % of such deduction for research and experimentation is apportioned exclusively to the statutory grouping or the residual grouping of gross income, as the case may be, arising from the geographic source where the research and experimental activities which account for more than 50 % of the amount of such deduction were performed.[24] However, if the applicable 50 % geographic source test of the preceding paragraph (b)(1)(i) or (ii) is not met, then no part of the deduction is apportioned under this paragraph (b)(1).

4.5.2 Stewardship Expenses

If services are provided for the benefit of the corporation as an investor, the services may be of a stewardship or overseeing character for which no charge is made. Deductions resulting from stewardship or overseeing functions are considered definitely related and allocable to dividends received or to be received from the related corporation.[25]

4.5.3 Losses on Sales of Property

The deduction allowed for loss recognized on the sale of a capital asset or § 1231 asset is considered definitely related and allocable to the class to which the asset would normally generate gross income.[26]

4.5.4 Legal and Accounting Fees

Legal and accounting fees are normally definitely related and allocable to the class of gross income for which the services are related.[27]

Notes

1. Ault & Bradford (1990): Taxing International Income: An Analysis of the United States System and its Economic Premises, Taxation in the Global Economy 11, 29 (Assaf Razin and Joel S. Pemrod, eds., Univ. of Chicago Press 1990).
2. IRC §884(f)(1)(A); Reg. §1.861-2(a)(2)(iv).
3. IRC §861(a)(1)(A)(i).
4. IRC Section 861(a)(2)(A).
5. IRC Section 865(a).
6. IRC Reg. 1.861-7(c).
7. IRC §863 (b).
8. IRC §865(a).
9. IRC §865(a)(1).
10. Rev. Rul. 2009-14, 2009-21 I.R.B. 1031 (2009).
11. IRC Section 863(c)(2).
12. IRC Section 863(d).
13. IRC Section 861(a)(8).
14. IRC Section 988(a)(3)(A).
15. Revenue Ruling 69-108, 1969-1 CB, 192.
16. A computer program is a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result. A computer program includes any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program.
17. Treas. Reg. 1.861-18(c)(2)(i) through (iv).
18. Sec. 1.861-18(b)(1).
19. Sec. 1.861-18(g)(1).
20. Sec. 1.861-18(g)(2).
21. IRC Reg. 1.861-14(a)(2).
22. IRC Reg. 1.861-14(a)(4).
23. IRC Reg. 1.861-14(b)(i).
24. IRC Reg. 1.861-14(b)(ii).
25. IRC Reg. 1.861-8(e)(4).
26. IRC Reg. 1.861-8(e)(7) and § 865 (j).
27. IRC Reg. 1.861-8(e)(5).

CHAPTER 5

The US Taxing Regime of Foreign Taxpayers

5.1 Introduction

The income of non-resident aliens or foreign corporations that is subject to tax at a rate of 30 % includes US source interest, dividends, rents, royalties, and other similar types of income that are fixed or determinable, annual or periodical gains, profits and income, commonly known as "FDAP income," that is not effectively connected with the conduct of a US trade or business. The words "annual or periodical" are "merely generally descriptive" of the payments that could be within the purview of the statute and do not preclude application of the withholding tax to one-time, lump sum payments to non-resident aliens. Withholding on FDAP payments to foreign payees is required unless the withholding agent or the person making the payment to the foreign person receiving the income, can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty. The principal statutory exemptions from the 30 % withholding tax apply to interest on bank deposits, and portfolio interest.

- Interest on bank deposits

Interest on bank deposits may qualify for exemption on two grounds, depending on where the underlying principal is held on deposit. Interest paid with respect to deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, are US

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F.I. Lessambo, *International Aspects of the US Taxation System*,
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source but are not subject to US withholding tax when paid to a foreign person, unless the interest is effectively connected with a US trade or business of the recipient. Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as US-source income and is thus exempt from US withholding tax (regardless of whether the recipient is a US citizen or foreign person). Similarly, interest and original issue discount on certain short-term obligations is also exempt from US withholding tax when paid to a foreign person. Further, there is no information reporting with respect to payments of such amounts.

- Portfolio interest

Portfolio interest received by a non-resident individual or foreign corporation from sources within the United States is exempt from 30 % withholding tax. A distinction is made between obligations issued before and after March 19, 2012. For obligations issued before March 19, 2012, the term “portfolio interest” means any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the US withholding agent a statement certifying that the beneficial owner is not a US person, as well as interest paid on an obligation that is not in registered form and that meets the foreign targeting requirements of Section 163(f)(2)(B). Portfolio interest, however, does not include interest received by a 10 % shareholder, certain contingent interest, interest received by a controlled foreign corporation from a related person, or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business. For obligations issued after March 18, 2012, the term “portfolio interest” no longer includes interest paid with respect to an obligation not in registered form. This narrowing of the scope of the portfolio interest exemption is a result of the repeal of the exception to the registration requirements for foreign targeted securities in 2010, effective for obligations issued two years after enactment.

5.1.1 Tax Treaty and Rate Reduction

The 30 % withholding tax on US source FDAP income is reduced or eliminated under bilateral income tax treaties unique to the relationship between the two treaty countries, treaty withholding tax rates on each

category of income are not uniform across treaties. The United States, however, has set forth its negotiating position on withholding rates and other provisions in the United States Model Income Tax Convention of November 15, 2006 (the "US Model Treaty").

5.2 Withholding Agent Liabilities

A withholding agent that makes payments of US source amounts to a foreign person is required to report and pay over relevant amounts of US tax withheld. The reports are due to be filed with the Internal Revenue Service (IRS) by March 15 of the calendar year following the year in which the payment is made.

Two types of report are required: (1) a summary of the total US-source income paid and withholding tax withheld on foreign persons for the year and (2) a report to both the IRS and the foreign person of that person's US-source income that is subject to reporting. The non-resident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions.

To the extent that the withholding agent deducts and withholds an amount, the withheld tax is credited to the recipient of the income. If the agent withholds more than is required, resulting in an overpayment of tax, the excess may be refunded to the recipient of the income upon filing of a timely claim for refund.

The US withholding tax rules are administered through a system of self-certification. A non-resident investor seeking to obtain withholding tax relief for US-source investment income must certify to the withholding agent, under penalty of perjury, the person's foreign status and eligibility for an exemption or reduced rate. This self-certification is made on the relevant IRS form, similar to those used by US persons to establish an exemption from the rules governing information reporting on IRS Form 1099 and backup withholding.

The United States imposes tax on the beneficial owner of income, not its formal recipient. To avoid cascading imposition of the withholding tax as payments move through intermediaries to the beneficial owner, a formal recipient must alert the US withholding agent, who in turn reflects that status in reports to the IRS. For example, a payee may receive a payment of US-source income as an intermediary on behalf of the beneficial owner of that income. The intermediary certifies its eligibility for exemption in a form submitted to the IRS and accompanied by documentation

furnished by the beneficial owner attesting to the owner's foreign status. The intermediary may then withhold tax upon remitting the payment to the beneficial owner.

5.3 Income for US Business or Trade

The United States taxes on a net basis the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States. Any gross income derived by the foreign person that is not effectively connected with the person's US business is not taken into account in determining the rates of US tax applicable to the person's income from the business.

5.3.1 The Concept of US Trade or Business

A foreign person is subject to US tax on a net basis if the person is engaged in a US trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged. The question whether a foreign person is engaged in a US trade or business is factual and has generated much case law. The IRS provides few clues as to when an activity will be considered as trade or business activity rather than a personal activity, or investing. The issue has been and often still is solved through court cases, which have developed four requirements in their effort to define a US trade or business: (i) the legitimate profit motive,[1] (ii) the level of the taxpayer involvement in the activity or the extent of the activity over a substantial period of time, (iii) whether the activity has already begun, and (iv) whether the taxpayer holds himself out as engaged in the selling of goods or services. The term "trade or business within the United States" is not defined in the IRC though several provisions therefrom refer to it. As applied to foreign persons, a US trade or business will be found to exist if their activities are regular, continuous, and considerable. That is, isolated or sporadic transactions will not usually be construed as the conduct of trade or business in the USA.

5.3.2 The Concept of Effectively Connected Income

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to US net-basis taxation on the income

that is "effectively connected" with the business. Specific statutory rules govern whether income is effectively connected income (ECI).

In the case of US-source capital gain and US-source income of a type that would be subject to gross basis US taxation, the factors taken into account in determining whether the income is ECI include whether the income is derived from assets used in or held for use in the conduct of the US trade or business and whether the activities of the trade or business were a material factor in the realization of the amount (the "asset use" and "business activities" tests).

Under these tests, due regard is given to whether the income, gain, or asset was accounted for through the US trade or business. All other US-source income is treated as ECI. A foreign person who is engaged in a US trade or business may have limited categories of foreign-source income that are considered to be ECI. Foreign-source income not included in one of these categories (described next) is generally exempt from US tax.

A foreign person's foreign-source income is generally considered to be ECI only if the person has an office or other fixed place of business within the United States to which the income is attributable and the income (1) is rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trade-marks, trade brands, franchises, or other like intangible properties derived in the active conduct of the trade or business; (2) is interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; or (3) is derived from the sale or exchange (outside the United States), through the US office or fixed place of business, of inventory or property held by the foreign person primarily for sale to customers in the ordinary course of the trade or business, unless the sale or exchange is for use, consumption, or disposition outside the United States and an office or other fixed place of business of the foreign person in a foreign country participated materially in the sale or exchange. Foreign-source dividends, interest, and royalties are not treated as ECI if the items are paid by a foreign corporation more than 50 % (by vote) of which is owned directly, indirectly, or constructively by the recipient of the income.

If a foreign person has a US office or fixed place of business, income, gain, deduction, or loss is not considered attributable to the office unless the office was a material factor in the production of the income, gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss was derived.

Special rules apply in determining the ECI of an insurance company. The foreign-source income of a foreign corporation that is subject to tax under the insurance company provisions of the Internal Revenue Code is treated as ECI if the income is attributable to its US business.

If any property ceases to be used or held for use in connection with the conduct of a US trade or business and the property is disposed of within 10 years after the cessation, the determination whether any income or gain attributable to the disposition of the property is taxable on a net basis is made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a US trade or business and without regard to the requirement that the taxpayer be engaged in a US business during the taxable year for which the income or gain is taken into account.

5.4 Foreign Activities Deemed US Trade or Business

The best approach to consider the issue of non-resident aliens or corporations engaged in US trade or business is through the analysis of specific provisions which refer to the term "trade or business" and through Court cases.

5.4.1 Performance of Services

Wages, salaries, fees, compensations, emoluments, or other remunerations, including bonuses, received by a non-resident alien individual for performing personal services in the United States which, under paragraph (a) of Section 1.864-2, constitute engaging in a trade or business in the United States, and pensions and retirement pay attributable to such personal services, constitute income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual if he or she is engaged in a trade or business in the United States at some time during the taxable year in which such income is received.

5.4.2 Trading in Securities and Commodities

Under IRC Section 864(b)(2)(A)(ii), foreign persons can trade in stocks or securities on US markets without having a US trade or business. Put differently, trading in stocks or securities for the taxpayer's own account, whether by the taxpayer or his or her employees or through a resident broker, commission agent, custodian, or other agent, and whether or not

any such employee or agent has discretionary authority to make decisions in effecting the transactions. Likewise, IRC Section 864(b)(2)(B)(ii) states that trading in commodities for the taxpayer's own account, whether by the taxpayer or his or her employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. To benefit from the safe harbor rules under the aforementioned statutes, the non-resident alien or corporation must not be a dealer in stocks or securities. Moreover, the non-resident alien or corporation must not have a trading office of its own in the United States to avail itself of this safe-harbor. A broker, employee, or commission agent can exercise discretionary authority to trade stocks, securities, or commodities without creating a US trade or business. See §864(b)(2)(A) and (B).

Prior to the enactment of the safe harbor under IRC Section 864(b)(2)(A), the distinction between trade and investment becomes a moot point between the IRS and taxpayers. In a seminal case known as *Higgins v CIR*,[2] the Supreme Court held that mere investing, including an active management of one's investments, however extensive, does not constitute a trade or business. Since then lower courts have struggled to find clear lines of distinction between trading and investing. Courts have sometimes added confusion as their rulings contradict one another without clear line of principle or thought. To cite just two cases: the Mollers and the Estate of Yaeger cases showed similar facts yet reached opposite decisions.

- *The Mollers v United States*[3]

The relevant facts under that case are as follow:

- Mr and Ms Mollers treated their investment activities as a full-time jobs, each spending approximately 40 hours per week monitoring the stock market and making investment decisions.
- In one year, they purchased securities in 83 transactions and sold securities in another 41 transactions.
- The next year, they engaged in 76 purchases and 30 sale transactions.
- The IRS considered that the Mollers were engaged in US trade or business.
- The Court determined that they were primarily seeking long-term growth and that they derived the bulk of their income from interest and dividends rather than from trading.

- The Estate of Yaeger v CIR[4]

The relevant facts are as follows:

- In the mid-1920s, Yaeger began actively trading stocks and bonds on the stock market on his own account in addition to conducting his investment consulting business. In the 1940s, Yaeger gave up his investment consulting business because the management of his own account had grown so demanding. Thereafter, he devoted himself exclusively to trading on his own account, which was his sole occupation until the day he died.
- Yaeger maintained accounts with three brokerage firms and occasionally dealt with two others. When he was out of town, he maintained telephone contact with the brokers who handled his accounts. Yaeger was trading on the stock market the day before he died.
- Yaeger increased his gain on his investments by using margin debt. Yaeger financed his purchases by borrowing to the maximum extent allowable under law and the custom of the brokerage houses, which was generally 50 %.
- When he died, his portfolio was subject to debt in the amount of $70,490,018.
- The pivotal inquiry in this case was whether Yaeger was interested in deriving income from capital appreciation or from short-term trading. The two fundamental criteria that distinguish traders from investors is the length of the holding period and the source of the profit.
- Yaeger initiated over 2,000 securities transactions in 1979 and 1980 and pursued his security activities vigorously and extensively.
- Most of Yaeger sales were of securities held for over a year. He did not sell any security held for less than three months. He realized a profit on the securities through both dividends and interest. Most of his profit, however, came from holding undervalued stock until its market improved.
- The court determined that Yaeger was an investor, not a trader, because Yaeger held his stocks and bonds for lengthy periods of time anticipating that they would appreciate in value.

It should be noted that the mere use of a website electronically present in the US to advertise products, services, or to give ordering information

to potential customers clearly does not constitute engaging in business in the United States. However, if the website is used as the situs (i.e. location) for actual sales and delivery of goods, then it may constitute engaging in US trade or business. Treasury Regulation §1.864-7(b)(1) provides that an office or other fixed place of business is a place, site, structure, or similar facility through which a foreign person engages in a trade or business (Treasury Regulation § 1.864-7(b)(1)). Further, the regulations under IRC § 864(c)(5) make no specific reference to electronic commerce or virtual offices.

Supporter of the PE (Permanent Establishment) extended concept often cite Treasury Regulation § 1.864-7(b)(1), which provides that "a store or other sales outlet" constitutes a fixed place of business. Thus, a website used to sell goods can be described as a "sales outlet." However, it is time for the IRS to clarify the federal tax treatment of e-commerce activities.

In 1986, the IRS enacted IRC Section 864(b)(2)(A), known as the safe harbor provision for foreigners trading in US securities. The safe harbor provision was later extended to commodities under IRC Section 864(b)(2)(B) and its scope exceeds the provisions under the common double tax treaty.

For eligible foreign persons, US bilateral income tax treaties restrict the application of net-basis US taxation. Under each treaty, the United States is permitted to tax business profits only to the extent those profits are attributable to a US permanent establishment of the foreign person. The threshold level of activities that constitute a permanent establishment is generally higher than the threshold level of activities that constitute a US trade or business.

5.4.3 Partnerships, Trusts, and Estates

If a partnership conducts a trade or business in the USA, each partner, whether general or limited, will be deemed to be conducting trade or business in the United States.[5] The same tax treatment applies to shareholders within a limited liability corporation. Further, if a trust or estate conducts a US trade or business, its beneficiaries are deemed to be conducting a US trade or business and will be taxed in the USA.

In Revenue Ruling 91-32,[6] the IRS departed from Section 741 of the partnership tax rules, whereby gain on the sale of a partnership interest is capital gain. Thus, non-resident aliens typically are not subject to US tax

on capital gains under Section 871(b) unless they are present in the United States for 183 days or more. The ruling concluded that gain or loss from a foreign partner's disposition of an interest in a partnership engaged in a trade or business through a fixed place of business in the United States will be ECI to the extent that the partner's distributive share of unrealized gain or loss of the partnership would be attributable to "ECI property" of the partnership.

Revenue Ruling 91-32 relied on the attribution and sourcing rules of Code Sections 875, 865(e) and 864(c) to reach its conclusion. Under Section 875, a non-resident alien partner is considered engaged in a trade or business in the United States if his/her partnership is so engaged. Section 865(e) provides that income from the sale of personal property by a non-resident is US source if the non-resident has a fixed place of business in the United States and the income is attributable to that fixed place of business under Section 864(c) principles. Among other things, Section 864(c)(2) provides that certain capital gain or loss from US sources may be ECI if the gain or loss is derived from assets used or held for use in a trade or business in the United States (i.e., ECI property).

In recently released Field Attorney Advice, the IRS reaffirmed its position that gain on the sale of a partnership interest by a non-resident alien may be subject to US tax as ECI. The taxpayer, a non-resident alien, was a partner in a US partnership that develops and markets consumer products. The IRS issued a Notice of Proposed Adjustment (NOPA), concluding that the taxpayer's gain from the sale of her partnership interest constituted ECI, according to Revenue Ruling 91-32. The taxpayer protested, arguing that, under Section 741, gain on the sale of a partnership interest is a capital asset and that, as a non-resident alien, she is not taxable on capital gains unless she is present in the United States for at least 183 days. The taxpayer further contended that the 183-day rule applies even if the Revenue Ruling's treatment of the gain as ECI is proper. Because she was not present in the United States for 183 days or more, taxpayer claimed that she was not subject to tax.

In rebuttal of the taxpayer's contention that the 183-day rule precludes taxation even of ECI of a non-resident alien, the IRS points to Section 871(b)(1) as providing a "general imposition of tax" on such income with no qualification based on the individual's presence in the United States.

5.4.4 Banking Activities

Under Treasury Regulation 1.864-4(c)(5), a non-resident alien individual or a foreign corporation is judged to be engaged in the active conduct of a

banking, financing, or similar business in the United States if at some time during the taxable year the taxpayer is engaged in business in the United States and the activities of such business consist of any one or more of the following activities carried on, in whole or in part, in the United States in transactions with persons situated within or without the United States:[7]

(a) Receiving deposits of funds from the public;
(b) Making personal, mortgage, industrial, or other loans to the public;
(c) Purchasing, selling, discounting, or negotiating for the public on a regular basis; notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness;
(d) Issuing letters of credit to the public and negotiating drafts drawn thereunder,
(e) Providing trust services for the public; or
(f) Financing foreign exchange transactions for the public.

The character of the business actually carried on during the taxable year in the United States will determine whether the taxpayer is actively conducting a banking, financing, or similar business in the country. However, a foreign corporation which acts merely as a financing vehicle for borrowing funds for its parent corporation or any other person who would be a related person within the meaning of Section 954(d)(3) if such foreign corporation is a controlled foreign corporation is not considered to be engaged in the active conduct of a banking, financing, or similar business in the United States.

5.4.5 Management of Real Property

The ownership and rental of real property does not necessarily constitute a US trade or business. However, a foreign owner who engages in tax planning in the US and thereby derives benefits from the considerable deductions ordinarily available in respect of real property investment would be deemed to be engaged in US trade or business. In the Lewenhaupt case,[8] for instance, the Tax Court found that petitioner was engaged in US trade or business. The relevant facts under the case are as follow:

- Lewenhaupt, a citizen and resident of Sweden, was the beneficiary of a trust established under the will of his mother, Caroline Lewenhaupt. The corpus of the trust comprised four parcels of real properties and securities in the USA.

- On January 28, 1941, Lewenhaupt appointed a Californian real estate broker, Mr La Montaigne as his agent for the purpose of managing the personal and real properties. La Montaigne was granted a broader power through a power of attorney to buy, sell real estate, execute leases, rent properties, collect rents, pay taxes, insurances and the like.
- Lewenhaupt sold a real property located in the USA and realized a capital gain in the amount of $ 152,555.87. He filed his tax return for the fiscal year 1946 with the collector for the District of Maryland. The return was filed on the basis that Lewenhaupt was a non-resident alien of the USA, not engaged in trade or business in the United States.
- Lewenhaupt was physically present in the USA from 11/20/1946 to 12/20/1946, and at no time prior to 1948, he did perform any personal services within the USA.

The Tax Court held that Lewenhaupt's activities during fiscal year 1946 connected with his ownership, and the management through a resident agent, of real property situated in the USA constituted engaging in a business. The aforementioned activities, carried on by his agent are beyond the scope of mere ownership of real property, or the receipt of income from real property.

The Tax court found that the activities conducted by Lewenhaupt were considerable, continuous and regular, and constituted engaging in a business within the meaning of Section 211(b) of the Code. The Circuit Court agreed.

5.4.6 Electronic Commerce

The US Treasury, in a recent study focused on international tax issues raised by e-commerce, suggested that existing principles be used to resolve issues presented by new forms of commerce. Lessambo argued that such a view is anachronistic,[9] as the PE concept was developed before the advent of e-commerce. The mere use of a website electronically present in the US to advertise products, services, or to give ordering information to potential customers clearly not constitute engaging in business in the United States. However, if the website is used as the situs (i.e. location) for actual sales and delivery of goods, then it may constitute engaging in US trade or business. Treasury Regulation §1.864-7(b)(1) provides that an office or other fixed place of business is a place, site, structure or similar facility through which a foreign person engages in a trade or business (Treasury

Regulation § 1.864-7(b)(1)). Further, the regulations under Internal Revenue Code § 864(c)(5) make no specific reference to electronic commerce or virtual offices.

Supporters of the PE extended concept often cite Treasury Regulation § 1.864-7(b)(1), which provides that "a store or other sales outlet" constitutes a fixed place of business. Thus, a website used to sell goods can be described as a "sales outlet." However, it is time for the IRS to clarify the federal tax treatment of e-commerce activities.

5.5 Determination of Taxable Income: Deduction Allowances

Deductions are allowed against ECI, and are taxed at graduated rates or lesser rates under a tax treaty. Put differently, taxable ECI is computed by taking into account deductions associated with gross ECI. For this purpose, the apportionment and allocation of deductions is addressed in detailed regulations. The regulations applicable to deductions other than interest expense set forth general guidelines for allocating deductions among classes of income and apportioning deductions between ECI and non-ECI. In some circumstances, deductions may be allocated on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. More specific guidelines are provided for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. Detailed regulations under Section 861 address the allocation and apportionment of interest deductions.

5.6 Electing for US Trade or Business ("ECI") Status

IRC Sections 871(d) and 882(d) provide relief by permitting a foreign person to elect to be treated as if it were engaged in a US trade or business with respect to all its US real property held for the production of income, even if the person is not in fact so engaged.

Under IRC Section 871(d) a non-resident alien can make an election to treat all his or her income from real property located in the United States and held for the production of income and to all income from any interest in such property as income effectively connected with a trade or business in the United States. This includes income from rents, royalties

from mines, oil or gas wells, or other natural resources, as well as gains from the sale or exchange of real property and from the sale or exchange of timber, coal, or domestic iron ore with a retained economic interest. The election does not treat a non-resident alien, who is not otherwise engaged in a US trade or business, as being engaged in a trade or business in the United States during the year. The non-resident alien makes the initial choice by attaching a statement to his return, or amended return, for the year of the choice. The election or election stays in effect for all later tax years unless the non-resident lien revokes it. The non-resident alien can revoke the choice without IRS approval by filing Form 1040X, Amended US Individual Income Tax Return, for the year he made the choice and for later tax years. Form 1040X must be filed within three years from the date your return was filed or two years from the time the tax was paid, whichever is later. If this time period has expired for the year of choice, the choice cannot be revoked for that year.

Likewise, under IRC Section 882(a), a foreign corporation which during the taxable year derives any income from real property located in the United States, or from any interest in such real property, including gains from the sale or exchange of real property or an interest therein, rents or royalties from mines, wells, or other natural deposits, and gains described in Section 631 (b) or (c), which would not be treated as income effectively connected with the conduct of a trade or business within the United States, may elect for such taxable year to treat all such income as income which is effectively connected with the conduct of a trade or business within the United States. An election made in any taxable year remains in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary with respect to any taxable year. However, in Revenue Ruling 91-7, 1991-1 CB 100, the IRS ruled that a non-resident alien or foreign corporation that derived no income from US real property during a tax year could not make such an election.

5.7 Income Considered ECI

The following categories of income and transactions are usually considered to be with a trade or business in the United States:

- The taxable part of any US-source scholarship or fellowship grant received by a non-immigrant in “F,” “J,” “M,” or “Q” status is treated as effectively connected with a trade or business in the United States;

- A member of a partnership that at any time during the tax year is engaged in a trade or business in the United States will be considered to be engaged in a trade or business in the United States;
- Usual performance of personal services in the United States;
- Owner and operator of a business in the United States which sells services, products, or merchandise, are deemed engaged in a trade or business in the United States;
- Gains and losses from the sale or exchange of US real property interests by one who is engaged in a trade or business in the United States;
- Income from the rental of real property may be treated as ECI if the taxpayer elects to do so.

5.8 Deferred Income and Look-Back Rules

The Deferred Income Rule, under IRC Section 864(c)(6), states that a non-resident alien cannot avoid US trade or business categorization by merely postponing receipt of operating income from a current US trade or business year to a non-US trade or business year.

The Look-Back Rule, under IRC Section 864(c)(7), states that a ten-year "claw-back rule" applies for income derived from the sale of US trade or business related property.

Notes

1. Doggett v. Burret, 1933.
2. Higgins v. CIR, 312 US 212 (1941).
3. Mollers v. United States, 721 F. 2d. 811, 1983.
4. Estate of Yaeger v. CIR, 889 F. 29 (2nd. Cir. 1989).
5. IRC Section 875(1).
6. Revenue Ruling 91-32; 1991-1 C.B. 107, 1991-20 IRB 20.
7. IRC 1. 864-4 (c)(5).
8. Lewenhaupt v. Commissioner, T.C. 1953.
9. Lessambo, Felix, E-Commerce, Permanent Establishment and Commerce Clause, BNA-TPI- E-Commerce, August 2002.

CHAPTER 6

The Branch Profits Tax

6.1 Introduction

In 1986 Congress added Branch tax provisions to the Internal Revenue Code (IRC) "to achieve greater parity between the remittance of branch profits and the distribution of subsidiary earnings." Prior to the enactment of the BPT, a dividend repatriated by a US branch of a foreign corporation to its non-resident corporate owner were exempt from US tax unless more than 50 % of the gross income of the parent, within three producing years, derived from US Effectively Connected Income (ECI) trade or business. The BPT applies regardless of whether the US trade or business of the foreign corporation is substantial compared with its worldwide activities. It treats the US trade or business of the foreign corporation as if it were incorporated as a subsidiary of the foreign corporation and deems the profits of the subsidiary to be remitted, pursuant to a formula, to the foreign corporation at the end of the year. It eliminates the competitive advantage in operating as a branch vis-à-vis a subsidiary with respect to repatriation of profits.[1]

BPT is a branch-level tax on the repatriation of earnings, in the form of dividends, from a foreign corporation's branch in the United States to the home office in the foreign country. Through the tax the US Congress attempted to eliminate the perceived disparity between the tax treatment of a US subsidiary and a US branch of foreign corporations with US investment. BPTs are comparable to these second-level taxes, and under certain circumstances, may be reduced or eliminated under an applicable income tax treaty. While the intent may be worthy, it is fair to say that through the

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BPT, the USA departed from its traditional federal income tax concepts, such as the principle that movement of assets among the branches of a single corporate taxpayer is not usually regarded as a taxable event.

6.2 BPT on Dividend Equivalent Amount

In addition to the tax imposed under IRC Section 882 for any taxable year, the USA imposes on any foreign corporation a tax equal to 30 % of the equivalent dividend amount for the taxable year. While it is simple to compute dividends declared and paid by a subsidiary, it is not so simple to measure the earnings and profits of a branch deemed remitted to its head office. Branches do not declare and pay dividends. Instead, they remit funds via intra-company transfers, which are similar to moving money from one pocket into another. Rather than tracking these intra-company remittances, however, Congress decided to impose the tax on a formulary basis, treating the branch as effectively operating with the same debt/equity ratio as the foreign corporation as a whole.[2]

The dividend equivalent amount (DEA) is the effectively connected earnings and profits, less the increase in US equity. Put differently, the DEA is a US branch's effectively connected earnings and profits (ECEP) for a taxable year reduced by the increase in a US branch's US net equity (USNE) or increased by a US branch's decrease in USNE.

In addition, effectively connected earnings and profits are increased for a US disinvestment, creating a decrease in US equity from the previous to current year. It is upon the dividend equivalent amount which the 30 % branch tax rate is applied, unless lowered by a treaty provision. The DEA, therefore, can be eliminated only if the USNE increases by the amount of the ECEP of the branch each year. The USNE can be increased by either (I) using the profits to purchase additional US assets, or (ii) electing to reduce US liabilities.

The following earnings and profits attributable to income effectively connected with a US trade or business are excluded from the imposition of branch profits tax: (i) certain earnings derived by a foreign sales corporation; (ii) certain foreign transportation earnings; (iii) earnings derived from the sale of any interest in US real property holding corporations; (iv) earnings derived by certain corporations organized in a US possession; (v) earnings derived by certain captive insurance companies; and (vi) certain exempt foreign government related income.

6.2.1 Determination of US Assets and Liabilities

US assets generally include the foreign corporation's assets held on the determination date if (i) all income produced by the asset is, or would be, ECI; and (ii) all gain from the disposition of the asset would be ECI if the asset were disposed of on that date and the disposition produced gain.

US liabilities include US-connected liabilities held by the foreign corporation on the determination date, which is often the end of the year. Under Reg. § 1.882-5, US liabilities are determined using one of the following ratios elected by the foreign corporation by multiplying US assets by one of the following: (i) the fixed ratio, (ii) the actual ratio.

However, a foreign corporation may elect, annually, to reduce a portion of its USCLs to the extent that such liabilities exceed the foreign corporation's US booked liabilities.

6.2.2 Reduction for Increase in US Net Equity

In case where the US net equity of the foreign corporation as of the close of the taxable year, exceeds the US net equity of the foreign corporation as of the close of the preceding taxable year, the effectively connected earnings and profits for the taxable year shall be reduced (but not below zero) by the amount of such excess.

6.2.3 Increase for Decrease in Net Equity

In general, if the US net equity of the foreign corporation as of the close of the preceding taxable year exceeds the US net equity of the foreign corporation as of the close of the taxable year, the effectively connected earnings and profits for the taxable year are increased by the amount of such excess. However, for any taxable year, the increase in net equity does not exceed the accumulated effectively connected earnings and profits as of the close of the preceding taxable year.

Example 1: Reinvestment of all Effectively Connected E&P
Foreign Corporation A, a calendar year taxpayer, had $1000 US net equity as of the close of 2010 and $100 of effectively connected earnings and profits for 2011. A acquires $100 of additional US

assets during 2011 and its US net equity as of the close of 2011 is $1100. In computing A's dividend equivalent amount for 2011, A's effectively connected earnings and profit of $100 is reduced by the $100 increase in US net equity between the close of 2010 and the close of 2011. A has no dividend equivalent amount for 2011.

Example 2: Existence of Dividend Equivalent Amount
UNC, Inc., a Greek Bank has a US branch which conducts banking activities in the USA.

In 2013, the US Branch provides the following information:

- Income effectively connected with US Trade/Business: $ 5,000,000.
- US corporate income tax (35 %): 1,750,000.
- Remittance to the parent company (UNC, Inc.): 2,000,000.
- Increase in US net equity: 800,000.

Question: (i) compute the US Branch BPT, and (ii) determine the DEA.

Solution:

First step: computation of the DEA:
E&P effectively connected to US Trade/ Business= (5,000,000–1,750,000)= 3,250,000.
Minus

- Increase in US Net equity: (800,000)
- Dividend Equivalent Amount: 2,450,000

Second step: Computation of the BPT

- Dividend Equivalent Amount: $2,450,000
- BPT (30 %): (735,000)

6.3 BPT on Excess Interest

6.3.1 Interest Expenses Allocation

Treasury Regulation § 1.882-5 provides for a three-step formulary approach for allocating interest expense to a foreign corporation's ECI: (i) the determination of the of US assets connected by ascertaining which assets generate ECI from the conduct of a trade or business in the United States; (ii) the determination of the amount of US-connected liabilities based on a "fixed" or "actual" ratio; and (iii) the determination of the amount of the interest expense allocable to ECI. The US-connected liabilities are multiplied by an appropriate interest rate to arrive at the interest expense allocable to ECI.

6.3.2 Excess Interest Allocation

IRC Section 884 (f)(1)(B) imposes a tax on excess interest to the extent the interest deduction allocable to the US trade or business in computing its taxable ECI exceeds the branch interest of Section 884 (f)(1)(A). The excess interest is treated as if it were paid to the foreign corporation by a wholly owned domestic corporation on the last day of the foreign corporation's taxable year and subject to tax under Section 881 (a) (the excess interest tax).

A foreign corporation engaged in a trade or business in the United States (or having gross income treated as effectively connected with the conduct of a trade or business in the United States) is subject to a 30 % BPT on excess interest paid or accrued on US-booked liabilities. That is, any interest paid by such trade or business in the United States is treated as if it were paid by a domestic corporation, and to the extent that the allocable interest exceeds the interest described under IRC Section 881 a BPT would be due.

IRC Sections 884(f)(1) (A) & (B) provide detailed rules concerning these excess interest. Section 884(f)(1)(A) provides in the case of a foreign corporation engaged in a trade or business in the United States (or having gross income treated as effectively connected with the conduct of a trade or business in the United States), any interest paid by such trade or business in the United States is treated as if it were paid by a domestic corporation. And IRC Section 884(f)(1)(B) goes on to add that to the extent that the allocable interest exceeds the interest described in IRC Section 884(f)(1)(A), the foreign corporation will be liable for tax under Section 881(a) in the same manner as if such excess were interest paid to

such foreign corporation by a wholly owned domestic corporation on the last day of such foreign corporation's taxable year.

The following types of interest are exempt from the branch profits tax:

- Inter-branch interest;
- Exempt interest in bank deposits.

However, double taxation is avoided in that when the US branch of a foreign corporation repatriates up dividends to its foreign owner, there should be no additional US tax.

6.4 Double Tax Treaty Implications

The foreign corporation may be able to reduce the 30 % rate under applicable treaty provisions.

Income Tax Treaties were created by Congress to help alleviate double taxation faced by foreign corporations in the USA and in the foreign country. The amount of BPT under a treaty is determined by either the BPT amount specified in the treaty or the dividend rate specified in the treaty. Typically these treaty provisions reduce the branch profits rate from 30 to 5 % or 15 % rates.

The 1989 US–Germany Income Tax Treaty defines the amount for a dividend tax rate under Article 10. If the beneficial owner is a company that owns at least 10 % of the voting shares of the corporation paying the dividends, then the rate is 5 %. In all other cases it is 15 %.

There are limitations under the US–Canada tax treaty which benefit Canadian corporations investing in US interests. If a Canadian corporation with a US branch has a deficit in accumulated effectively connected earnings and profits in preceding years and a positive amount in the current year. There will be no dividend equivalent amount in the current year if positive earnings and profits do not exceed the aggregate deficit. In addition, there is a $500,000 one-time exemption allowing Canadian corporations to accrue $500,000 of dividend equivalent before any excess faces the branch profits tax.

6.4.1 Limitations on Tax Treaty Exemption

No treaty between the United States and a foreign country exempts any foreign corporation from BPT or reduces the amount thereof, unless such

treaty is an income tax treaty, and such foreign corporation is a qualified resident of such foreign country.

6.4.2 *Qualified Resident Test*

The foreign corporation must also be a qualified resident of the foreign country to benefit from treaty provisions. A foreign corporation can be a qualified resident by meeting either an ownership or active business test. A qualified resident, for ownership purposes, is defined as a foreign corporation who is also a resident of the foreign country unless more than 50 % of the company is owned by shareholders who are not residents of the same foreign corporation or US citizens or resident aliens, or 50 % or more of its income does not go to support liabilities of such residents. A publicly traded corporation can be treated as a qualified resident if its stock is primarily traded in the country of its foreign residence. A foreign corporation may also qualify as a qualified resident if engaged actively in a US trade or business that is integral to its business and has a substantial presence in its home country.

6.5 Branch Profit Tax Terminations

A corporation is not subject to branch profits tax in the year in which it terminates all its US branches and operations and in which its effectively connected earnings and profits are eliminated. Four conditions must be met for the termination to be validated:

1. The corporation must have no US assets, or all shareholders must agree to a complete liquidation.
2. Neither the corporation nor any related corporation may use the terminated US assets within three years of liquidation.
3. The corporation must not have any US effectively connected income three years from the date of liquidation.
4. A waiver of the statute of limitations must be signed and filed by the corporation in the year of termination and not less than six years after that year.

The corporation may also be deemed to have a complete termination if the acquiring corporation elects §338 in an acquisition. As long as a related corporation does not carry on business from the proceeds of the

stock sale, the acquired corporation's effectively connected earnings and profits are extinguished and the corporation will not be subject to branch profits tax in the year of termination.

6.6 BPT Tax Planning

Typically, branch profits are triggered when a foreign corporation transfers assets to a domestic trade or business. When choosing to incorporate, a foreign company can partially escape the branch profits tax if it elects to incorporate under IRC §351, transfer to a corporation controlled by transferor. Section 351 dictates that the foreign corporation has control, owning at least 80 % of the US corporation's stock immediately after the exchange. In the year in which the §351 transaction occurs, the repatriated effectively connected earnings and profits are subject to BPT. However, reinvested earnings in the US transferee corporation are not subject to BPT. The transferee corporation must agree to elect to increase its earnings and profits by the transferor's effectively connected earnings and profits. As an effect of the transfer and election, the effectively connected earnings and profits of the transferor corporation are reduced in the year following the §351 transaction by the amount transferred to the US corporation. Finally, the transferor must agree to pay any branch profits tax that may arise on the disposition of the US corporate stock.

A foreign corporation seeking to make investments in the USA can also just choose not to operate with a US branch. Creating a US subsidiary or purchasing stock in a domestic corporation are viable options for avoiding BPT. A US subsidiary helps shield the parent corporation from having to file a US tax return. The subsidiary is still liable for US taxes but will not be faced with BPT on repatriation of earnings.

6.7 BPT and Double Tax Treaty

BPT applies only to the ECEP attributable to the profits of the Permanent Establishment (PE), and not to any other profits. Thus, US income tax treaties generally reduce the rate of the branch profits tax to the same rate that applies to direct dividends. This rate is generally 5 % unless the USA has negotiated a treaty or protocol that reduces the direct dividend rate to zero. To qualify for the full exemption, the foreign corporation must meet not only the treaty's "limitation on benefits" article but also additional requirements in the dividend or branch profits tax articles. That

is, if a foreign corporation is a qualified resident under a treaty, BPT will not apply because the BPT was effectively acknowledged by the regulations as violating the non-discrimination article of the treaties, unless the treaty already allowed the other state to impose its BPT.[3] A taxpayer must file Form 8833 (Treaty-Based Return Position Disclosure under Section 6114 or 7701(b)) with its Form 1120-F to disclose the basis on which it is claiming a reduced rate or exemption from BPT under a tax treaty (but not under IRC §884). If a taxpayer fails to file a Form 8833 a penalty of $10,000 is imposed under IRC §6712.[4]

6.8 Case Study: Taiyo Hawai v. Commissioner

- Taiyo Hawaii, Ltd. was a Japanese corporation, formed in 1985 that primarily conducted business in Honolulu.[5]
- In 1986, after a merger, Taiyo Hawai Ltd. received funding from Seiyo, another Japanese corporation (its parent) and from unrelated banks to develop certain properties ("Ginter and Gomes").
- In 1995, Seiyo listed over $18m as the loan balance with over $5.8M as the outstanding interest that was payable to Seiyo.
- When making payments to the unrelated banks, Taiyo withheld 10 % of the interest and remitted the amount to the United States. However, the interest accrued on the promissory notes were not paid and no tax was withheld or remitted.
- Neither Taiyo nor Seiyo made a §882(d) election in order to treat the income from the real estate activity as effectively connected to a US trade or business.
- The CIR determined that the accrued interest to related entities did not qualify as branch interest and, instead, constituted excess interest within the meaning of Section 884 (f)(1)(B).
- Petitioner contended that the deductibility of the interest on several grounds including:

The interest must have been paid in order for it to be deductible is a prerequisite for inclusion in the calculation of a foreign corporation's excess interest tax liability under Section 884 (f)(1)(B).

- The undeveloped properties, Ginter and Gomes, should not have been included in the calculation of the US-connected assets. Taiyo claimed that the land was not held as an asset for business use, or at least, that property could still be held for passive activities.

- The Tax Court held that in enacting and retroactively amending Section 884, Congress did not intend to allow the principles of Section 267 to preempt the parity between US branches and subsidiaries of foreign corporations that the excess interest tax was designed and intended to accomplish. The Tax Court also looked at the history of the property, and determined that the property had been held for development and a course of action had been pursued to accomplish this.
- Second, the Tax Court found that since the assets were put forth as business assets, and Taiyo had been actively trying to develop both properties in a manner that resembled their normal course of business.

Notes

1. IRS (2014): LB&I International Practice Service Concept Unit- BPT, p. 3.
2. IRS (2014) – LB&I International Practice Service Concept Unit- BPT, p. 3.
3. Treas. Reg. §1.884-1(g).
4. IRS (2014) – LB&I International Practice Service Concept Unit- BPT, p. 10.
5. Taiyo Hawai v. Commissioner, 108 T.C. 590 (1997).

CHAPTER 7

Foreign Investment in the Real Property Transaction Act

7.1 Introduction

In general, a foreign person that is not engaged in business in the USA (and is not an individual who is present in the USA for at least 183 days in the year) is not subject to any US tax on capital gain from US sources. However, the Foreign Investment in Real Property Tax Act (FIRPTA) of 1980 treats a foreign person's gain or loss from the disposition of US real property interest (USRPI) as income that is effectively connected with a US trade or business, and thus taxable at the income tax rates applicable to US persons, including the rates for net capital gain. Internal Revenue Code (IRC) Section 897(a)(1) states that gain or loss of a non-resident alien individual or a foreign corporation from the disposition of a United States real property interest shall be treated as effectively connected with US trade or business during the taxable year.

A foreign person subject to tax on this income is required to file a US tax return under the normal rules relating to receipt of income effectively connected with a US trade or business. In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30 % rate (or lower treaty rate).

The Senate Finance Committee reports to predecessor bills, and the Senate Budget Committee Report to the Revenue Reconciliation Act of 1980 in which the provision was enacted. Both committees stated:

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> The committee believes it is essential to establish equity of tax treatment in US real property between foreign and domestic investors. The committee does not intend by the provisions of this bill to impose a penalty on foreign investors or to discourage foreign investors from investing in the United States. However, the committee believes that the United States should not continue to provide an inducement through the tax laws for foreign investment in US real property which affords the foreign investor a number of mechanisms to minimize or eliminate his tax on income from the property, while at the same time effectively exempting him from US tax on the gain realized on disposition of the property.

FIRPTA was thus created to ensure that taxes are paid on real estate that is sold by a foreign real estate investor in the United States. Prior to 1986, a US corporation holding US real property could sell the property and liquidate within a year of the sale.

Prior to the passage of FIRPTA, it was possible for foreign real estate investors to purchase real property in the US, sell it at a profit, and not pay anything in taxes. This proved to be advantageous to foreign real estate sellers, but not to legal US residents. FIRPTA was created to address this failing and protect real estate property buyers from liability for IRS payments.

FIRPTA applies to any disposition of a US real property interest by a foreign person (the transferor) and triggers a withholding under IRC Section 1445. Normally the sale/purchase of real estate qualifies as a disposition however many other transactions also qualify as dispositions (e.g. gifts, redemptions, capital contributions, etc.).

Under FIRPTA, a foreign person is defined as:

- A non-resident alien individual;
- A foreign corporation not treated as a domestic corporation; or
- A foreign partnership, trust or estate.

There are some instances where the seller may be exempt from FIRPTA; the most common is when the property sale is less than $300,000 and the buyer intends to use the property as his or her primary residence. In this case, FIRPTA does not apply and the 10 % does not need to be withheld.

7.2 US Real Property Interest

Under IRC Section 897(c)(1)(A) a US real property interest is any interest, other than solely as a creditor, in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the US Virgin

Islands, as well as certain personal property that is associated with the use of real property (such as farming machinery or hotel furniture). It also means any interest, other than solely as a creditor, in any domestic corporation unless it is established that the corporation was at no time a US real property holding corporation during the period in which the interest was held or, if a shorter period, the five-year period ending on the date of disposition. If, on the date of disposition, the corporation did not hold any US real property interests, and all the interests held at any time during the shorter of the applicable periods were disposed of in transactions in which the full amount of any gain was recognized, then FIRPTA withholding would not apply.

7.2.1 US Real Property Holding Corporation (USRPHC)

Under Treasury Regulation 1.897-2, a corporation is a US real property holding corporation if the fair market value of the US real property interests held by the corporation on any applicable determination date equals or exceeds 50 % of the sum of the fair market values of its:

- US real property interests;
- Interests in real property located outside the United States; and
- Certain business assets.

As explained above, the US generally taxes foreign investors on their US-source income and income that is "effectively connected" (or treated as effectively connected) with a US trade or business. Under Section 897(a), income from the disposition of a US real property interest (USRPI) is treated as effectively connected income and, therefore, subject to net taxation in the United States. Thus, foreign investors with effectively connected income must file US tax returns.

Section 897(c) broadly defines the term USRPI to mean (i) an interest in real property located in the United States or the Virgin Islands, and (ii) any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes that such corporation was at no time a United States real property holding corporation (USRPHC) during the five-year period ending on the date of the disposition of such interest. A USRPHC is any corporation for which the fair market value of its USRPIs equals or exceeds 50 % of the fair market value of (i) its USRPIs, plus (ii) its interests in real property located outside the United States, plus (iii) any other of its assets which are used or held for use in a trade or business.

Example

- Bett Corp., a US domestic corporation owns US Real Property (USRP) with a Fair Market Value (FMV) of $100,000;
- Bett Corp owns also foreign real property with a FMV of 100,000 and business assets with a FMV of $40,000.

Question: Is Bett corp. a US RPHC?
Solution:

- USRPI = $100,000
- Sum of Bett corp. Total worldwide RPI plus business assets = $100,000 + 40,000 = 140,000
- USRPHC = $100,000/140,000 = <50 %. Thus, Bett corp, is not a US RPHC and its stocks are not Real Property Interests.

There are some exceptions to the rules outlines under IRC Section 897(c):

(i) Shares in a USRPHC that are part of a publicly traded class of shares are not treated as USRPIs if the foreign investor held 5 % or less of such class of stock at all times during the past five years.
(ii) Special rules govern the taxation of non-US persons that invest in domestic real estate investment trusts (REITs). An ownership interest in a REIT that is also a USRPHC is not treated as a USRPI if the REIT is "domestically controlled" (meaning that less than 50 % in value of the stock of the REIT was directly or indirectly owned by foreign persons at any time during the past five years). Consequently, a foreign investor's gain from the sale of shares of a domestically controlled REIT is not treated as effectively connected income, therefore, not subject to FIRPTA.
(iii) Certain foreign corporations that would otherwise be subject to FIRPTA may elect to be treated as domestic corporations for purposes of IRC Section 897 and the related withholding and reporting provisions of the Code. The purpose of the election is to prevent claims of discrimination under FIRPTA by foreign corporations that are residents of countries whose treaties with the United States contain non-discrimination provisions. Benefits of making this election include the ability to utilize certain non-recognition provisions of the

Code and the avoidance of FIRPTA withholding on sales of USRPIs by the electing corporation.

7.2.2 REIT Avoiding FIRPTA

Under FIRPTA the income and gain earned by a SWF is subject to US tax if investing in a United States Real Property Holding Corporation ("USRPHC"). A corporation is a USRPHC if 50 % or more of its assets are attributable to US real estate. Therefore, a REIT qualifies as a USRPHC because greater than 50 % of its assets are US real estate. To avoid FIRPTA a Sovereign Wealth Fund (SWF) must use a private (US) domestically controlled REIT. Under such a structuring, non-US investors own a minority interest of less than 50 % of the domestically controlled REIT's shares, and the US investors maintain control of greater than 50 % of the domestically controlled REIT. Additionally, in order to meet the exemption requirements, FIRPTA mandates that the REIT does not sell any of its real estate while the SWF is a shareholder. This structure effectively shelters the SWF from US tax on the income and gain from the sale of its REIT stock shares.

7.2.3 Exceptions from FIRPTA Withholding

Generally one does not have to withhold in the following situations; however, notification requirements must be met:

1. The transferee acquires the property for use as a home and the amount realized is not more than $300,000. The transferee or a member of his family must have definite plans to reside at the property for at least 50 % of the number of days the property is used by any person during each of the first two 12-month periods following the date of transfer. When counting the number of days the property is used, the days the property was vacant are not be counted for.
2. The property disposed of (other than certain dispositions of non-publicly traded interests) is an interest in a domestic corporation if any class of stock of the corporation is regularly traded on an established securities market. However, if the class of stock had been held by a foreign person who beneficially owned more than 5 % of the fair market value of that class at any time during the previous five-year period, then that interest is a US real property interest if the corporation qualifies as a United States Real Property Holding Corporation (USRPHC), and any disposition must be withheld.

3. The disposition is of an interest in a domestic corporation and that corporation furnishes a certification stating, under penalties of perjury, that the interest is not a US real property interest. Generally, the corporation can make this certification only if the corporation was not a USRPHC during the previous five years (or, if shorter, the period the interest was held by its present owner), or as of the date of disposition, the interest in the corporation is not a US real property interest by reason of Section 897(c)(1)(B) of the IRCC. The certification must be dated not more than 30 days before the date of transfer.
4. The transferor provides a certification stating, under penalties of perjury, that the transferor is not a foreign person and containing the transferor's name, US taxpayer identification number, and home address (or office address, in the case of an entity).
5. A withholding certificate from the Internal Revenue Service (IRS) excuses withholding.
6. The transferor provides to the transferee a written notice that no recognition of any gain or loss on the transfer is required because of a non-recognition provision in the IRC or a provision in a US tax treaty.
7. The amount the transferor realizes on the transfer of a US real property interest is zero.
8. The property is acquired by the United States, a US state or possession, a political subdivision thereof, or the District of Columbia.
9. The grantor realizes an amount on the grant or lapse of an option to acquire a US real property interest. However, a withholding tax is due on the sale, exchange, or exercise of that option.
10. The disposition (other than certain dispositions of non-publicly traded interests) is of publicly traded partnerships or trusts. However, if an interest in a publicly traded partnership or trust was owned by a foreign person with a greater than 5 % interest at any time during the previous five-year period, then that interest is a US real property interest if the partnership or trust would otherwise qualify as a USRPHC if it were a corporation, and it must be withheld.

7.3 Special Rules for REITs and RICs

REITs and RICs are generally passive investment entities (though certain activities are permitted). They are organized as US domestic entities and are taxed as US domestic corporations. However, because of their special status, they are entitled to deduct amounts distributed to

shareholders and, in some cases, to allow the shareholders to characterize these amounts based on the type of income the REIT or RIC received. Among numerous other requirements for qualification as a REIT or RIC, such entities are generally required to distribute to shareholders at least 90 % of their income (excluding net capital gain) annually. A REIT or RIC may designate a capital gain dividend to its shareholders, who then treat the amount designated as capital gain. A REIT or RIC is taxed at regular corporate rates on undistributed income; but the combination of the requirement to distribute income other than net capital gain, plus the ability to declare a capital gain dividend and avoid corporate level tax on such income, typically results in little, if any, corporate-level tax paid by a REIT or RIC.

Instead, the shareholder-level tax on distributions is the principal tax paid with respect to income of these entities. The requirements for REIT eligibility include primary investment in real estate assets (which assets can include mortgages). The requirements for RIC eligibility include primary investment in stocks and securities (which can include stock of REITs or of other RICs).

- FIRPTA rules for REITs and RICs.

Certain special rules under FIRPTA apply to REITs, and to certain RICs that are largely invested in US real property interests. REITs and such RICs are called “qualified investment entities.” Stock of a “domestically controlled” qualified investment entity is excluded from the definition of a USRPI. The term “domestically controlled” is defined to mean that less than 50 % in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant holding period, generally the five-year period ending on the date of a disposition or distribution to which the exception applies. Thus, stock of a domestically controlled REIT or of a domestically controlled RIC that is a qualified investment entity for this purpose can be sold without FIRPTA consequences. This exception applies regardless of whether the sale of stock is made directly by a foreign person, or by a REIT or RIC whose distributions to foreign persons of gain attributable to the sale of USRPIs are subject to FIRPTA.

A distribution by a qualified investment entity to a foreign shareholder, to the extent attributable to gain from the entity’s sale or exchange of USRPIs, is generally treated as FIRPTA income to the shareholder.

The FIRPTA character is also retained if the distribution occurs from one qualified investment entity to another, through a tier of US REITs or RICs. An IRS notice states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to both non-liquidating and liquidating distributions to a qualified investment entity shareholder and that the IRS will issue regulations to that effect. An exception to this rule applies if the distribution is made on a class of qualified investment entity stock that is regularly traded on an established securities market located in the United States and the foreign person has not held more than 5 % of the class of stock at any time during the one-year period ending on the date of the distribution. Where the exception applies, a distribution to the foreign shareholder is treated as the distribution of an ordinary dividend (rather than as a capital gain dividend), subject to 30-% (or lower treaty rate) withholding. Such a dividend distribution is not exempt from US tax as capital gain, but also is not treated as FIRPTA income that would require a US tax return to be filed.

7.4 Rates of Withholding (10 %; 35 %; 10 %)

The transferee must deduct and withhold a tax equal to 10 % (or other amount) of the total amount realized by the foreign person on the disposition. The amount realized is the sum of (1) the cash paid, or to be paid (principal only), (2) the fair market value of other property transferred, or to be transferred, and (3) the amount of any liability assumed by the transferee or to which the property is subject immediately before and after the transfer. The amount realized is generally the amount paid for the property. If the property transferred was owned jointly by US and foreign persons, the amount realized is allocated between the transferors based on the capital contribution of each transferor.

A foreign corporation that distributes a US real property interest must withhold a tax equal to 35 % of the gain it recognizes on the distribution to its shareholders.

A domestic corporation must withhold a tax equal to 10 % of the fair market value of the property distributed to a foreign shareholder if (1) the shareholder's interest in the corporation is a US real property interest, and (2) the property distributed is either in redemption of stock or in liquidation of the corporation.

7.4.1 Withholding Certificates

The amount that must be withheld from the disposition of a US real property interest can be adjusted pursuant to a withholding certificate issued by the IRS. The transferee, the transferee's agent, or the transferor may request a withholding certificate. The IRS will generally act on these requests within 90 days after receipt of a complete application including the Taxpayer Identification Numbers (TIN's) of all the parties to the transaction. A transferor that applies for a withholding certificate must notify the transferee in writing that the certificate has been applied for on the day of or the day prior to the transfer.

A withholding certificate may be issued due to:

- A determination by the IRS that reduced withholding is appropriate because either: (i) the amount that must be withheld would be more than the transferor's maximum tax liability, or (ii) withholding of the reduced amount would not jeopardize collection of the tax;
- The exemption from US tax of all gain realized by the transferor; or
- An agreement for the payment of tax providing security for the tax liability, entered into by the transferee or transferor.

The applicant must make available to the IRS, within the time prescribed, all information required to verify that representations relied upon in accepting the agreement are accurate, and that the obligations assumed by the applicant will be performed pursuant to the agreement. Failure to promptly provide the information requested will usually result in rejection of the application, unless the IRS grants an extension of the target date.

7.4.2 Tax Treaty Effects

Some US income tax treaties that apply a reduced withholding tax rate to dividend distributions contain special provisions for distributions that are treated as ordinary dividends from REITs or RICs. These treaties generally restrict the withholding tax rate reduction for such dividends to no lower than 15 %. In the case of REITs, they also limit qualification for the 15 % rate to foreign shareholders that own no more than a specified percentage of the REIT. The percentage varies according to whether the REIT stock is held by an individual (generally 10 %, sometimes more, e.g.,

25 %), or is held by any person in a diversified REIT (generally 10 %) or, if neither of the other exceptions applies, generally 5 % in the case of dividends paid with respect to a class of publicly traded stock. Some treaties further provide an exception to these shareholder ownership limits to permit certain publicly traded investment entities of the other country to own more REIT stock than the otherwise applicable limit. Under some such treaties, however, the shareholder REIT ownership limitations are applied separately, on a "look-through" basis, to any shareholder that the other country entity knows or should know owns more than 5 % of such entity.

7.5 Reforming FIRPTA

FIRPTA is an anomaly in the pattern of US taxation of foreign investors; with a few technical exceptions, FIRPTA is literally the only major provision of the US tax code which subjects foreign investors to taxation on capital gains realized from investment in US assets.

FIRPTA is a discriminatory tax regime. It is applicable only to investors in US real property. It imposes a higher tax cost on gains from real property, even gains from passive investments, than that imposed on gains from any other type of US asset.

FIRPTA treats any gain or loss realized by a foreign investor in a "US real property interest" as though the gain or loss were effectively connected to a US trade or business, and taxes such gain or loss in the same manner as a US resident is taxed.

FIRPTA leads to inefficient allocations of capital by foreign owners of US real property. Given the tax burden faced upon disposition of such property, foreign holders of US real property may be overly influenced by US tax considerations when deciding when to sell their US real property interests or how long to hold them. Capital that might be more effectively put to use via other investment opportunities thus remains locked in US real properties. Moreover, US real properties that might be put to a more productive use in the hands of other owners are unavailable to prospective buyers.

7.6 Legislative Proposal for Simplification

Currently, under FIRPTA of 1980 a SWF is subject to a capital gains tax on the disposition of US real property in the range of 35–45 %.

- In 2010, Congress made its first attempt to amend the Foreign Investment in Real Property Tax Act with the Real Estate Revitalization Act of 2010 (RERA).[1] That Act aimed to redefine FIRPTA by eliminating interest tax on the sale of US real estate by foreign investors. The RERA could have modified FIRPTA in several ways: (i) by eliminating the USRPHC provisions from the Code; (ii) by characterizing distributions by a "qualified investment entity" (defined as any REIT or regulated investment company (RIC)), to the extent attributable to gain from sales or exchanges by the qualified investment entity of US real property, as ordinary dividends rather than effectively connected income; (iii) by treatingliquidating distributions from a qualified investment entity as ordinary dividends to the extent the distributions exceed the foreign investor's basis in its stock (but not to exceed the amount attributable to gain from sales or exchanges by the qualified investment entity of US real property); and (iv) by repealing the ability of foreign corporations to elect to be treated as domestic corporations under Section 897(i). The Bill would also make conforming changes to various definitional, withholding, and other related provisions.

The RERA was never enacted.

- Another attempt to alter FIRPTA was made in the same FY 2009 by the House of Representatives, with the Real Estate Jobs and investment Act.[2] That Bill sought to amend FIRPTA by allowing foreign investors to control a 10 % stake in a publically traded real estate investment trust without triggering FIRPTA rules. The efforts were aborted by the US Senate, despite their budgetary benefits. Indeed, the Congressional Budget Office (CBO) concluded that the "Real Estate Jobs and Investment Act of 2010" would reduce the federal deficit by $143 million between 2010 and 2015 by stimulating the economy with the increase of foreign investment in public REITs.

Notes

1. The Real Estate Revitalization Act of 2010 (H.R. 4539).
2. Real Estate Jobs and Investment Act (H.R. 5901) during the 111th Congress.

CHAPTER 8

The Taxation of Foreign Sovereign in the United States

8.1 Introduction

Section 892 of the Internal Revenue Code (IRC) provides tax exemption to foreign governments, and, by extension, to sovereign wealth funds. Enacted in 1917, IRC Section 982 has remained unchanged since then. Based on the justification of sovereign immunity, the model adopted by the US Tax Code offers a tax exemption to foreign governments who earn income in their governmental capacity, but taxes income earned from any so-called "commercial activity."[1]

8.2 Qualified Entities under IRC Section 892

The exemption provided under IRC Section 892 is available not only to foreign governments themselves, but also to the "integral parts" and "controlled entities" of those governments.

Under Temporary Treasury Regulation 1.892-2T(a)(1), an "integral part" of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country. The net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person.

Temporary Treasury Regulation 1.892-2T(a)(2) defines a controlled entity as an entity that is separate in form from a foreign sovereign or

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otherwise constitutes a separate juridical entity if it satisfies the following requirements: (i) [i]t is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities; (ii) [i]t is organized under the laws of the foreign sovereign by which owned; (iii) [i]ts net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and (iv) [i]ts assets vest in the foreign sovereign upon dissolution.

As a general rule, the income of foreign governments:

(A) investments in the United States in— (i) stocks, bonds, or other domestic securities owned by such foreign governments, or (ii) financial instruments held in the execution of governmental financial or monetary policy, or
(B) interest on deposits in banks in the United States of moneys belonging to such foreign governments shall not be included in gross income and shall be exempt from taxation under this subtitle. However, there are two exceptions: income received directly or indirectly from commercial activities

The provisions of IRC Section 892(a) shall not apply to any income (i) derived from the conduct of any commercial activity (whether within or outside the United States), (ii) received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity, or (iii) derived from the disposition of any interest in a controlled commercial entity.

8.3 Controlled Commercial Entity

The Treasury Regulations under Section 892 define commercial activity for purposes of the foreign sovereign tax exemption. This definition is remarkably broad. Anything that is an activity "with a view towards the current or future production of income or gain" is a commercial activity.

The term "controlled commercial entity" means any entity engaged in commercial activities (whether within or outside the United States) if the government (i) holds (directly or indirectly) any interest in such entity which (by value or voting interest) is 50 % or more of the total of such interests in such entity, or (ii) holds (directly or indirectly) any other interest in such entity which provides the foreign government with effective control of such entity.

For the purposes of the preceding sentence, a central bank of issue shall be treated as a controlled commercial entity only if engaged in commercial activities within the United States.

8.4 Tax Treatment

Whenever one of the two exceptions applied, a foreign government shall be treated as a corporate resident of its country. A foreign government shall be so treated for purposes of any income tax treaty obligation of the United States if such government grants equivalent treatment to the government of the United States.

8.5 International Organizations

The income of international organizations received from investments in the United States in stocks, bonds, or other domestic securities owned by such international organizations, or from interest on deposits in banks in the United States of moneys belonging to such international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

8.6 The IRS Proposed Regulations of 2011

On November 2, 2011, the Internal Revenue Service (IRS) issued new guidance relating to the taxation of foreign governments, including sovereign wealth funds.[2] The proposed regulations supplement without replacing the temporary regulations issued in 1998. The proposed regulations introduced the following changes:

- An extension of the Commercial Activity Income

Section 1.892–4T of the 1988 Temporary Regulations provides rules for determining whether income is derived from the conduct of a commercial activity, and specifically identifies certain activities that are not commercial, including certain investments, trading activities, cultural events, non-profit activities, and governmental functions. The proposed regulations go further to list certain activities that will not be considered commercial activities.[3] One such activity is investments in financial

instruments, as defined in §1.892–3T(a)(4), which, if held in the execution of governmental financial or monetary policy, are not commercial activities for purposes of Section 892. In addition, §1.892–4(e)(1)(ii) of the proposed regulations expands the existing exception in §1.892–4T(c)(1)(ii) from commercial activity for trading of stocks, securities, and commodities to include financial instruments, without regard to whether such financial instruments are held in the execution of governmental financial or monetary policy.

Section 1.892–4(d) of the proposed regulations further provides that only the nature of an activity, not the purpose or motivation for conducting the activity, is determinative of whether the activity is a commercial activity. In addition, §1.892–4(d) provides that an activity may be considered a commercial activity even if the activity does not constitute a trade or business for purposes of §162 or does not constitute (or would not constitute if undertaken in the United States) the conduct of a trade or business in the United States for purposes of § 864(b).

- An Inadvertent Commercial Activity Exception

The proposed regulations clarify the so-called ""all or nothing" rule that existed for entities engaging in commercial activities under the 1998 temporary regulations. The Treasury Department and the IRS revise §1.892–5T(a) to provide for a de minimis exception under which an entity would not be treated as a controlled commercial entity as a result of certain inadvertent commercial activity. The proposed regulations provide that an entity will not be considered to engage in commercial activities if it conducts only inadvertent commercial activity.[4] Commercial activity will be treated as inadvertent commercial activity only if:

1. The failure to avoid conducting the commercial activity is reasonable;
2. The commercial activity is promptly cured; and
3. Certain record maintenance requirements are met. However, none of the income derived from such inadvertent commercial activity will qualify for exemption from tax under Section 892.

In determining whether an entity's failure to avoid conducting a particular commercial activity is reasonable, due regard will be given to the number of commercial activities conducted during the taxable year, as well

as the amount of income earned from, and assets used in, the conduct of the commercial activity in relationship to the entity's total income and assets.

- The new safeguard under the proposed regulations [5]

Failure to avoid conducting commercial activity will not be considered reasonable unless adequate written policies and operational procedures are in place to monitor the entity's worldwide activities. The controlled entity's failure to avoid the conduct of commercial activity during a taxable year will be considered reasonable if:

1. The value of the assets used in, or held for use in, the activity does not exceed 5 % of the total value of the assets reflected on the entity's balance sheet for the taxable year as prepared for financial accounting purposes; and
2. The income earned by the entity from the commercial activity does not exceed 5 % of the entity's gross income as reflected on its income statement for the taxable year as prepared for financial accounting purposes.

The determination of whether an entity is a controlled commercial entity within the meaning of Section 892(a)(2)(B) will be made on an annual basis. Accordingly, an entity will not be considered a controlled commercial entity for a taxable year solely because the entity engaged in commercial activities in a prior taxable year.[6]

- Disposition of a USRPI as defined in Section 897(c)[7]

IRC Section 897(a)(1) requires that a non-resident alien or foreign corporation take into account gain or loss from the disposition of a USRPI as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with that trade or business. The Treasury Department and the IRS believe that an entity that only holds passive investments and is not otherwise engaged in commercial activities should not be deemed to be engaged in commercial activities solely by reason of the operation of Section 897(a)(1). Accordingly, §1.892–4(e)(1)(iv) of the proposed

regulations provides that a disposition, including a deemed disposition under Section 897(h)(1), of a USRPI, by itself, does not constitute the conduct of a commercial activity. However, as provided in §1.892–3T(a), the income derived from the disposition of the USRPI described in Section 897(c)(1)(A)(i) shall in no event qualify for the exemption from tax under Section 892.

- Treatment of partnerships

IRC Section 1.892–5T(d)(3) provides a general rule that commercial activities of a partnership are attributable to its general and limited partners ("partnership attribution rule") and provides a limited exception to this rule for partners of publicly traded partnerships (PTPs).

The proposed regulations modify the existing exception to the partnership attribution rule for PTP interests by providing a more general exception for limited partnership interests.[8] Under this revised exception, an entity that is not otherwise engaged in commercial activities will not be treated as engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership, including a publicly traded partnership that qualifies as a limited partnership. For this purpose, an interest as a limited partner in a limited partnership is defined as an interest in an entity classified as a partnership for federal tax purposes if the holder of the interest does not have rights to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year under the law of the jurisdiction in which the partnership is organized or under the governing agreement. Although the commercial activity of a limited partnership will not cause a controlled entity of a foreign sovereign limited partner meeting the requirements of the exception for limited partnerships to be engaged in commercial activities, the controlled entity partner's distributive share of partnership income attributable to such commercial activity will be considered to be derived from the conduct of commercial activity, and therefore will not be exempt from taxation under Section 892. Additionally, in the case of a partnership that is a controlled commercial entity, no part of the foreign government partner's distributive share of partnership income will qualify for exemption from tax under Section 892. Further, §1.892–5(d)(5)(ii) of the proposed regulations provides that an entity that is not otherwise engaged in commercial activities will not be considered to be engaged in commercial activities solely because it is a member of a partnership that effects transactions in stocks, bonds, other securities, commodities, or financial

instruments for the partnership's own account. However, this exception does not apply in the case of a partnership that is a dealer in stocks, bonds, other securities, commodities, or financial instruments. For this purpose, whether a partnership is a dealer is determined under the principles of §1.864–2(c)(2)(iv)(a).

Example 1

K, a controlled entity of a foreign sovereign, has investments in various stocks and bonds of United States corporations and in a 20 % interest in Opco, a limited liability company that is classified as a partnership for federal tax purposes. Under the governing agreement of Opco, K has the authority to participate in the management and conduct of Opco's business. Opco has investments in various stocks and bonds of US corporations and also owns and manages an office building in New York. Because K has authority to participate in the management and conduct of Opco's business, its interest in Opco is not a limited partner interest.

Therefore, K will be deemed to be engaged in commercial activities because of attribution of Opco's commercial activity, even if K does not actually make management decisions with regard to Opco's commercial activity, the operation of the office building. Accordingly, K is a controlled commercial entity, and all of its income, including its distributive share of partnership income from its interest in Opco and its income from the stocks and bonds it owns directly, will not be exempt from tax under Section 892.

Example 2

The facts are the same as in Example 1, except that Opco has hired a real estate management firm to lease offices and manage the office building. Notwithstanding the fact that an independent contractor is performing the activities, Opco will still be deemed to be engaged in commercial activities. Accordingly, K is a controlled commercial entity, and all of its income, including its distributive share of partnership income from its interest in Opco and its income from the stocks and bonds it owns directly, will not be exempt from tax under Section 892.

Example 3
The facts are the same as in Example 1, except that K is a member that has no right to participate in the management and conduct of Opco's business. Assume further that K is not otherwise engaged in commercial activities. Under paragraph (d)(5)(iii) of this section, Opco's commercial activities will not be attributed to K. Accordingly, K will not be a controlled commercial entity, and its income derived from the stocks and bonds it owns directly and the portion of its distributive share of partnership income from its interest in Opco that is derived from stocks and bonds will be exempt from tax under Section 892. The portion of K's distributive share of partnership income from its interest in Opco that is derived from the operation of the office building will not be exempt from tax under Sections 892 and 1.892–3T(a)(1).

Notes

1. Jennifer Bird Pollan (2013): The Unjustified Subsidy: Sovereign Wealth Funds and the Foreign Sovereign Tax Exemption, Fordham Journal of Corporate & Financial law, Vol. XVII, pp. 898–90.
2. Reg-146537-06.
3. Section 1.892–4T(c).
4. §1.892–5(a)(2).
5. §1.892–5(a)(2)(ii)(C).
6. §1.892–5(a)(3).
7. USRPI means United States real property interest.
8. §1.892–5(d)(5)(iii).

CHAPTER 9

The International Tax Treaty

9.1 Introduction

International double taxation was recognized by the Organisation for Economic Co-operation and Development (OECD) as an obstacle to the development of economic relations between member countries. In an effort to enhance economic development, in 1963 the OECD published a draft Double Taxation Convention on Income and Capital, which has subsequently been updated. For each article in the convention there is a detailed commentary which is designed to illustrate or interpret the provision. The OECD Model Convention pursues three objectives: (i) to fight against double taxation, (ii) to fight against tax avoidance and tax evasion, and (iii) cooperation between or among tax authorities of member countries.

9.2 OECD Tax Treaty Objectives

9.2.1 Fight against Double or Multiple Taxation

Double or multiple taxations refer to the situation whereby the same taxpayer (whether an individual or a corporation) is subject to taxation more than once by two or more tax authorities. Double or multiple taxations are referred to as either "juridical double taxation" or "economic double taxation."

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- Juridical double (or multiple) taxation is generally defined as the imposition of comparable taxes in two (or more) states or jurisdictions on the same taxpayer in respect of the same subject matter for identical period.[1]
- In contrast, double (or multiple) economic transaction describes the situation in which the same economic transaction or asset is taxed in two or more states or jurisdictions during the same period to different taxpayers.[2]

9.2.2 Fight against Tax Avoidance and Tax Evasion

9.2.2.1 Tax Avoidance

Tax avoidance consists of using the tax code and regulations in such a way to maximize the benefit, often outside the spirit of the text. In the USA, an upper estimate of the loss from tax planning by multinationals is about $ 60 billion each year—about one-quarter of all governmental revenue from corporate income tax.[3]

9.2.2.2 Tax Evasion

Tax evasion refers to illegal arrangements where tax liability is hidden or ignored, i.e. the taxpayer pays less tax than he or she is legally obligated to pay by hiding income or information from the tax authorities.

9.2.3 Cooperation between Tax Authorities

Article 26 of the OECD Tax Convention provides for cooperation or administrative assistance between or among treaty partners. The exchange is based upon reciprocal agreement between or among treaty partners. The United States takes a robust approach to the exchange of information within the most recently negotiated tax treaties (i.e. the US–Hungary treaty, the US–Colombia treaty). Under certain circumstances, information may be exchanged outside the bounds of formal agreement or when there is no obligation to provide the information. For example, the Department of the Treasury's Financial Crimes and Enforcement Network (FinCEN) may coordinate with financial intelligence agencies in other countries to facilitate exchange of information for certain financial crimes.

For instance, the proposed protocol of US–Switzerland tax treaty allows the tax authorities of both countries to exchange information that may be

relevant to carrying out the provisions of the agreement or the domestic tax laws of either country, including information that would otherwise be protected by the bank secrecy laws of either country. It allows the United States to obtain information from Switzerland whether or not Switzerland needs the information for its own tax purposes, and provides that requests for information cannot be declined solely because the information is held by a bank or other financial institution.[4]

9.3 US Approach to Double Tax Treaties

The US Treasury Department has developed its own Model Income Tax Convention. This is used as a starting point in bilateral treaty negotiations with other countries. The United States has a network of 60 income tax treaties covering 68 countries. This network covers the vast majority of foreign trade and investment of US businesses and investors. The Treasury Department actively pursues opportunities to establish new tax treaty relationships with countries in which US businesses encounter unrelieved double taxation with respect to their investments. The rationale is that tax treaties provide certainty to businesses and individuals in respect of their potential liability to tax in foreign jurisdictions, as well as the means to allocate taxation rights between jurisdictions in order to reduce the risk of double taxation. Tax treaties also ensure that businesses and individuals are not subject to discriminatory taxation in foreign jurisdictions.

9.3.1 US Tax Treaty Objectives

One of the primary functions of tax treaties is to provide certainty to businesses and individual taxpayers regarding a threshold question with respect to international taxation—namely, whether a taxpayer's cross-border activities will subject it to taxation by more than one country.[5]

Another primary function of tax treaties is relief of double taxation. This is achieved primarily through the allocation of taxation rights between the two countries.

Other tax treaty benefits include:

- Provision of rules for determining the country of source for each category of income;
- The obligation of the residence country to eliminate double taxation that otherwise would arise from the exercise of concurrent taxing jurisdiction by the two countries.;

- Resolution of disputes between jurisdictions with the goal of avoiding double taxation;
- Reduction of potential “excessive” taxation by reducing withholding taxes that are imposed at source;
- Provision of a mechanism for dealing with disputes between countries regarding the proper application of a treaty.

Tax treaties also include provisions intended to ensure that cross-border investors do not suffer discrimination in the application of the tax laws of the other country. In addition to these core provisions, tax treaties include provisions dealing with more specialized situations, such as rules addressing and coordinating the taxation of pensions, social security benefits, and alimony and child-support payments in the cross-border context (the Social Security Administration separately negotiates and administers bilateral totalization agreements). Though the objectives and means of the US Treasury Department are clearly known, conflicts exist as to the relationship between Tax Treaty and US domestic laws.

9.3.2 Hierarchy of the Tax Treaty in the USA

9.3.2.1 Tax Treaty vs. US Constitution

The US Constitution does not speak directly to the hierarchy of the various sources of federal law. Nonetheless, it does set forth the hierarchy of federal and state law. It is largely accepted that no international obligation of the USA (i.e., tax treaty) shall contravene the US Constitution.

9.3.2.2 Tax Treaty vs. US Statutes

The relationship between international tax treaties and US statutes has and remains an area of contention between “internationalist” and “sovereignist” scholars. The former argue that the USA should respect or at least honor its international conventions. To that end, they express the view that once an international convention has been entered into by the two branches of the government, no unilateral action by a single branch can alter the international convention. Sovereignists, on the other hand, argue that Senate can alter any provision within an international convention if it determines any abuse not foreseen by the time of the consent or approval. The USA has embraced both sides of the argument.

Until 1988, the IRC contained two articles which clearly recognized the supremacy of the any tax treaty entered into by the US (It is general) federal tax laws:

a. IRC Section 894(a) stated: "Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from US taxation", and
b. IRC Section 7852(d) added: " No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title."

In 1988, due to some abuse of treaty benefits the US Congress, through the TAMR(Technical and Miscellaneous Revenue Act), amended and reversed the hierarchy between international tax treaty and US federal laws. It revisited IRC Sections 894(a) and 7852(d):

> Section 894(a) states: "The provisions of this title shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer";
>
> Section 7852(d) (1) states: "For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law of the United States shall have preferential status by reason of its being a treaty or a law."

The United States reverted to an ancient common law rule (the latest-in-time), formulated for conflicts between statutes.[6]

"Further, most US income tax treaties contain a provision similar in effect to article 1, paragraph 2 of the 1996 US Model Income Tax Convention, which provides that [t]he Convention shall not restrict in any manner any benefit now or hereafter accorded: (a) by the laws of either Contracting State; or (b) by any other agreement between the contracting states. As the Treasury Department has explained, this provision ensures that the Convention may not increase the tax burden on a resident of a contracting states [*sic*]".

9.3.2.3 Tax Treaty vs. US IRC Regulation

As to the relationship between tax treaties and US regulations, US courts have unanimously agreed that no tax regulations from the US Treasury

Department regulation shall contravene the provisions of international tax treaty.[7]

9.4 Interpretation of Tax Treaty

Double tax treaties are international (bilateral) agreements subject to interpretation according to international law principles. Those rules are expressed within the Vienna Convention, Articles 31 through 33. Articles 31–33 contain binding interpretation rules of international law for parties of the VCLT(Vienna Convention on the Law of Treaties). As of to date, the US has signed but not yet ratified the VCLT.

Article 31 (1) VCLT provides the general rule of interpretation, under which "a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."

Article 31 (2) VCLT defines the term "context", which includes the entire text of the treaty (including preamble/annexes), any agreement between all the parties in connection with the conclusion of the treaty and any instrument related to the treaty made by one party, accepted by other party related to the treaty.

Article 31 (3) VCLT, which lays down the authentic interpretation principle states: "any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions", "any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation," and "any relevant rules of international law applicable in the relations between the parties" shall be taken into account, together with the context.

Article 31 (4) VCLT, which provides special meaning of a term "if it is established that the contracting parties provides so intended."

Article 32 VCLT provides supplementary means of interpretation, including the preparatory work of the treaty or the circumstances to confirm interpretation under Article 31 VCLT, or to determine a reasonable meaning.

Article 33 VCLT provides rules for interpretation of treaties in different languages or with reference to third language.

Thus, the starting point for any treaty interpretation consists of the literal interpretation of the treaty terms seeking to restitute ordinary meaning, which prevails over the intentions of the contracting states.

9.5 Abuse of Double Tax Treaty

Double tax treaty provisions (articles) can lead to abuse. That is, treaty provisions can be used in ways contrary to the treaty goals and objectives. The OECD, while recognizing the phenomenon, did not provide a comprehensive definition as to what constitutes treaty abuse. Rather, the OECD provides guidance to be followed by its member countries.

> A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favorable tax position and obtaining that more favorable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

The OECD Model Tax Convention recognizes the usefulness of domestic specific anti-abuse rules.[8] The OECD commentaries recognize two possible approaches to dealing with a potential abuse: (i) one approach is to consider the abuse of the treaty provisions as an abuse of the treaty itself and to disregard abusive transactions under a proper interpretation of the relevant treaty provisions taking into account the context, the object and the purpose of the overall treaty, as well as the obligation to interpret treaty provisions in good faith. (ii) Another approach consists of relying upon domestic anti-abuse rules or principles to combat treaty abuse. However, in order for an anti-abuse domestic provision to be effective, it must respect the primacy of tax treaties, and not lead to a result that may override unilaterally the obligations imposed by such a tax treaty. However, the OECD Model Convention does not define "beneficial ownership" or "beneficial owner," but merely attempts to describe its character. In common law countries, the concept of "beneficial rights" derives from trust law. Trust law allows for the division of property interests into legal and beneficial interests. The law allocates equitable rights to the beneficiary and legal rights to the trustee, who holds title to the trust property. Strictly speaking, the beneficiary does not own trust property. He or she merely has the right to enforce the terms of the trust—which may provide that the beneficiary acquire ultimate ownership of the trust property.

The OECD states, as a principle:

> The potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques

is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy. This will be especially necessary where a state which adopts the view described in paragraph 9.2 above believes that its domestic law lacks the anti-avoidance rules or principles necessary to properly address such strategy.

9.6 Treaty Shopping

The United States has been a longstanding world leader in the development of limitation on benefits rules to prevent the inappropriate use of bilateral tax treaties by residents of third countries, known as "treaty shopping."

9.6.1 The Nature of Treaty Shopping

Treaty shopping refers to the use of a treaty by persons who might not ordinarily come within its scope to avoid taxes. The objective is to mitigate and under certain instances to annihilate the taxation otherwise due.

The OECD recognizes that the existence and extension of double tax treaties has given rise to artificial legal constructions (i.e. conduits) aimed at securing the benefits under tax treaties. Like with the abuse of tax treaty, the OECD identifies two ways in which contracting states can address the issue of treaty shopping:

1. States may take the position that an abuse of the provisions of a treaty could also be characterized as an abuse of the provisions of domestic law. If so, the states must then determine whether the provisions of the applicable tax conventions operate to prevent the application of any anti-avoidance rules in domestic law.
2. Alternatively, states may take the position that treaty shopping is an abuse of a treaty in itself, as opposed to an abuse of domestic law, and that a proper interpretation of taxing conventions allows States to disregard abusive transactions.

The OECD commentaries recognize two possible approaches to dealing with a potential abuse: (i) one approach would be to consider the abuse of the treaty provisions as an abuse of the treaty itself and to disregard

abusive transactions under a proper interpretation of the relevant treaty provisions taking into account the context, the object and the purpose of the overall treaty, as well as the obligation to interpret treaty provisions in good faith. (ii) Another approach consists of relying upon domestic anti-abuse rules or principles to combat treaty abuse. However, in order for an anti-abuse domestic provision to be effective, it must respect the primacy of tax treaties, and not lead to a result that may override unilaterally the obligations imposed by such a tax treaty. The OECD Model Convention uses the concept of "beneficial owner' as the benchmark for treaty benefit recognition. However, the OECD Model Convention does not define "beneficial ownership" or "beneficial owner," but merely attempts to describe its character. In common law countries, the concept of "beneficial rights" derives from trust law. Trust law allows for the division of property interests into legal and beneficial interests. The law allocates equitable rights to the beneficiary and legal rights to the trustee, who holds title to the trust property. Strictly speaking, the beneficiary does not own trust property. He merely has the right to enforce the terms of the trust – which may provide that the beneficiary acquires ultimate ownership of the trust property.

The OECD states, as a principle:

> The potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy. Also, this will be necessary where a state which adopts the view described in paragraph 9.2 (of the Commentaries) believes that its domestic law lacks the anti-avoidance rules or principles necessary to properly address such strategy.

9.6.2 Features of Treaty Shopping

Treaty shopping typically involves three features:

- The beneficial owner of the entity used to treaty shop does not reside in the country (T) where the entity is created;

- The conduit entity has minimal presence or economic activity in the country (T) in which it is located; and
- The income is subject to minimal (if any) tax in the country of the conduit holding company (T).

One particular form of treaty shopping consists of the intermediation of a conduit entity.

9.6.3 The US Approach to Treaty Shopping

The US commitment to including comprehensive "limitation on benefits" provisions is one of the keys to improving its overall treaty network. US tax treaties are intended to provide benefits to residents of the United States and residents of the particular treaty partner on a reciprocal basis. The reductions in source-country taxes agreed to in a particular treaty mean that US persons pay less tax to that country on income from their investments there, and residents of that country pay less US tax on income from their investments in the United States. Those reductions and benefits are not intended to flow to residents of a third country. If third-country residents are able to exploit US tax treaties to secure reductions in US tax, such as through the use of an entity resident in a treaty country that merely holds passive US assets, the benefits would flow only in one direction. That is, if third-country residents enjoy US tax reductions for their US investments, US residents would not enjoy reciprocal tax reductions for their investments in that third country. Moreover, such third-country residents may be securing benefits that are not appropriate in the context of the interaction between their home countries' tax systems and policies and those of the United States. However, this use of tax treaties is seen as not consistent with the balance of the deal negotiated in the underlying tax treaty. Preventing this exploitation of US tax treaties is critical to ensuring that the third country will negotiate on a reciprocal basis so that the US can secure the benefits of reductions in source-country tax on their investments in that country. Effective anti-treaty shopping rules also ensure that the benefits of a US tax treaty are not enjoyed by residents of countries with which the United States does not have a bilateral tax treaty because that country imposes little or no tax, and thus the potential of unrelieved double taxation is low.

9.6.4 Interposition of Conduit Entities

In 1993, Congress added Section 7701(l) to the Code. This provision authorizes the Treasury Department to prescribe regulations re-characterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where theTreasury Department determines that such re-characterization is appropriate to prevent avoidance of any tax imposed by the Code. In 1995, the Treasury Department acted on this grant of authority and promulgated Treasury Regulations Section 1.881-3.

For purposes of that regulation, a financing arrangement is a series of transactions by which one person (the financing entity) advances money or other property and another person (the financed entity) receives money or other property, provided that the advance and receipt are effected through one or more other persons (the intermediate entities). An intermediate entity will be considered a conduit, and its participation in the financing arrangement may be disregarded by the IRS, if three conditions are satisfied:

1. The participation of the intermediate entity reduces the tax imposed by Section 881 of the Code;
2. The participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan; and
3. Either the intermediate entity is related to the financing entity or the financed entity, or the intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transactions with the intermediate entity. If the participation of an intermediate entity is disregarded, then the transaction is re-characterized both for Code and treaty purposes as a transaction directly between the remaining parties to the financing arrangement (normally, the financing and the financed entities). Despite the Treasury Department's protestations to the contrary, these conduit financing regulations are viewed by commentators as potentially overriding income tax treaty obligations.

9.6.5 Hybrid Entities

In 1997, Congress enacted Section 894(c) of the Code to prevent treaty abuse through the use of hybrid entities (i.e., entities that are treated as fiscally transparent under the tax laws of one contracting state but not under

the tax laws of the other contracting state). IRC Section 894(c)(1) denies treaty benefits to an item of income derived by a foreign person through an entity that is treated as fiscally transparent for purposes of the Code if:

1. The item is not treated as an item of income of the foreign person under the tax laws of the treaty partner;
2. the treaty does not address its application to items of income derived through fiscally transparent entities; and
3. The treaty partner does not impose tax on a distribution of the item of income from the entity to the foreign person.

IRC Section 894(c)(2) authorizes the Treasury Department to promulgate regulations addressing the availability of treaty benefits to arrangements involving hybrid entities that are not covered by Section 894(c)(1). The Treasury Department has now promulgated regulations addressing the availability of treaty benefits to arrangements involving both hybrid and reverse hybrid entities. Commentators have argued that both Section 894(c)(1) and the regulations promulgated under Section 894(c)(2) may potentially override income tax treaties.

9.7 Use of US Judicial Doctrines to Combat Treaty Shopping

To prevent perceived abuses, the US courts have applied domestic judicial doctrines (e.g., step transaction, substance over form, and business purpose) when interpreting tax treaties.

Below are the legal and tax discussions of a few selected cases.

9.7.1 The SDI Netherlands

In *SDI Netherlands*, for example, SDI Netherlands acquired non-exclusive worldwide rights to software from SDI Bermuda for use on IBM mainframe computers.

SDI Netherlands agreed to pay 93 % of the net amount (after deduction of withholding tax) of all royalties that it received from sub-licensees to SDI Bermuda. SDI Netherlands in turn granted exclusive sub-licenses of the software to SDI US, its wholly owned subsidiary. SDI US paid gross royalties to SDI Netherlands without withholding tax under Article 13 of the US–Netherlands Treaty, which, in part, read as follows:

1. Royalties arising in one of the States and beneficially owned by a resident of the other State shall be taxable *only* in that other State.
2. The term "royalties" as used in this Convention means payments of any kind received as a consideration for the *use of, or the right to use*, any copyright of literary, artistic, or scientific work (but not including motion pictures or works on film, tape or other means of reproduction used for radio or television broadcasting), any patent, trademark, trade name, brand name, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience. The term "royalties" also includes gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof.
3. The provisions of paragraph 1 shall *not* apply *if the beneficial own*er of the royalties, being a resident of one of the States, carries on business in the other State, in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the royalties are attributable to such permanent establishment or fixed base. ("In such case the provisions of Article 7 Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply".

The article is based on the OECD Model, which grants the residence country exclusive taxing jurisdiction over royalties. The central issue was whether SDI Bermuda derived royalties from US sources:

- Did the US royalties retain their character as US-source income and flow through to SDI Bermuda?
- Was SDI Netherlands merely a conduit company as in *Aiken Industries*?
- Did the US royalties merge with other royalties and lose their identity as US-source income?

The Internal Revenue Service (IRS) maintained that the royalties retained their character as US-source royalties as they flowed through the Netherlands corporation and, as such, were liable to US withholding taxes. The court held that royalties to the Bermuda company did not derive from the USA and, therefore, there was no withholding required. SDI Netherlands was a valid foreign corporation. The arrangements between the affiliated corporations were valid. SDI Netherlands was not a conduit or agent of the Bermuda company. The Bermuda company was not the beneficial owner of the royalties so as to negate the treaty.

9.7.2 The Indofood Case

The facts of Indofood are as follows (as summarized in the Prevost Car Inc. case[9]):

- An Indonesian company, Indofood (Parent), set up a Mauritian special purpose vehicle (Issuer) to issue loan notes. Back-to-back loans were put in place. The loan notes contained a gross-up clause and provided for early redemption in case that, due to tax or treaty changes, the Issuer had to pay additional tax. The notes also contained a clause requiring the Issuer to try to mitigate any additional tax liability by "taking reasonable measures available to it" before seeking to redeem the notes. The financing was structured via Mauritius to avail of the beneficial withholding tax rates under the Indonesia–Mauritius Double Tax Treaty. Mauritius has no outbound withholding taxes.
- As a result of abuse of the treaty by conduit companies, Indonesia terminated its tax treaty with Mauritius, effective from January 1, 2005, thus increasing to 20 % the withholding on the interest payments between the Parent and the Issuer. In other words, the gross-up, instead of being 10 % became 20 % under domestic Indonesian law. Since the issue of the notes in 2002, both interest and exchange rates had moved against the Parent and in favour of the noteholders. The Parent, therefore, sought to redeem the notes and refinance more cheaply. However, JP Morgan Chase (the Defendant) acting as trustee for the bondholders was not satisfied that the best endeavors clause had been complied with, alleged that Indofood could have interposed a Dutch entity (Newco) into their structure and availed of the preferable rates under the Netherlands–Indonesia Double Taxation Convention. Therefore, the Defendant refused to approve the redemption.
- The main substantive issue at trial was whether Newco would be the beneficial owner of the interest payable to it by the Parent for the purposes of the reduced withholding tax rate in Article 11 of the Indonesia-Netherlands Tax Convention.
- In the High Court [2005- EWCA 2103(Ch)] Justice Evans-Lombe found largely in favor of the Defendant and found that Newco would be the beneficial owner of the interest from the Parent. In particular, he noted:

It is clear that Newco, just as the Issuer, will not be a nominee or agent for any other party and, not being any sort of trustee or fiduciary, will have power to dispose of the interest when received as it wishes, although it will be constrained by its contractual obligation to the Issuer to apply the proceeds of the interest payments in performance of those obligations.

- Justice Evans-Lombe determined beneficial ownership by referring to the rights of creditors in the event of Newco's insolvency:

It is clear to me that in the absence of any trust or fiduciary relationship between Newco and the Issuer, in an insolvency of Newco undistributed interest received from the Parent Guarantor would be an asset of Newco for distribution amongst its creditors generally, including the Issuer, pari passu.

- Indofood appealed to the Court of Appeal, while, JPMorgan, cross-appealed on the point that had gone against them. The Court of Appeal found unanimously for Indofood, that the Issuer was not the beneficial owner and, if interposed, Newco could not be the beneficial owner of the interest received from the Parent for purposes of Article 11(2) of the Indonesia–Mauritius Tax Convention or the Indonesia–Netherlands Tax Convention.
- On the question of whether Newco would be the beneficial owner of the interest, Sir Andrew Morritt is the Chancellor of the High Court and Senior Judge of the Chancery Division said as follows:

The fact that neither the Issuer nor Newco was or would be a trustee, agent or nominee for the noteholders or anyone else in relation to the interest receivable from the Parent Guarantor is by no means conclusive. Nor is the absence of any entitlement of a noteholder to security over or right to call for the interest receivable from the Parent Guarantor. The passages from the OECD commentary and Professor Baker's observations thereon show that the term "beneficial owner" is to be given an international fiscal meaning not derived from the domestic laws of contracting states. "As shown by those commentaries and observations, the concept of beneficial ownership is incompatible with that of the formal owner who does not have the full privilege to directly benefit from the income".

- Judge Evans-Lome continued pursued:

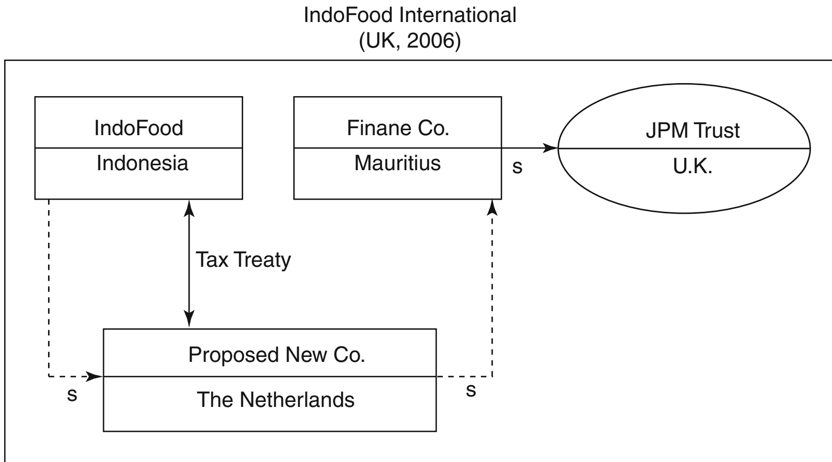

Fig. 9.1 Indofood International (UK, 2006)

> The legal, commercial and practical structure behind the loan notes is inconsistent with the concept that the Issuer or, if interposed, Newco could enjoy any such privilege. In accordance with the legal structure the Parent Guarantor is obliged to pay the interest two business days before the due date to the credit of an account nominated for the purpose by the Issuer. The Issuer is obliged to pay the interest due to the noteholders one business day before the due date to the account specified by the Principal Paying Agent. The Principal Paying Agent is bound to pay the noteholders on the due date.

– As Michael McGowan clearly summarized the case, the Court of Appeal found that Newco would not be the beneficial owner, for purposes of article 11 of the Dutch treaty, of the interest paid by Indofood on the loan originally existing between the Mauritian company and Indofood, if the Mauritian company transferred to Newco its rights under that loan. Newco would not be tax resident in the Netherlands, but rather in Indonesia, for the purposes of article 11 of the Dutch treaty. Therefore, interposing Newco would be ineffective in reducing Indonesian withholding tax. Therefore, the Mauritian company had provided sufficient evidence to establish that it was entitled to redeem the notes early, there being no reasonable mitigating measures available to avoid the increased Indonesian withholding tax (Fig. 9.1)[10].

9.7.3 The Prévost Car, Inc.

The facts of the case can be summarized as follows:

- Prévost Car Inc. was a Canadian corporation, incorporated under the laws of Quebec and is resident in Canada. It manufactures buses and related products in Quebec and has parts and services facilities throughout North America.
- On or about May 3, 1995 Prevost's erstwhile shareholders agreed to sell their shares of Prevost Car Inc. to Volvo Bus Corporation (Volvo), a resident of Sweden and Henlys Group PLC (Henlys), a resident of the United Kingdom.
- Volvo and Henlys were parties to a Shareholders' and Subscription Agreement under which Volvo undertook to incorporate a Netherlands resident company and subsequently transfer to the Dutch Company all the shares Volvo acquired in Prévost; the shares of the Netherlands company would be owned as to 51 % by Volvo and 49 % by Henlys. The transfer of Prévost shares to Henlys would take place after Henlys had secured funding for its share of the purchase.
- The Shareholders' Agreement also provided, among other things, that not less than 80 % of the profits of the appellant and PHB.V. and their subsidiaries, if any, (together called the Corporate Group) were to be distributed to the shareholders. Amounts were to be distributed by way of dividend, return of capital or loan. The distribution for a fiscal year was to be declared and paid to shareholders "as soon as practicable" after the end of the fiscal year.
- On or about June 12, 1995, the agreements of May 3, 1995 were carried out: Volvo transferred all the issued and outstanding shares in Prévost to PHB.V. Shares of PHB.V. were transferred by Volvo to Henlys so that the issued and outstanding shares of PHB.V. were owned by Volvo as to 51 % (51 Class "A" shares) and Henlys as to 49 % (49 Class "B" shares).
- The reason for choosing a Dutch holding company was very simple, according to Mr. Tore Backstrom was a Senior Vice-president for North and South America for Volvo Bus Operations. Tax was a consideration, but not an overriding consideration. The office of Arthur Anderson & Co. in Rotterdam had recommended that in order to avoid tax claims from the United Kingdom or Sweden, and other international tax issues, the effective management and control of PHB.V. be located in the Netherlands.

– On March 23, 1996 the shareholders met and agreed that a dividend representing 80 % of the retained earnings for the period June 7, 1995 to December 31, 1995 be paid by April 30, 1996.
– There were 11 payments made by Prévost Bank (Banque Nationale du Canada) to Citco Bank Netherlands (the bank of the Holding or PHB.V). Prévost Car Inc. withheld a tax prior to any payments under the less explicit Article 10, §2 the double tax treaty in force between Canada and the Netherlands, which did not explicitly defines the term "beneficial owner" included in the treaty.
– During the years in appeal, PHB.V. had no employees in the Netherlands nor does it appear it had any investments other than the shares in Prévost.
– The main issue at trial was whether the Dutch Holding was the "beneficial owner" of the so-paid dividends by Prévost Car Inc., or a mere conduit for Volvo and Henlys.
– The Court, after considering all the facts and circumstances, found that:

There is no evidence that PHB.V. was a conduit for Volvo and Henlys. It is true that PHB.V. had no physical office or employees in the Netherlands or elsewhere. It also mandated to Trent International Management PHB.V ("TIM") the transaction of its business as well for TIM to pay interim dividends on its behalf to Volvo and Henlys. However, there is no evidence that the dividends from Prévost were ab initio destined for Volvo and Henlys with PHB.V. as a funnel of flowing dividends from Prévost… For Volvo and Henlys to obtain dividends, the directors of PHB.V. had to declare interim dividends and subsequently shareholders had to approve the dividend. There was no predetermined or automatic flow of funds to Volvo and Henlys even though Henlys' representatives were trying to expedite the process.

– The Court found also that:

PHB.V. was a statutory entity carrying on business operations and corporate activity in accordance with the Dutch law under which it was constituted. PHB.V. was not party to the Shareholders' Agreement; neither Henlys nor Volvo could take action against PHB.V. for failure to follow the dividend policy described in the Shareholders' Agreement…That Article 24 of PHB.V.'s Deed of Incorporation does not obligate it to pay any dividend to its shareholders. PHB.V. was the registered owner of Prévost shares. It paid for the shares. It owned the shares for itself. When dividends are received by PHB.V. in respect of shares it owns, the dividends are the property of

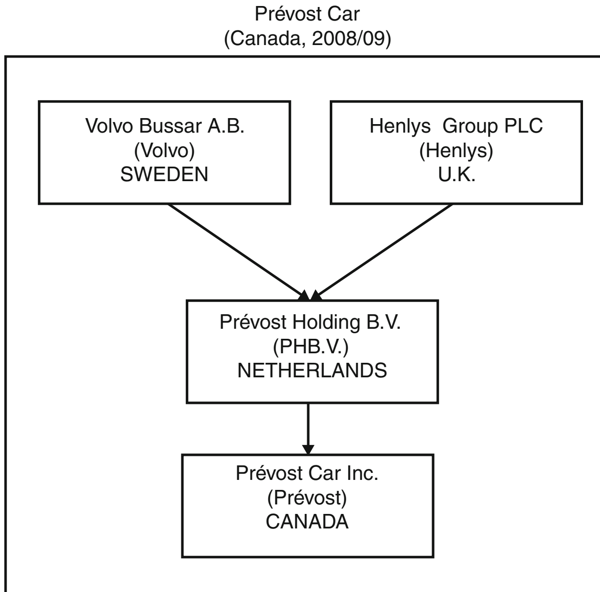

Fig. 9.2 Prévost Car (Canada, 2008/9)

PHB.V. Until such time as the management board declares an interim dividend and the dividend is approved by the shareholders, the monies represented by the dividend continue to be property of, and is owned solely by, PHB.V. The dividends are an asset of PHB.V. and are available to its creditors, if any. No other person other than PHB.V. has an interest in the dividends received from Prévost. PHB.V. can use the dividends as it wishes and is not accountable to its shareholders except by virtue of the laws of the Netherlands. Volvo and Henlys only obtain a right to dividends that are properly declared and paid by PHB.V. itself, notwithstanding that the payment of the dividend has been mandated to TIM.

– From the above, the Court found that Volvo and Henlys were not the beneficial owners of the dividends paid by Prévost Car Inc. (Fig. 9.2).

There is no clear international consensus on controlling treaty shopping and restricting treaty benefits.

Despite some early success in the United States, it became clear that countries can only control treaty shopping through specific and detailed

limitation of benefits provisions. That is the route that the US took and continues to press in its treaties.

9.8 The Non-discrimination Principle in Tax Treaty

9.8.1 The OECD Approach

Article 24, paragraph 1 of the OECD Model Treaty establishes the principle that for purposes of taxation discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a contracting state may not be less favourably treated in the other contracting state than nationals of the latter state in the same circumstances.

9.8.2 The US Approach

Article 24 of the US Model Convention of 2006 provides that:

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall also apply to persons who are not residents of one or both of the Contracting States. However, for the purposes of United States taxation, United States nationals who are subject to tax on a worldwide basis are not in the same circumstances as nationals of… who are not residents of the United States.
2. The taxation on a permanent establishment that an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.
3. The provisions of paragraphs 1 and 2 shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs, and reductions for taxation purposes on account of civil status or family responsibilities that it grants to its own residents.
4. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 11 (Interest), or paragraph 4 of

Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of a resident of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of the first-mentioned resident, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.
6. Nothing in this Article shall be construed as preventing either Contracting State from imposing a tax as described in paragraph 8 of Article 10 (Dividends).
7. The provisions of this Article shall, notwithstanding the provisions of Article 2 (Taxes Covered), apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof.

The US view on non-discrimination is somehow restricted as, for instance, the USA would not recognize any tax treaty discrimination based upon EU principles, such as freedom of establishment and the like.

9.8.3 The US Branch Profit Tax

In 1986, Congress enacted Section 884 of the Code, which imposes branch profits and branch-level interest taxes on foreign corporations. These taxes were enacted in an attempt to reduce the disparity in US income tax treatment of foreign corporations that conduct businesses in the United States through branches or through domestic subsidiaries. To prevent foreign corporations from engaging in treaty shopping to lower or eliminate branch taxes, Congress included in Section 884 a statutory limitation on taxpayers' ability to rely on a treaty to reduce the rate of these taxes. A foreign

corporation may rely on a treaty to reduce the rate of the branch taxes only if it is otherwise eligible for the benefits of the treaty and either (1) the foreign corporation is a qualified resident of the treaty partner or (2) the limitation on benefits article of the treaty entered into force after 1986.

A foreign corporation is a qualified resident only if:

1. It meets a stock ownership and a base erosion test;
2. It is publicly traded (or, subject to certain limitations, is the subsidiary of a publicly traded corporation);
3. It meets an active trade or business test; or
4. It obtains a ruling from the Service.

Under the latest-in-time doctrine, this statutory limitation on obtaining treaty benefits overrides the provisions of older treaties that lower or eliminate branch taxes, if the treaties either lack a limitation on benefits article or have a limitation on benefits article that is less restrictive than the qualified resident rules of the Code and regulations. Unfortunately, all the recent tax treaties entered into by the USA contain or have obtained recognition of the US Branch Profit Tax (i.e., US–Chile Treaty).

9.9 The Exchange of Information

Article 26 of the US Model Convention provides that:

1. The competent authorities of the Contracting States shall exchange such information as may be relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes of every kind imposed by a Contracting State to the extent that the taxation thereunder is not contrary to the Convention, including information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, such taxes. The exchange of information is not restricted by paragraph 1 of Article 1 (General Scope) or Article 2 (Taxes Covered).
2. Any information received under this Article by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in

relation to, the taxes referred to above, or the oversight of such functions. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

3. In no case shall the provisions of the preceding paragraphs be construed so as to impose on a Contracting State the obligation:

   a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
   b) to supply information that is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
   c) to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitation be construed to permit a Contracting State to decline to supply information because it has no domestic interest in such information.
5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information requested by the other Contracting State because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.
6. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings).
7. Each of the Contracting States shall endeavor to collect on behalf of the other Contracting State such amounts as may be necessary to

ensure that relief granted by the Convention from taxation imposed by that other State does not inure to the benefit of persons not entitled thereto. This paragraph shall not impose upon either of the Contracting States the obligation to carry out administrative measures that would be contrary to its sovereignty, security, or public policy.

8. The requested State shall allow representatives of the requesting State to enter the requested State to interview individuals and examine books and records with the consent of the persons subject to examination.

The competent authorities of the contracting states may develop an agreement upon the mode of application of this article, including agreement to ensure comparable levels of assistance to each of the contracting states, but in no case will the lack of such agreement relieve a contracting state of its obligations under this article.

The US Treasury is taking a step forward to ensure that it has all information it needs from any contracting state, regardless of the treaty provisions. This is done through amendments of the pre-existing tax treaty or by including a specific paragraph which allows the Treasury to request and obtain information far behind treaty obligations. For instance, the proposed protocol between the USA and Switzerland replaces the existing treaty's information exchange provisions with updated rules that are consistent with current US tax treaty practice and the current international standards for exchange of information. The proposed protocol allows the tax authorities of each country to exchange information that may be relevant to carrying out the provisions of the agreement or the domestic tax laws of either country, including information that would otherwise be protected by the bank secrecy laws of either country. The proposed protocol allows the United States to obtain information from Switzerland whether or not Switzerland needs the information for its own tax purposes, and provides that requests for information cannot be declined solely because the information is held by a bank or other financial institution.

The proposed protocol amends a paragraph of the existing protocol to the existing treaty by incorporating procedural rules to govern requests for information and an agreement between the United States and Switzerland that such procedural rules are to be interpreted in order not to frustrate effective exchange of information.

The proposed protocol and related agreement effected by exchange of notes update the provisions of the existing treaty with respect to the mutual agreement procedure by incorporating mandatory arbitration of

certain cases that the competent authorities of the United States and Switzerland have been unable to resolve after a reasonable period of time.

Finally, the proposed protocol updates the provisions of the existing treaty to provide that individual retirement accounts are eligible for the benefits afforded a pension under the existing treaty. The proposed protocol amends the Multilateral Convention by providing that a request for assistance is adequate even if the name of the person(s) under examination is not known, provided that the request contains sufficient information to identify the person or ascertainable group or category of persons.

9.10 Mutual Agreement Procedure

Taxpayers may request the assistance of the US Competent Authority for relief from double taxation by means of a dispute-resolution process called the Mutual Agreement Procedure (MAP).[11] In a MAP, the competent authorities of the United States and the treaty partner meet to seek mutual agreement concerning difficulties or doubts concerning the interpretation or application of a tax treaty. The competent authority shall act in good faith to attempt to arrive at a satisfactory position in accordance with the Treaty. Because a MAP involves a negotiation between treaty partners, the final outcome is uncertain. The US Competent Authority has pursued with US treaty partners various means to reduce the overall backlog of cases and the number of cases that cannot be resolved in a manner that eliminates double taxation. For example, in 2004, the US Competent Authority entered into a Memorandum of Understanding with the Canadian Competent Authority to resolve factual disputes that prevent resolution of pending MAPs between the two countries.

9.11 Conclusion

There is no clear international consensus on controlling treaty shopping and restricting treaty benefits. The US approach to tax treaty is creative and aims to enhance the pre-existing consensus among OECD partners. Through the LOB (Limitations on Benefits), GAAR (General Anti-Abuse Rule) treaty shopping provisions, and more recently an extended obligation under exchange of information rulings, the USA has served to shake the OECD from its lethargy and enhance the debate.

Notes

1. Klaus Vogel (1986): Double Tax Treaties and their Interpretation, Berkeley Journal of International Law, pp. 4–6.
2. Klaus Vogel (1986): Double Tax Treaties and their Interpretation, Berkeley Journal of International Law, pp. 4–6.
3. IMF (2013): World Economic and Financial Surveys – Fiscal Monitor (October 13), p. 33.
4. Opening Statement of Robert B. Stack Treasury Deputy Assistant Secretary (International Tax Affairs): Senate Committee on Foreign Relations February 26, 2014, p. 17.
5. Opening Statement of Robert B. Stack Treasury Deputy Assistant Secretary (International Tax Affairs): Senate Committee on Foreign Relations February 26, 2014, pp. 2–3.
6. Boris I. Bittker, and Lawrence Lokken (2004): Fundamentals of International Taxation, Warren, Gorham, & Lamont, pp. 65–55.
7. National Westminster Bank, PLC v. United States 44 Fed. Cl. 120 (1999), appeal denied, 232 F. 3d 906 (Fed. Cir. 2000).
8. These include the concept of "beneficial owner" the "special relationship" rule applicable to interest, the rule on alienation of shares of immovable property companies , and the rule on "star-companies."
9. Prevost Car Inc. v. The Queen, 2008 TCC 231 (CanLII).
10. Michel McGowan (2006): Indofood Court Expands Interpretation of Beneficial Ownership, Tax Notes International, Volume 42, Number 13, p. 1091.
11. Rev. Proc. 2006-54, 2006-49 I.R.B. 1035.

CHAPTER 10

Foreign Account Tax Compliance Act

10.1 Introduction

Enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act on March 18, 2010, the Foreign Account Tax Compliance Act (FATCA) imposes a 30 % withholding tax on payments to certain foreign financial institutions that fail to enter into agreement with the Internal Revenue Service (IRS) to provide information on US account holders. FATCA sets forth an information reporting regime intended to curb evasion of US taxes by identifying US persons holding assets through offshore entities and accounts. In essence, FATCA aims to lift the opaque veil of privacy in the banking/financial industry by compelling financial institutions to report, on behest of the US Treasury, all accounts that fall into its ambit. Withholding payments under FATCA include payments of interests, dividends, rents, royalties, as well as some gross proceeds. On January 17, 2013, the Treasury issued the final regulations for the implementation of IRC sections 1471 through 1474 (FATCA rules). The 543- page regulation provides clarifications upon most debated aspects of the FATCA Act.[1]

On July 15, 2014, the Organisation for Economic Co-operation and Development (OECD) adopted a new 'Standard for Automatic Exchange of Financial Information in Tax Matters'. Under the Standard, jurisdictions obtain information from their financial institutions and automatically exchange that information with other jurisdictions on an annual basis. Further, the Standard provides rules as to the financial account information

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F.I. Lessambo, *International Aspects of the US Taxation System*,
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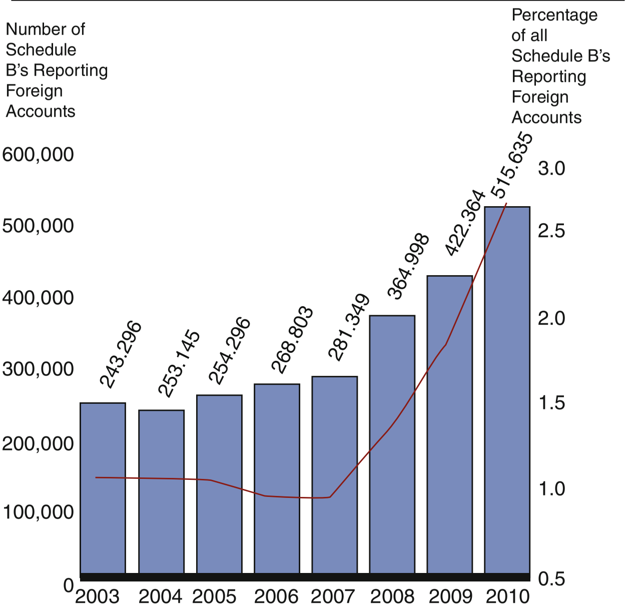
to be exchanged, the financial institutions that need to report, the different types of account and taxpayer covered, as well as common due diligence procedures to be followed by financial institutions (Fig. 10.1).

10.2 Financial Institutions Covered

Under the FATCA, a foreign financial institution (FFI) is generally a non-US entity that accepts deposits in the ordinary course of banking or similar business, holds financial assets for the accounts of others, or is engaged in the business of investing or trading financial instruments. An FFI can avoid withholding under FATCA by entering into an agreement with the IRS through an online registration (the Portal).

10.2.1 Investment Entities

The primary concern of FATCA is its extraterritorial application to financial institutions that are organized in a foreign jurisdiction. Thus, the definition of a financial institution is critical. Many comments were provided to the IRS regarding the different categories of entities classified as financial institutions, given the importance of the definition to potential stakeholders. One of the broadest categories of financial institution is an investment entity. An important change was made to that definition in the final regulations. This change made the definition more consistent with the analogous definition of investment entity in the intergovernmental agreements (IGAs). In the IGAs, an investment entity is defined broadly as any entity that conducts business (or is managed by an entity that conducts business) in (i) trading in money market instruments; foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading; (ii) individual and collective portfolio management; or (iii) otherwise investing, administering or managing funds or money on behalf of other persons. These activities must be "for or on behalf of a customer." The proposed regulations also contained a broad definition (with slightly different language, although directed towards the same activities), but without the requirement that the activities be "for or on behalf of a customer." The final regulations make a welcome change by following the approach in the IGAs and requiring that activities be performed on behalf of customers, and also adopting definitional language mirroring the IGAs. This new definition, however, leaves open the possibility that private equity and hedge fund managers, in addition to their funds, are considered financial institutions.



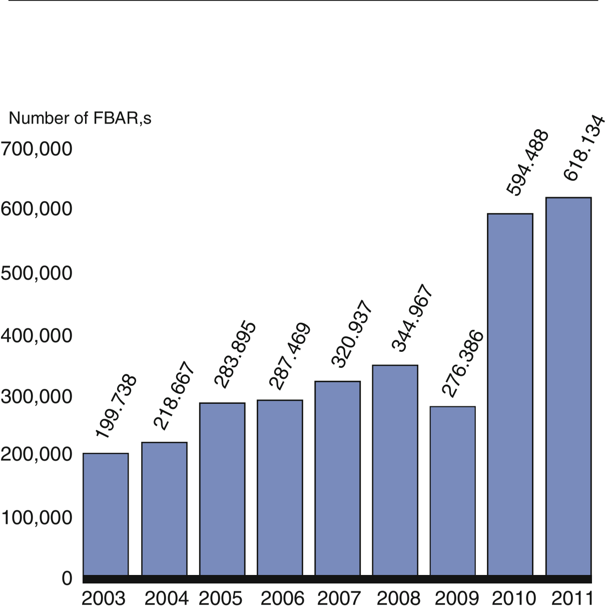


Fig. 10.1 Form 1040 Schedule B Line 7a

In addition, the final regulations narrow the investment entity definition further by treating an entity (other than an entity that primarily conducts as a business on behalf of customers) the gross income of which is primarily attributable to investing, reinvesting or trading as an investment entity only if the entity is managed by a depository institution, a custodial institution, another investment entity, or an insurance company that qualifies as a financial institution. This narrower definition precludes many passive entities that are not professionally managed from being treated as financial institutions. However, private equity funds, mutual funds, hedge funds, and similar managed funds are investment entities.

The IGA definition of an investment entity also differs from the definition in the final regulations, in that the IGA interprets the definition in a manner consistent with similar language set forth in the definition of financial institution in the Financial Action Task Force (FATF) recommendations. This may cause additional entities to be treated as investment entities under the final regulations that would not otherwise be treated as investment entities under an IGA (such as managed passive investment companies).

The final regulations also provide additional interpretive guidance as to the definition of an investment entity. Significantly, the final regulations provide that an entity is treated as "primarily attributable" to investing, reinvesting or trading in financial assets if the entity's gross income attributable to those activities equals or exceeds 50 % of the entity's gross income during the three-year period ending the year preceding the year of the determination, or the period during which the entity has been in existence. The IGAs do not contain a similar definitional clarification.

While the final regulations contain additional clarifications using similar objective tests, it may be necessary for additional guidance to be provided to operate the tests. For example, no guidance is provided in the case of an entity that has disregarded subsidiaries in jurisdictions with an IGA. In this case, the disregarded subsidiary could be an FFI under the IGA definition (as a disregarded entity appears to be regarded as an entity under the IGA definition as noted above), but it is unclear whether that disregarded subsidiary's income would be counted in any objective test to determine whether the parent is an FFI.

An additional peculiarity in the final regulations may affect private equity funds and hedge funds. The first example of an investment entity in the final regulations involves an investment advisor. The example begins by noting that the fund manager is an investment entity, but that the

fund manager hires an investment advisor to provide advice about the financial assets in which the fund invests. Because the investment advisor earns more than 50 % of its gross income from the preceding three years from providing services as an investment advisor (and, therefore, primarily conducts business providing investment advice on behalf of clients), the investment advisor is an FFI. Depending on how this example is interpreted, multinational private equity and hedge fund sponsors may be subject to duplicative and unnecessary reporting (although this may be alleviated by certain entities in the multinational group being treated as sponsored FFIs).

10.2.2 Depository Institutions

More limited changes were made to the definition of depository institution, another category of financial institution. The final regulations clarify that accepting deposits is necessary, but not sufficient by itself in order for an entity to be defined as a depository institution. The entity must also engage in additional banking and financing activities (the activities are drawn from the definitions of active banking or financing activities under the sourcing and subpart F rules). These activities also must be performed on a regular basis.

The definition of a depository institution was further narrowed to address concerns of the remittance industry, as remittances are not typically used to avoid US taxes. The final regulations provide that merely completing money transfers by instructing agents to transmit funds is not in a banking or similar business, as this is not treated as accepting deposits or other similar temporary investment of funds. Similarly, finance companies that do not fund their operations through deposits, entities acting as networks for credit card banks that hold cash collateral, and entities that solely accept deposits from persons as collateral or security pursuant to a lease, loan or similar financing arrangement are not depository institutions.

However, some financial institutions are exempt from FATCA application.

10.2.3 Exceptions to FFI Status

Like proposed regulations, final regulations provide exceptions to FFI status for holding companies, treasury centers and captive finance companies

that are part of a non-financial group (unless availed of by private equity funds or similar entities). Entities that qualify for an exception are instead treated as excepted non-financial foreign entities (NFFEs). The final regulations contain significantly more detailed exceptions than the proposed regulations, in particular with respect to holding companies, captive financing and treasury centers. These changes were necessary given the refinements to the definition of an investment entity discussed above (pursuant to which an entity is only an investment entity if managed by a depository institution, a custodial institution, another investment entity or an insurance company that qualifies as a financial institution), to ensure that holding companies and treasury centers cannot be used by financial groups with non-participating FFIs or limited FFIs to shelter payments from FATCA withholding. While the new exceptions are arguably more complex than the analogous definitions in the proposed regulations, the overall change is welcome for non-financial groups that would have been treated as owning FFIs under the Proposed Regulations.

10.2.4 Deemed-Compliant FFI Status

Certain categories of FFI are deemed to comply with FATCA and thus are not required to enter into an FFI agreement to avoid withholding under FATCA. There are three types of deemed-compliant FFI that are not required to enter into an FFI agreement and are not subject to the rigorous reporting requirements of FATCA: (1) registered deemed-compliant FFI (which must be registered with the IRS); and (2) certified deemed-compliant FFIs (which need only to certify their status to withholding agents on Form(s) W-8); and (3) owner documented FFIs.

The final regulations generally retain the same deemed-compliant categories as proposed regulations, but also add categories of deemed-compliant FFIs for certain credit card issuers, sponsored FFIs and limited-life debt investment entities. The final regulations also simplify some of the categories of the deemed-compliant status by, for example, treating non-profits as exempt from FFI status and instead, treating all non-profits as excepted NFFEs. Few other changes were made, and it appears that Treasury and the IRS will address additional deemed-compliant FFIs on a jurisdiction-by-jurisdiction basis through IGAs.

The final regulations retain the entities that qualify as local FFIs (which can qualify as registered deemed-compliant FFIs), but also expand this category to include insurance companies, credit unions, and investment

entities. In addition, local FFIs are permitted to have a place of business outside of the country or organization, provided that the location is not publicly advertised and provides only back-office functions. Otherwise, the local FFI category is limited to FFIs whose activities are limited to a single country. In addition, final regulations allow local FFIs to advertise US dollar accounts, so long as the FFI does not solicit customers outside its country of incorporation. The final regulations provide specific guidance as to the types of advertising permitted by local FFIs.

Under the proposed regulations, certain foreign retirement plans or pension funds were treated as deemed-compliant FFIs if they met certain requirements and were otherwise treated as exempt beneficial owners (a classification of NFFE for which no withholding is required, which includes entities such as foreign governments, foreign central banks and other entities where there is a low risk of tax evasion). Under the final regulations, this category has been eliminated. Instead, qualified foreign retirement plans and pension funds are all treated as exempt beneficial owners.

- Sponsored FFIs

The final regulations add a new category of sponsored FFI. A sponsored FFI is an investment entity that has a contractual arrangement with a sponsoring FFI. This category allows a fund manager or trustee to enroll as a "sponsor" for its funds (that are also treated as FFIs). The sponsor is required to perform the due diligence and reporting for all of the FFIs that it sponsors. The sponsored FFI is treated as certified deemed-compliant and is not required to enter into its own FFI agreement. This change was especially important for the private equity and hedge fund industry and also could be advantageous for professionally managed trust groups.

- Owner-documented FFIs

This category of FFI is available only to investment entities. An investment entity that qualifies as an owner-documented FFI (i) avoids FATCA withholding tax only with respect to payments from a withholding agent that is either a US financial institution or a participating FFI; and (ii) agrees to collect and report to the withholding agent (and the agent agrees to report to the IRS) certain information with respect to the owner-documented FFI's equity holders. Under the proposed regulations,

owner-documented FFIs could not issue non-regularly traded debt interests in excess of $50,000. The final regulations remove this prohibition, provided that the owner-documented FFI reports all individuals and specified US persons that directly or indirectly hold the debt interests

10.3 Intergovernmental Agreements

IGAs aim to gather the same information as is required from FFIs under the final regulations, while solving local law conflicts. Some have argued that IGAs are likely to be the primary approach to FATCA implementation for a variety of reasons. There may be certain privacy or banking secrecy requirements under foreign law that prevent an FFI from reporting to the IRS, making it a violation of foreign law to comply with FATCA. Thus, IGAs are often necessary to overcome the foreign legal impediments to FATCA implementation. To date Treasury has already concluded or initiated eight IGAs with the United Kingdom, Mexico, Denmark, Ireland, Norway, Switzerland, and Spain and these will soon be signed. Treasury also has announced that it is in negotiations with more than 50 countries to conclude IGAs.

There are two types of IGA: (1) the Model 1 IGA published on July 26, 2012, allows reporting to the foreign government, followed by automatic information exchange with the IRS; and (2) the Model 2 IGA published on November 14, 2012, which allows for reporting directly to the IRS. There is a reciprocal and non-reciprocal version of the Model 1 IGA. On February 14, 2013, Switzerland became the first country to enter into Model 2 IGA with the USA. The reciprocal Model 1 IGA is available only to jurisdictions with which the United States has an income tax treaty or information exchange agreement, as it provides for reciprocal information sharing by the United States. The non-reciprocal version does not require the United States to provide information on US accounts and only requires the foreign jurisdiction to provide information to the United States. The Model 2 IGA requires the foreign jurisdiction to direct and enable FFIs located in the jurisdiction that are not otherwise excepted or exempt to register with the IRS and report specific information about US accounts directly to the IRS in a manner consistent with the final regulations.

The IGAs were released subsequent to the proposed regulations, and there were numerous coordination issues between them. The final regulations resolve a number of these issues and attempt to coordinate with future IGAs.

The final regulations provide that an FFI in a jurisdiction with a Model 1 IGA is a registered deemed compliant FFI if it is compliant with local require-

ments. Thus, these FFIs may not need to follow certain aspects of the final regulations and instead are subject to local law requirements. In some cases, however, the laws of the partner jurisdiction may allow the resident FFI to elect to apply the final regulations rather than local law. While FFIs are not required to register for a GIIN (Global Intermediary Identification Number) under the Model 1 IGA, the IRS has indicated that it may seek for FFIs in Model 1 jurisdictions to register for a GIIN. In addition, for payments made prior to January 1, 2015, a withholding agent may treat the payee as a resident in a Model 1 IGA country if it receives a withholding certificate from the payee, indicating that the payee is a reporting FFI and the FATCA partner country in which the payee is treated as a reporting FFI. FFIs in Model 2 jurisdictions are required to implement FATCA, except that the final regulations allow for an FFI in a Model 2 jurisdiction to be treated as a registered deemed compliant FFI if the Model 2 IGA so provides.

Under the final regulations, entities are classified based on their classification for US federal tax purposes, meaning that accounts held by disregarded entities are treated as held by the owner of the disregarded entity rather than by the disregarded entity itself. In contrast, the IGA definition of an "entity" is any legal person or legal arrangement, which appears to include entities that are disregarded for US federal tax purposes (e.g., a limited company that has elected disregarded status). It is not clear under the final regulations how the regulatory withholding requirements apply to an entity that is disregarded for US federal tax purposes, but is treated as a regarded entity under an IGA. There also is limited guidance addressing FFIs that operate in multiple jurisdictions that do and do not have an IGA.

10.4 Grandfathered Transactions

FATCA provides that certain obligations are grandfathered and no withholding is required on such obligations. While the statute provides that withholding is not required on any payments relating to an obligation outstanding on March 18, 2012, Treasury and the IRS have already extended this deadline in the proposed regulations. The final regulations further extend this date, providing that debt obligations outstanding on or before January 1, 2014, are not subject to withholding. In addition, consistent with Announcement 2012-42, the final regulations provide that certain obligations that produce dividend equivalents (such as certain equity swaps) are grandfathered if the obligations are outstanding prior to six months after implementing regulations are published under Section 871(m). Consistent with the delayed effective date for withholding on

foreign pass-thru payments, grandfathering is also available for obligations outstanding prior to six months after implementing regulations providing guidance on foreign pass-thru payment withholding. A grandfathered obligation also includes any agreement requiring a secured party to make payments with respect to collateral securing one or more grandfathered obligations (even if the collateral is not itself a grandfathered obligation). It is important not to amend a grandfathered obligation (in a manner that would result in a material modification within the meaning of US realization rules) in order to prevent forfeiture of grandfathered status.

10.5 Documentation and Due Diligence

The final regulations provide some relief with respect to the documentation and due diligence requirements. Importantly, in response to numerous comments, the final regulations allow a withholding agent to rely on documentary evidence in lieu of a Form W-9 (essentially adopting the "eyeball test" from the standard Chap. 3 withholding documentation requirements). The proposed regulations contained a particularly burdensome requirement to collect new Forms W-8 during the due diligence process and to refresh that form every three years. The final regulations relax this requirement and provide that a withholding agent may rely upon pre-FATCA Form W-8 in lieu of obtaining an updated version of the withholding certificate in certain circumstances. Finally, the final regulations allow the use of substitute forms (such as internally prepared forms), as long as those forms contain the required information and a translated version (if the form is in a language other than English) of the form is provided to the IRS upon request. The substitute forms may be used for purposes of standard Chap. 3 withholding as well.

Consistent with the proposed regulations, once sufficient documentation is obtained, it is valid for three years. There is a new exception in the final regulations that permits documentation to remain valid indefinitely, subject to a change in circumstances, for certain payees where there is a low risk of tax evasion (such as certificates from a foreign individual in which there is no US address or phone number on file with the FFI, retirement funds, non-financial groups, certain charitable and non-profit organizations, certain public companies or foreign governments, among others).

Another helpful change made in the final regulations is a change in the definition of what accounts are treated as pre-existing accounts subject to the due diligence requirements. Under the final regulations,

an account that is later opened by a pre-existing account owner generally is also treated as pre-existing. This change eliminates the need for new account opening procedures to be put in place for certain existing account owners.

10.6 Reporting and Withholding

Numerous changes have been made to the timeline for withholding and reporting, as noted above. In response to comments, the final regulations also change some of the withholding and reporting requirements contained in the proposed regulations. A significant change is the addition of a consolidated compliance program. Under the final regulations an FFI (or US financial institution) may agree to establish and maintain a consolidated compliance program and perform a consolidated periodic review on behalf of one or more FFIs in the same expanded affiliated group, thereby becoming a "Compliance FI." The consolidated compliance group is not required to include every FFI in an expanded affiliated group (allowing flexibility, for example, if some members are in IGA jurisdictions and others are not). Similarly, as discussed above, the regulations add a category of Sponsored FFI. The sponsoring entity must act as the Compliance FFI for all Sponsored FFIs.

FATCA only requires withholding on certain withholdable payments. These generally include payments of interest, dividends, rents, royalties, and certain gross proceeds, among others. Certain payments are specifically excluded under the final regulations:

- Interest on certain short-term obligations;
- Income already taxable in the United States that is treated as effectively connected income;
- Non-financial payments for certain services, leases, licenses, transportation, awards, prizes, scholarships and interest on accounts payable; and
- Certain gross proceeds from the sale of property that produces income otherwise excluded in the above list.

Note

1. Examples of FFIs include hedged funds, private equity funds, and issuers of collateralized debt obligations.

CHAPTER 11

Taxation Regime of Expatriates and Corporate Inversion

11.1 Introduction

The expatriation of US citizens and long-term residents has become a challenging issue for the Internal Revenue Service (IRS). A great number of US citizens and long-term residents have given up or are relinquishing their residency status to cut ties with the IRS and the US taxing regime. On May 7, 2015, the US Treasury Department published its first quarter 2015 list of individuals who have relinquished their US citizenship. The 1335 published names is the highest quarterly figure ever reported in the Federal Register. The number of individuals voluntarily choosing to renounce their US citizenship continues to grow at record pace, presumably in response to measures put in place by Congress and the Treasury to crack down on offshore tax evasion and noncompliance. On the other hand, US incorporated corporations are finding means to continue doing business as usual in the USA by inverting their corporate charts: the US parent corporations then become a subsidiary of the foreign parents located in low-tax jurisdictions.

11.2 The Expatriation of Individual Residents

The expatriation of US citizens and long-term residents has accelerated within recent decades. Former provisions under Section 877 of the Internal Revenue Code (IRC) have become easily circumventable.

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The American Jobs Creation Act of 2004 (P.L. 108) (the Act)[1] has amended the provisions of IRC Section 877 and related provisions affecting the US taxation of US citizens and long-term residents who relinquish their citizenship or residence.[2] During the May 2008 Session, the House of Representatives and the Senate unanimously approved H.R. 6081, the "Heroes Earnings Assistance and Relief Tax Act of 2008" (the Heroes Act).[3] The Act adds IRC Sections 877A and 2801. These provisions of the Act are effective for expatriations on or after June 17, 2008, and gifts and bequests made on or after June 17, 2008. Prior law continues to apply to individuals and transfers not subject to the new rules.

US citizens and resident aliens are generally subject to US federal income tax on their worldwide income. Non-resident aliens are taxed at a flat rate on "fixed or determinable annual or periodic income" derived from US sources and at graduated rates on income "effectively connected" with the conduct of a US trade or business. Prior to the American Jobs Creation Act of 2004 (P.L. 108–357), former US citizens were subject to an expatriation tax on US-source income (more broadly defined than for non-resident aliens generally) at rates applicable to US citizens for the following ten taxable years, unless the loss of US citizenship did not have as one of its principal purposes the avoidance of US federal income, estate or gift taxes. The Health Insurance Portability and Accountability Act of 1996 (P.L. 104–191)[4] caused certain high income tax paying or high net worth individuals to be treated as automatically having tax-avoidance motives and so extended the expatriation rules to long-term US residents. The American Jobs Creation Act of 2004 eliminated the tax-avoidance purpose test and made the expatriation tax rules applicable only to certain high income tax paying or net worth individuals and to individuals failing to certify compliance with US federal income tax laws for the five taxable years preceding the taxable year of expatriation (Fig. 11.1).

11.2.1 Covered Expatriates

The Act continues prior law by applying the expatriation regime to former US citizens and former long-term residents (i) whose average annual net income tax for the five years ending before the date of expatriation or termination of residency is more than a specified amount that is adjusted for inflation ($147,000 for 2011, $151,000 for 2012, $155,000 for 2013 and $157,000 for 2014); (ii) whose net worth is $2 million or more on the date of their expatriation or termination of residency; (iii) who have failed to certify under penalty of perjury (Form 8854) that has complied

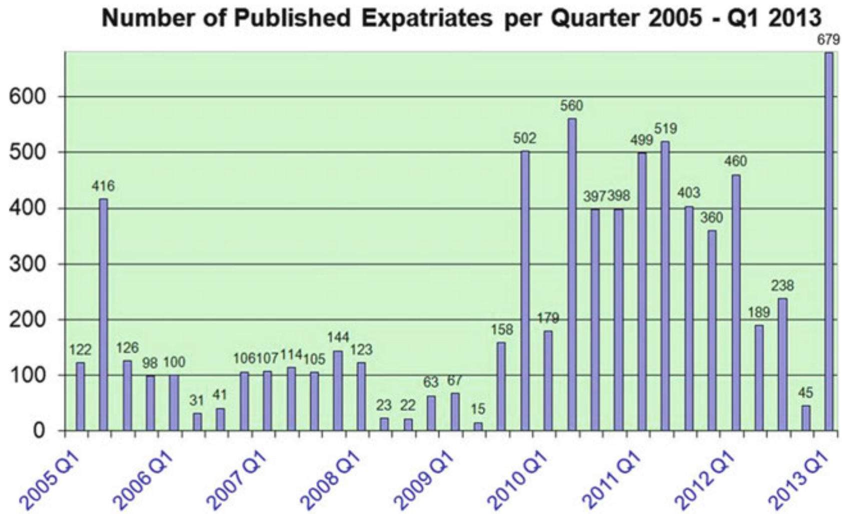

Fig. 11.1 Number of published expatriates

with all US federal tax obligations for the five years preceding the date of their expatriation or termination of residency.[5]

The Act retains the definition of long-term resident as any individual who has been a lawful permanent resident (i.e., green card holder) in at least eight out of the last 15 taxable years ending with the year in which the individual ceases to be a lawful permanent resident or commences to be treated as a resident of a foreign country under a tax treaty and does not waive the benefits of that treaty. An individual does not need to be a green card holder for a full eight years; holding a green card for any one day during a taxable year is sufficient for that year to count towards the eight-year threshold. On the other hand, if an individual is a resident in the United States during a taxable year, but is not a green card holder, that year will not count towards meeting the eight-year threshold for long-term residency.

11.2.2 *Timing of Expatriation*

Under the Act, an individual ceases to be a US citizen for US tax purposes upon relinquishment of his or her US citizenship, deemed to occur on the earliest of (i) the date the individual renounces US nationality before a diplomatic or consular officer of the United States (provided that the voluntary

relinquishment is later confirmed by the issuance of a certificate of loss of nationality), (ii) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of US nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality), (iii) the date that the State Department issues a certificate of loss of nationality and (iv) the date that a US court cancels a naturalized citizen's certificate of naturalization. Long-term residency continues to terminate when an individual loses his or her green card status through revocation or has been administratively or judicially determined to have abandoned such status, but now also terminates if an individual is treated as a resident of a foreign country having a tax treaty with the United States, does not waive the benefits of that treaty and notifies the IRS of such treatment.

11.2.3 US Taxing Regime

11.2.3.1 "Mark-to-Market" Regime

IRC Section 877A imposes a mark-to-market regime, which generally means that all property of a covered expatriate is deemed sold for its fair market value on the day before the expatriation date. Any gain arising from the deemed sale is taken into account for the tax year of the deemed sale notwithstanding any other provisions of the Code. Any loss from the deemed sale is taken into account for the tax year of the deemed sale to the extent otherwise provided in the Code, except that the wash sale rules of IRC Section 1091 do not apply.

This tax applies only to the extent that the net gain exceeds $600,000, adjusted for inflation. For calendar year 2014, the exclusion amount was $680,000.

For purposes of the mark-to-market tax, property held by an individual on the date such individual became a resident of the United States is considered to have a basis on that date of no less than the property's then fair market value unless an irrevocable election is made for the basis to be calculated under general US tax principals. Recall that gain is taken into account without regard to any other Code provisions; loss may be taken into account only as provided in the Code, except that the "wash sale" rules of Internal Revenue Code section 1091 do not apply .

However, the amount of any gain or loss subsequently realized (i.e., pursuant to the disposition of the property) will be adjusted for gain and

loss taken into account under the IRC Section 877A mark-to-market regime, without regard to the exclusion amount.

Under IRC Section 877A(b)(1) individuals may elect to defer payment of all or a portion of the mark-to-market tax until property is sold. This election is made with respect only to property identified by the taxpayer in the election and is irrevocable The amount of mark-to-market tax attributable to property is the same proportion of the total tax as the ratio of the property's gain subject to the tax bears to the total gain so subject. Interest accrues during the deferral period at the normal underpayment rate. Any deferred tax is generally due at the earlier of the due date of the return for the taxable year during which the property is disposed of or for the taxable year that includes the individual's death. To be eligible to make the election, an individual must furnish a bond or letter of credit to the IRS and must waive treaty rights that would preclude the assessment or collection of taxes.

11.2.3.2 Deferred Compensation and Specified Tax Deferred Accounts

Withholding requirements apply to deferred compensation of expatriates arising from both services performed in the United States and services performed while an individual was a citizen or resident of the United States. Deferred compensation will be considered "eligible" if the payor is a US person or non-US person that elects to be treated as a US person for purposes of withholding, and if the expatriate notifies the payor of his expatriate status and irrevocably waives a claim of withholding reduction under a tax treaty.

If the deferred compensation is eligible deferred compensation, the payor must deduct and withhold 30 % of the payment if that payment would be included in gross income had the expatriate been a US citizen or resident. The timing of the withholding is the same as if the expatriate were a US citizen or resident, and the income is also subject to tax under IRC Section 871. I.R.C.[6]

On the other hand, if deferred compensation is not eligible deferred compensation, the present value of the deferred compensation is treated as being received on the day before the expatriation date. Additionally, expatriation causes property transferred in connection with the performance of services to be treated as transferable and as ceasing to be subject to a risk of forfeiture on the day preceding the expiration date for purposes of IRC Section 83.

11.2.4 Dual Citizenships

An individual born with citizenship in both the United States and another country who relinquishes US citizenship is not subject to the expatriation regime if as of the expatriation date the individual continues to be a citizen of and taxable as a resident of such other country and has not been a resident of the US for more than ten of the 15 taxable years ending with the taxable year of expatriation. A US citizen relinquishing his or her US citizenship before age 18½ is not subject to the expatriation regime if the individual was a IRC Section 7701(b)(1)(A)(i)) for no more than ten taxable years before such relinquishment.[7] I.R.C. These exceptions do not apply to individuals who become subject to the expatriation regime because of a failure to certify compliance with US federal tax obligations.

If an expatriate holds an interest in specified tax deferred accounts (such as health savings accounts and certain IRAs) on the day before expatriation, the expatriate is treated as receiving a distribution of his entire interest on the day before expatriation, and that deemed distribution is taxed accordingly. With respect to both deferred compensation and specified tax deferred accounts, appropriate adjustments are made for subsequent distributions to take into account the earlier taxation. Additionally, early distribution taxes do not apply to the deemed distributions.

11.3 Nongrantor Trusts

Under existing law, a transfer of property by a US person to a foreign estate or trust is treated by the transferor as if the property had been sold to the estate or trust. This rule also applied if a domestic trust becomes a foreign trust. Under the Act, where a covered expatriate is the beneficiary of a nongrantor trust on the day before expatriation, upon any subsequent distribution from the trust, the trustee must deduct and withhold 30 % of the amount that would be includible in the gross income of an expatriate as if he or she was still a US citizen. This distribution is subject to tax under IRC Section 871, and the expatriate is treated as having waived any right to claim any reduction in withholding under a tax treaty. The Act's legislative history clarifies that a distribution includes an expatriate becoming the owner of trust property under the grantor trust rules. Additionally, if the trust distributes appreciated property to an expatriate, the trust must recognize gain as if the property were sold at its fair market value.

11.4 Additional Rules

Under the Act, when holding property for a minimum amount of time results in a reduction of recognized gain, such as with like-kind exchanges or involuntary conversions, the property will be deemed disposed of on the date an individual expatriates. Additionally, extensions of time for payment of taxes cease on the day an individual expatriates, and unpaid taxes become due upon expatriation. The Act's legislative history indicates that the information return requirements currently applicable to former US citizens and long-term residents under IRC Section 6039G continue to apply.

11.5 US Federal Estate and Gift Tax Provisions

Under the Act, a transfer tax is imposed on a US citizen or resident on any property acquired from a covered expatriate by bequest or gift. The transfer tax is assessed at the highest marginal estate or gift tax rate applicable at the time of the bequest or gift. However, the tax so imposed is reduced by the amount of any foreign estate or gift tax paid on the bequest or gift. Additionally, the gift tax annual exclusion applies, as do the rules for charitable donations and spousal transfers under the general estate and gift tax rules, and only those assets not included on a US federal estate or gift tax return will be assessed the transfer tax.

If a gift or bequest is made to a domestic trust, the tax applies as if the trust were a US citizen and the trust is required to pay the tax. If a gift or bequest is made to a foreign trust, the tax applies to any distribution from the trust to a US citizen or resident beneficiary; for income tax purposes, the beneficiary may deduct the amount of this tax to the extent that it was imposed on an amount also included in his or her gross income (I.R.C. § 2801(e)(4)(B)). A foreign trust may make an election to be treated as a domestic trust solely for purposes of these rules, but this election is generally irrevocable.

11.6 Corporate Inversion

With an effective corporate tax rate of 40 %, 35 % at federal level, and an average of 5 % at state level; and the ban on US-chartered corporations to filing a consolidated tax return including overseas subsidiaries, the "Inversion" is seen by many corporations as an efficient tax planning tool. Ingersoll-Rand Co. Ltd., Cooper Industries Inc., Tyco International Ltd, Stanley Works, have re-chartered in Bermuda.

Indeed, until recently, there were no barriers in the IRC against corporations becoming to chartered overseas, while remaining in the same business.

11.6.1 *The Corporate Inversion Phenomenon*

The corporate inversion masks a real problem. As changes to the international provisions of the US corporate tax code have ignored, in recent decades, the globalization trends of multinational corporations (MNCs), US-chartered corporations became creative in order to stay ahead of the worldwide competition.

For decades, many large US-based MNCs have expanded abroad to the point that they cannot be called "American" in any meaningful sense; while they still benefit from US subsidies and are bailed out of failure with US-taxpayers' funds.

The concept of "legal personhood" of a corporation is outdated. The concept came into existence in 1886 when large US companies were shifting their legal headquarters to Delaware, which molded its commercial law to be especially beneficial to management. Then, the United States Supreme Court granted legal personhood to corporations, thereby giving them equal rights with people. The new ways of doing business challenge our view of the so-called US-corporation.

A corporation as such is a social phenomenon, created under a particular legal system to serve a particular purpose. Corporate inversion can be seen to be legal:

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permit, cannot be doubted.

However, there were no clear rules with regard to the candidate of the US-chartered corporation moving abroad; until recently, the US Treasury Department encouraged this. The Homeland Security Act of 2002 and the American Job Creation Act of 2004 contain binding rules to crack down on the US corporate inversion.

11.6.2 *The Inversion Structures*

Inversion transactions can be structured through three main forms, with no real change being undertaken in the operational activities of the corporation. Of the three, the stock transaction is the most used.

11.6.2.1 The Stock Transaction

Under the stock transaction, the new foreign parent corporation acquires all the stock of the inverting corporation, and the US inverting corporation becomes a subsidiary of the new foreign parent corporation. The shareholders of a US parent corporation exchange their shares for those of the newly formed foreign corporation incorporated in a tax haven jurisdiction such as Bermuda or the Cayman Islands. Where the tax haven jurisdiction does not have an income tax treaty with the United States, the foreign parent corporation sets up a foreign subsidiary in a third-country that has an income tax treaty with the United States, such as Barbados or Luxemburg. Therefore, the income tax treaty usually eliminates withholding tax on the payment of royalties or interests from the United States to the treaty jurisdiction. Shareholders recognize taxable gains on their shares upon completion of stock inversion. However, they cannot recognize any loss.

11.6.2.2 The Asset Transaction

In an asset transaction inversion, tax is levied against the US Inverting corporation to the extent that the fair market value (FMV) of its assets exceeds its adjusted basis in those assets.

However, the resulting stock distribution is not taxable to shareholders as long as it conforms to the requirements of Section 368 of the IRC. The new foreign parent corporation exchanges its own stock for the assets of the US Inverting corporation; after which the US Inverting corporation is liquidated and the shares of the new foreign parent corporation are distributed to the shareholders of the US Inverting corporation. As opposed to the stock transaction inversion, shareholders in the asset transaction inversion do not recognize any gain thereto. The asset inversion transaction is a complete corporate restructuring that eliminates the former US parent and replaces it with the new foreign parent corporation.

11.6.2.3 The Drop-Down Transaction

The drop-down transaction is a mix of the two preceding transactions with a specific intent to achieve a top-level corporate structure. The first step of the transaction is structured in substantially the same way as an asset inversion. Then, comes the second step, which consists of the "drop-down," that is, the transfer of certain assets deemed received by the newly foreign corporation to a newly formed US subsidiary in exchange for the stock of the US new subsidiary.

11.6.3 Government Efforts to Combat Corporate Inversion

Tax planners attempting to go through corporate inversion must comply with the requirements of the two legal authorties or provisions.

11.6.3.1 The Homeland Security Act of 2002

The Homeland Security Act of 2002 prohibits the US Department of Homeland Security from contracting with corporate expatriates. The statute's effectiveness, however, is limited by a potentially far-reaching exception under Section 395(d), which allows a waiver of the prohibition if it is in the interest of national security. Therefore, the effectiveness of such legislation will depend on how much current and perspective expatriate corporations value those contracts and the tax savings they receive through expatriation. Of great significance is the American Jobs Creation Act.

11.6.3.2 The American Jobs Creation Act of 2004

The American Jobs Creation Act contains specific requirements with regard to the US inverting corporation and its shareholders.

1. Requirements with regard to the US inverting corporation

A new section 7874 of the IRC penalizes the inverting corporation by removing the tax benefit of the inversion for one class of re-incorporation transactions (80 % inversion), and increasing taxation on another class (60 % inversion).

In an 80 % inversion, the new parent corporation acquires, pursuant to a plan (or a series of related transactions), "substantially all of the properties held directly or indirectly" by a US inverting corporation; and where former shareholders of the US inverting corporation own at least 80 % of the new foreign parent's stock; and neither the new foreign parent corporation nor its 50 % subsidiaries have "substantial business activities" in the country or jurisdiction of incorporation.

For the purpose of the Jobs Act, the foreign parent corporation that results from an 80 % inversion will be treated as though still chartered in the United States. That is, it will be taxed on income earned worldwide.

J. Mitchell, one of the opponents of the provision labeled it "the dead Scott Tax Act", 6 by reference to the infamous Supreme Court decision in *Scott v. Sandford*, which said "

> slaves were still property even if they escaped to a free state."

The Jobs Creation Act imposes an additional tax on a new corporation resulting from 60 % inversion, where between 60 % and 80 % of the US inverting corporation's stock is owned by former US inverting shareholders. The "surrogate foreign corporation" is qualified as a foreign entity for tax purposes. However, such a foreign corporation remains subject to a full tax on any related inversion gain during the period beginning on the first date where properties are acquired as part of the inversion and ending ten years after the last date properties are so acquired. Under Section 7874(e)(1) of the IRC, accumulated tax benefits resulting from the transfer of assets and ownership can offset the tax due on the inversion gain. Furthermore, Section 7874(g) of the IRC requires the Secretary of Treasury to implement regulations to prevent avoidance. Section 7874(e)(4) of the IRC establishes the applicable statute of limitations notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment; and Section 7874 (f) removes any possibility of avoiding the consequences of the provision by means of pre-existing and future tax treaties.

2. The US inverting corporation shareholders

The Jobs Creation Act has added numerous provisions in the IRC: for example,

Section 4985 of the IRC imposes an additional excise tax liability, which is triggered if any shareholder recognizes a gain on the value of any stock of the corporation as a result of a corporation inversion.

11.6.4 Corporate Inversion Case Study

11.6.4.1 Ensco International

- Ensco is a provider of offshore drill rigs for oil companies that have rights to the underlying hydrocarbons.
  - Ensco had provided drill rigs in the UK portion of the North Sea for well over 20 years. It has significant assets, operations, cash flows, and employees in the UK.
  - Ensco management believed that it met the then requirement or the substantial business activity test under IRC Section 7874(a)(2)(B)(ii) (Fig. 11.2).

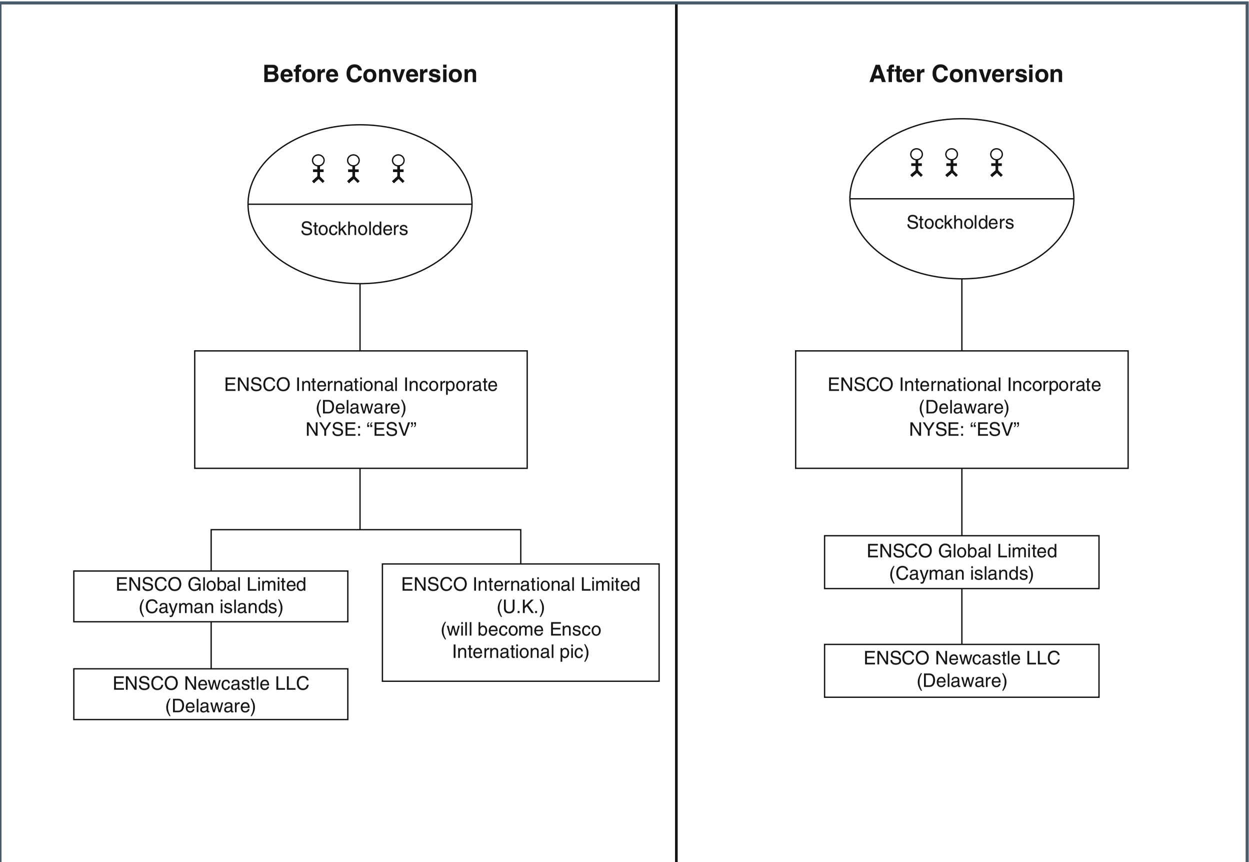

Fig 11.2 ENSCO conversion

11.6.4.2 Helen of Troy

The main facts under the Helen of Troy inversion were as follows:

- Helen of Troy, a US chartered corporation, established a new Bermuda corporation;
- The New Helen of Troy (Bermuda) formed Helen of Troy MergerCo (US);
- The shareholders exchanged their shares in the US corporation for the shares of the Bermuda corporation, in a transaction intended to qualify as a reorganization under IRC Section 368(a)(2)(E);
- Subsequent to the inversion, “Helen of Troy Bermuda” contributed its stock in the US corporation to a Barbados corporation to obtain the benefit of the US–Barbados income tax treaty for payments of interests and dividends originating from the US corporation.
- Subsequently, through a number of intra-group sales, the assets of the US corporation were transferred to affiliated corporations, including newly created Cayman Island and Hong Kong affiliates.

The IRS, deprived at the time of such transaction, as Section 269 of the IRC was ineffective, began to move toward legislation and sanction to crack down on the inversion phenomenon (Fig. 11.3).

11.6.5 Second Generation Inversions: Outbound mergers

Though the Daimler–Chrysler merger remains to many as the infamous case of a merged entity being headquartered overseas, the move seems to resume a great path since 2013.

An inverted company is subject to potential adverse tax consequences if, after the transaction: (1) less than 25 % of the new multinational entity’s business activity is in the home country of the new foreign parent, and (2) the shareholders of the old US parent end up owning at least 60 % of the shares of the new foreign parent. If these criteria are met for an inverted company, the tax consequences depend on the continuing ownership stake of the shareholders from the former US parent. If the continuing ownership stake is 80 % or more, the new foreign parent is treated as a US corporation (despite the new corporate address), thereby nullifying the inversion for tax purposes. If the continuing ownership stake is at least 60 % but less than 80 %, US tax law respects the foreign status of the new foreign parent but other potentially adverse tax consequences may follow. The current wave of inversions involves transactions in this continuing ownership range of 60–80 %.

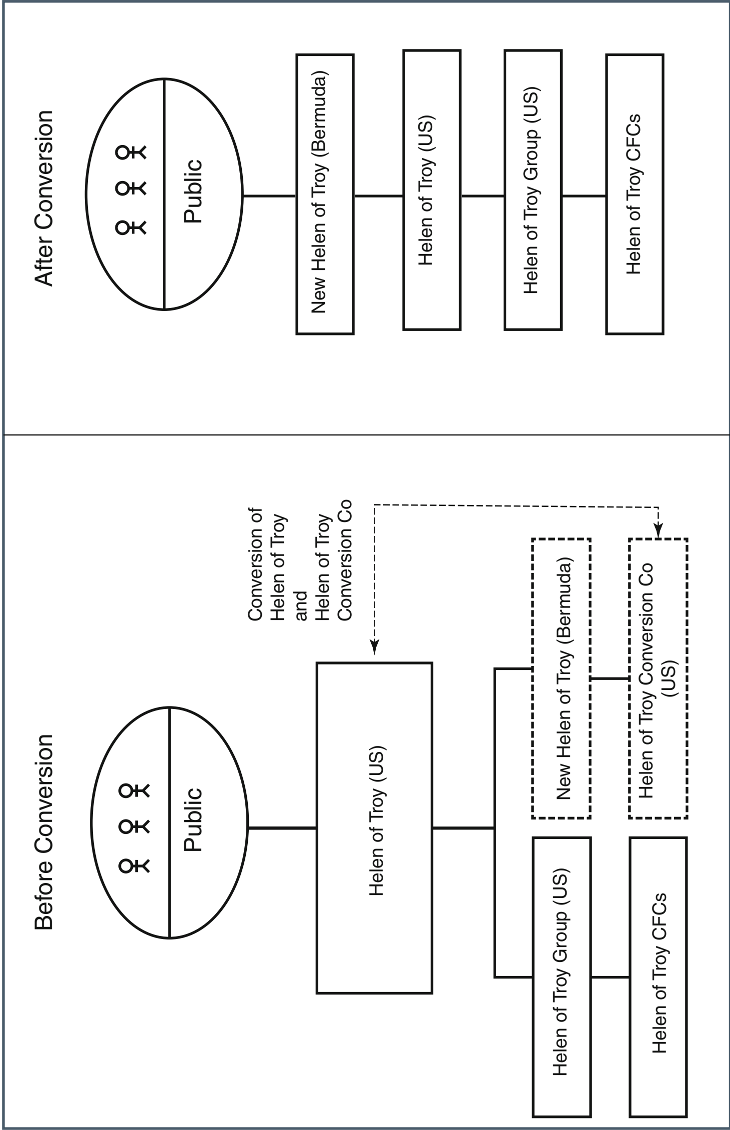

Fig. 11.3 Helen de Troy conversion

Today US multinationals, particularly, in the pharmaceutical and, technology industries, are contemplating or to seeking to expatriate from the United States in order to reduce their current tax burden and to be able to access offshore cash more easily. For virtually all these companies the only one viable option consists of merging with a non-US company in a transaction in which the shareholders of the offshore merger partner receive more than 20 % of the shares in the combined offshore entity (which may be the merger partner itself or a third party jurisdiction holding company). Virtually all inversion transactions satisfy this greater-than-20 % share ownership test.

Treasury Actions to Rein in Corporate Tax Inversions

US Treasury Notice[8] would need to invoke specific sections from the IRC: 304(b)(5)(B), 367, 956(e), 7701(l), and 7874 to (i) prevent inverted companies from accessing a foreign subsidiary's earnings while deferring US tax through the use of creative loans, which are known as "hopscotch" loans (Action under section 956(e)); (ii) prevent inverted companies from restructuring a foreign subsidiary in order to access the subsidiary's earnings tax-free (Action under section 7701(l)); (iii) close a loophole to prevent an inverted companies from transferring cash or property from a controlled foreign corporation (CFC) to the new parent to completely avoid US tax (Action under section 304(b)(5)(B)); (iv) make it more difficult for US entities to invert by strengthening the requirement that the former owners of the US entity own less than 80 % of the new combined entity.

- Preventing inverted companies from accessing a foreign subsidiary's earnings while deferring US tax through the use of creative loans, which are known as "hopscotch" loans (Action under section 956(e))

Under current law, US multinationals owe US tax on the profits of their CFCs although they don't usually have to pay this tax until those profits are repatriated (that is, paid to the US parent firm as a dividend). Profits that have not yet been repatriated are known as deferred earnings. Likewise, if a CFC tries to avoid this dividend tax by investing in certain US property—such as by making a loan to, or investing in stock of its US parent or one of its domestic affiliates—the US parent is still treated as if it received a taxable dividend from the CFC. However, some inverted companies get around this rule by having the CFC make the loan to the new foreign parent, instead of its US parent. The strategy is referred to as

"hopscotch" loan, and allows US multinationals to complete eliminate the payment of US tax.

The Treasury Notice removes benefits of these "hopscotch" loans by providing that such loans are considered "US property" for purposes of applying the anti-avoidance rule .[9] The same dividend rules will now apply as if the CFC had made a loan to the US parent prior to the inversion.

- Preventing inverted companies from restructuring a foreign subsidiary in order to access the subsidiary's earnings tax-free (Action under section 7701(l))

After an inversion, some US multinationals avoid ever paying US tax on the deferred earnings of their CFC by having the new foreign parent buy enough stock to take control of the CFC away from the former US parent. The strategy, known as "de-controlling" strategy, was used to allow the new foreign parent to access the deferred earnings of the CFC without ever paying US tax on them.

Under the Treasury Notice, the new foreign parent is treated as owning stock in the former US parent, rather than the CFC, to remove the benefits of the "de-controlling" strategy. The CFC remains a CFC and continues to be subject to US tax on its profits and deferred earnings.

- Closing a loophole to prevent an inverted company from transferring cash or property from a CFC to the new parent to completely avoid US tax (Action under section 304(b)(5)(B))

These transactions involve the new foreign parent selling its stock in the former US parent to a CFC with deferred earnings in exchange for cash or property of the CFC, effectively resulting in a tax-free repatriation of cash or property bypassing the US parent. Today's action (Action taken under Notice 2014-52) would eliminate the ability to use this strategy.

(i) Making it more difficult for US entities to invert by strengthening the requirement that the former owners of the US entity own less than 80 % of the new combined entity:
(ii) Limit the ability of companies to count passive assets that are not part of the entity's daily business functions in order to inflate the new foreign parent's size and therefore evade the 80 % rule – known as using a "cash box" (Action under section 7874 of the code).

Companies can successfully invert when the US entity has, for example, a value of 79 %, and the foreign "acquirer" has a value of 21 % of the combined entity. However in some inversion transactions, the foreign acquirer's size is inflated by passive assets, also known as "cash boxes," such as cash or marketable securities. These assets are not used by the entity for daily business functions. Today's notice would disregard stock of the foreign parent that is attributable to passive assets in the context of this 80 % requirement. This would apply if at least 50 % of the foreign corporation's assets are passive. Banks and other financial services companies would be exempted.

(iii) Prevent US companies from reducing their size pre-inversion by making extraordinary dividends (Action under section 7874 of the code). In some instances, a US entity may pay out large dividends pre-inversion to reduce its size and meet the 80 % threshold, also known as "skinny-down" dividends. Today's notice would disregard these pre-inversion extraordinary dividends for purposes of the ownership requirement, thereby raising the US entity's ownership, possibly above the 80 % threshold.

(iv) Prevent a US entity from inverting a portion of its operations by transferring assets to a newly formed foreign corporation that it spins off to its shareholders, thereby avoiding the associated US tax liabilities, a practice known as "spinversion" (Action under section 7874 of the code). In some cases a US entity may inverse a portion of its operations by transferring a portion of its assets to a newly formed foreign corporation and then spinning-off that corporation to its public shareholders. This transaction takes advantage of a rule that was intended to permit purely internal restructurings by multinationals. Under today's action, the spun-off foreign corporation would not benefit from these internal restructuring rules with the result that the spun off company would be treated as a domestic corporation, eliminating the use of this technique for these transactions.

Notes

1. H.R. 4520 (108th): American Jobs Creation Act of 2004.
2. IRC Sections 877, 2501, 2107, 6039G, 7701.
3. H.R. 6081 (110th): Heroes Earnings Assistance and Relief Tax Act of 2008.

4. H.R.3103 – Health Insurance Portability and Accountability Act of 1996 (Enrolled as Agreed to or Passed by Both House and Senate).
5. IRC Section 877 A.
6. IRC§§ 877A(d)(2)(A)(ii), 877A(d)(4)(D).
7. I.R.C. § 877A(g)(1)(B)(ii).
8. Notice 2014-52.
9. Notice 2014-52.

CHAPTER 12

The Investments of US Individuals or Corporations Abroad

12.1 Introduction

The United States is the largest investor abroad (outside the United States of America), just after China, and the largest recipient of direct investment in the world. Net investments rose from $328 billion in 2010 to $419 billion in 2011, including adjustments for changes in the value of some components, according to the US Department of Commerce.

US foreign direct investment (FDI) totaled $194 billion in 2010. Some 84 % of FDI in the US in 2010 came from or through eight countries: Switzerland, the United Kingdom, Japan, France, Germany, Luxembourg, the Netherlands, and Canada. In September 2013, the US House of Representatives voted to pass the Global Investment in American Jobs Act of 2013 (H.R. 2052; 113th Congress), a Bill that directed the US Department of Commerce to "conduct a review of the global competitiveness of the United States in attracting foreign direct investment." Supporters of the Bill argued that increased FDI would help job creation in the United States.

The US international tax rules are out of balance. They are too generous to foreign income and not strong enough in protecting against US base erosion by foreign companies investing in and carrying on business in the United States. The losers are domestic businesses, the Treasury, and individual taxpayers.[1] By location, in 2010 and 2011, US firms focused slightly more than half of their investments in the highly developed economies of Europe, with investments in other developed economies raising

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the share of investments going to developed economies to about 70 % of total US direct investment abroad. Another 20 % of US direct investment abroad is sent to Latin America and 15 % of investments are located in Asia. Investments in Africa account for about 1.5 % of total US direct investment abroad, with investments in the Middle East accounting for about 1 % of the total. Current estimates indicate that US multinationals have more than $1.7 trillion in undistributed foreign earnings and keep at least 60 % of their cash overseas.[2]

The US individual or corporation seeking to invest abroad must resolve whether to conduct the business through a branch or through a subsidiary (Table. 12.1).

12.2 Branch or Subsidiary

A branch is an office through which a foreign company engages in business. A branch has no independent legal personality and constitutes a mere continuation of the activities of the US business entity. That is, the US business entity is directly and fully responsible for all liabilities that derive from the activities or business of the branch. However, for income tax purposes, a branch is subject to tax for any profit it attributes to its operations in the guest country. In general, no withholding tax is imposed on the earnings of a branch that are transferred back to the foreign headquarters.

On the other hand, a subsidiary is a separate legal entity created under and governed by the locale of the guest country. It is an independent entity from the US business entity. In general, subsidiaries are subject to double taxation: (i) at the close of their fiscal year, and (ii) if dividends to the US business parent are repatriated, in which case a second layer of taxation is triggered.

12.3 The Entity Classification Regulation

Once the decision to set up a branch or a subsidiary is made, the US business entity or individual must comply with the entity classification regulation, commonly referred to as the "check-the-box" regulations.

The entity classification regulations under IRC Section 7701, effective since January 1, 1997, allow certain business entities to choose their classification for federal tax purposes under an elective regime.

Prior to Check-the-Box (CTB) regulations, a business entity was classified as either a corporation or a partnership depending of a variety of factors

Top U.S. Trade Partners

Ranked by 2013 U.S. Total Import Value for Goods (in millions of U.S. dollars)

Rank	Country	Imports 2012	Imports 2013	Imports % Change	Imports YTD Nov. 2013	Imports YTD Nov. 2014	Imports % Change	Exports 2012	Exports 2013	Exports % Change	Exports YTD Nov. 2013	Exports YTD Nov. 2014	Exports % Change
1	China	425,626	440,448	3.5%	402,950	426,125	5.8%	110,516	121,736	10.2%	108,730	111,793	2.8%
2	Canada	324,264	332,553	2.6%	305,584	317,408	3.9%	292,651	301,610	3.1%	277,893	287,819	3.6%
3	Mexico	277,594	280,529	1.1%	258,401	270,296	4.6%	215,907	226,079	4.7%	207,986	221,437	6.5%
4	Japan	146,438	138,573	-5.4%	127,409	122,459	-3.9%	69,964	65,206	-6.8%	59,946	61,186	2.1%
5	Germany	109,226	114,345	4.7%	104,924	113,058	7.8%	48,801	47,362	-2.9%	43,730	45,668	4.4%
6	Korea	58,902	62,386	5.9%	57,517	63,559	10.5%	42,265	41,715	-1.3%	37,742	40,721	7.9%
7	United Kingdom	55,003	52,817	-4.0%	48,469	49,197	1.5%	54,860	47,353	-13.7%	43,967	49,250	12.0%
8	Saudi Arabia	55,667	51,807	-6.9%	47,034	44,061	-6.3%	17,967	18,956	5.5%	16,972	16,424	-3.2%
9	France	41,647	45,708	9.8%	41,414	43,053	4.0%	30,811	31,745	3.0%	28,981	28,686	-1.0%
10	India	40,513	41,845	3.3%	38,830	41,762	7.6%	22,106	21,842	-1.2%	20,283	19,664	-3.1%
11	Italy	36,965	38,692	4.7%	35,330	38,464	8.9%	16,097	16,755	4.1%	15,391	15,574	1.2%
12	Taiwan	38,861	37,940	-2.4%	34,911	37,351	7.0%	24,337	25,472	4.7%	23,176	24,459	5.5%
13	Venezuela	38,724	31,997	-17.4%	29,431	28,237	-4.1%	17,518	13,204	-24.6%	12,208	10,188	-16.6%
14	Ireland	33,372	31,496	-5.6%	29,186	30,402	4.2%	7,393	6,640	-10.2%	6,031	7,227	19.8%
15	Switzerland	25,672	28,276	10.1%	26,002	28,481	9.5%	26,406	26,773	1.4%	25,275	20,815	-17.6%
16	Brazil	32,123	27,634	-14.0%	25,410	27,525	8.3%	43,807	44,119	0.7%	40,413	39,281	-2.8%
17	Malaysia	25,935	27,289	5.2%	24,935	27,562	10.5%	12,818	13,007	1.5%	11,996	11,914	-0.7%
18	Russia	29,379	27,086	-7.8%	25,608	21,967	-14.2%	10,695	11,136	4.1%	10,145	10,220	0.7%
19	Thailand	26,072	26,173	0.4%	24,001	24,639	2.7%	10,888	11,797	8.4%	10,902	10,601	-2.8%
20	Vietnam	20,268	24,657	21.7%	22,529	27,945	24.0%	4,623	5,036	8.9%	4,576	5,135	12.2%
21	Israel	22,131	22,809	3.1%	20,773	21,079	1.5%	14,271	13,747	-3.7%	12,521	13,828	10.4%
22	Colombia	24,622	21,626	-12.2%	20,188	16,613	-17.7%	16,357	18,392	12.4%	16,599	18,394	10.8%
23	Netherlands	22,260	19,231	-13.6%	17,874	19,165	7.2%	40,619	42,572	4.8%	39,137	40,031	2.3%
24	Belgium	17,368	19,012	9.5%	17,492	19,219	9.9%	29,447	31,941	8.5%	29,368	32,249	9.8%
25	Indonesia	18,002	18,877	4.9%	17,416	17,858	2.5%	7,999	9,100	13.8%	8,353	7,800	-6.6%
26	Singapore	20,232	17,843	-11.8%	16,608	15,148	-8.8%	30,526	30,672	0.5%	28,261	28,067	-0.7%
27	Iraq	19,265	13,306	-30.9%	12,528	12,654	1.0%	2,054	2,021	-1.6%	1,832	1,829	-0.2%
28	Kuwait	13,021	12,637	-2.9%	11,503	10,780	-6.3%	2,681	2,595	-3.2%	2,386	3,292	38.0%
29	Costa Rica	12,046	11,914	-1.1%	10,991	9,033	-17.8%	7,236	7,224	-0.2%	6,604	6,510	-1.4%
30	Nigeria	19,014	11,724	-38.3%	11,488	3,460	-69.9%	5,030	6,392	27.1%	5,846	5,539	-5.3%
	EU-28	382,197	387,591	1.4%	355,511	382,054	7.5%	265,686	262,151	-1.3%	241,351	254,552	5.5%
	TPP	843,604	852,726	1.1%	784,313	808,365	3.1%	689,155	699,140	1.4%	643,251	669,129	4.0%
	Top 30 - Total	2,030,210	2,031,228	0.1%	1,866,737	1,928,560	3.3%	1,236,648	1,262,197	2.1%	1,157,251	1,195,599	3.3%
	World Merchandise Total	2,276,302	2,268,321	-0.4%	2,085,856	2,149,013	3.0%	1,545,703	1,579,593	2.2%	1,447,637	1,489,634	2.9%
	Top 30 - % Share	89.2%	89.5%	-	89.5%	89.7%	-	80.0%	79.9%	-	79.9%	80.3%	-
	U.S. Services Trade	450,360	462,134	2.6%	422,734	437,470	3.5%	654,850	687,410	5.0%	628,821	649,747	3.3%
	U.S. Total Trade*	2,754,145	2,756,586	0.1%	2,526,394	2,608,777	3.3%	2,216,540	2,280,194	2.9%	2,087,395	2,147,441	2.9%

*Notes: U.S. Total Trade is calculated on a seasonally adjusted Balance of Payments (BOP) basis, merchandise trade is calculated on a non-seasonally adjusted Census basis. Export figures are for Total Exports on a Free Alongside Ship basis. Import figures are the Customs value of U.S. General Imports. Percent changes calculated using dollars.

Table 12.1 Top US trade partners (2013)

developed by the US courts. The late regulations, referred to as Kintner regulations, by reference to the Ninth Circuit's decision in *US v. Kintner* , enumerated six characteristics of a corporate venture: (i) the presence of associates; (ii) an objective to carry on business; (iii) continuity of life; (iv) centralization of management; (v) limited liability; and (vi) free transferability of interests.

Because the first two characteristics are common to both corporations and partnerships, the test turned on the remaining four factors—an entity possessing three or more was treated as a corporation, two or fewer was treated as a partnership.

The prior regulations remain applicable prior to January 1, 1997. If an entity incorrectly claimed a classification prior to January 1, 1997, the default classification rule for existing eligible entities in the new regulations could cause a change in entity classification as of January 1, 1997. However, the check-the-box regulations provide that an entity's claimed classification will be respected for prior periods if:

- The entity had a reasonable basis (within the meaning of section 6662) for its claimed classification;
- The entity and all owners recognized the federal tax consequences of any change in classification within 60 months prior to January 1, 1997; and,
- Neither the entity nor its owners had been advised that the entity was under examination on or before May 8, 1996.

Entity classification affects the extent of the US taxing jurisdiction, including, in some cases, whether the entity is subject to US tax at all. The classification of a foreign entity as a corporation, a partnership, or disregarded entity, potentially affects many aspects of US taxation. Keeping in mind that US tax law governs the classification of a form of foreign business organization for US tax purposes, the choice or the election is significant in many respects.

12.3.1 Business Entity Classification Process

Under the CTB regulations, an eligible business entity is able to elect its federal income tax classification—that is, it can decide whether it is taxed as a corporation or as a partnership.

The first step under the check-the-box regulations is to decide whether there is an entity for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law. The next step is to determine whether an entity is a business entity. A business entity is any entity recognized for federal tax purposes that is not properly classified as a trust or otherwise subject to special treatment under the IRC. The rules for determining

whether an entity is classified as a trust for federal tax purposes are in Treasury Regulation Section 301.7701-4. Usually, the beneficiaries of an entity properly classified as a trust for this purpose do no more than accept the benefits of trust property and do not create the trust.

For federal tax purposes, certain business entities are automatically classified as corporations under Treasury Regulation Section 301.7701-2(b)(8), and the Internal Revenue Service (IRS) provides and updates a list of foreign business entities that are always classified as corporations for US federal tax purposes.

Other business entities may choose how they are classified for federal tax purposes. Other than a business entity automatically classified as a corporation, a business entity with at least two members can choose to be classified as either an association taxable as a corporation or a partnership, and a business entity with a single member can choose to be classified as either an association taxable as a corporation or disregarded as an entity separate from its owner.

To make the election, the business must file Form 8832, Entity Classification Election, with the IRS Service Center designated on the form, within 90 days from the date of the business entity formation. If a business entity is required to file a federal tax or information return for the tax year that the election is made, it must also attach a copy of the form to its tax return for the year that it wants to make the election. However, Revenue Procedure 2009-41, effective from September 28, 2009, allows the IRS extend the date for entities to make an initial classification election or to change a classification election. To make a late election under the provisions of the revenue procedure, an eligible entity must file a completed Form 8832 with the applicable IRS Service Center within three years and 75 days of the effective date of the election, along with a statement explaining the reason for its failure to make the election on time. The IRS will notify the entity if it is granting late election relief.

12.3.2 Use of Hybrid Entities

The extension of the CTB to foreign entities has increased opportunities for tax planning whereby a single entity has two different tax treatments under two different tax authorities. For instance, a single entity can be a corporation for US tax purposes, while remaining a partnership for foreign tax purposes. This is known as a hybrid entity. Further, the entity classification provides substantial tax arbitrage to international tax practitioners.

12.3.3 Default Entity Classifications

The regulations provide default classification rules for eligible non-US entities which failed to make a proper election. The most significant factor for the default classification for foreign entities is whether or not the members have limited liability. Whether or not the shareholders of an entity have limited or unlimited liability, the law of the country where the entity has been formed and the charter or by-laws of the entity itself will be the controlling factors. The rule for a foreign eligible entity is that it will default to be treated as:

- a corporation if all its owners have limited liability;
- a partnership if it has two or more owners and at least one owner does not have limited liability; and
- a disregarded entity if it has a single owner that does not have limited liability.

12.3.4 Disregarded Entity Treatment

If a foreign entity is treated as a disregarded entity, its income, deductions; and credits are reported on the owner's tax return. Foreign law will apply the foreign tax at the entity level when the entity is recognized as a tax paying entity under foreign law, even if it is a disregarded entity under US law. Under those circumstances, the person that is treated as owning the assets of the disregarded entity is considered as legally obligated to pay the foreign tax for US tax purposes. If the US owner is an individual or a C corporation, the foreign taxes are claimed as a foreign tax credit on the US federal tax return, subject to limitation.

12.3.5 Changes in Entity Classification

A change from one business entity form to another business entity form triggers several tax consequences. For instance, if a taxpayer has previously checked the business entity as a partnership, and then reversed course by altering the first election into a corporation, the change would produce the following tax consequences: (i) the partnership is deemed to contribute all its assets and liabilities to the corporation in exchange for stock in the corporation, (ii) the partnership liquidates by distributing the corporation's stock to its former partners, who become shareholders in

the corporation. By contrast, if a previously elected corporation converts into a partnership, the following tax consequences should be analyzed: (i) the former corporation is deemed to distribute all its assets and liabilities, in complete liquidation, (ii) the former shareholders are deemed to contribute all the distributed assets and liabilities to a newly formed partnership (Regulation 1.301.7701-3(g)(2)(i).

12.3.6 Tax Compliance

The IRS requires a series of annual tax forms for US taxpayers conducting foreign operations. US taxpayers are required to file Form 5471 (Information Return of U.S Persons with Respect to Certain Foreign Corporations); Form 8858 (Information Return of US Persons with Respect to Foreign Disregarded Entities); Form 8865 (Returns of US Persons with Respect to Certain Foreign Partnerships).

Notes

1. US Senate Committee (May, 21, 2013): Offshore Profit Shifting and the US Tax Code, p. 19.
2. US Senate Committee (May, 21, 2013): Offshore Profit Shifting and the US Tax Code, p. 158.

CHAPTER 13

The US Foreign Tax Credit Regime

13.1 Introduction

As stated in the introduction to this book, the US tax regime is known as the worldwide tax system. That is, US citizens and corporations are subject to federal income for their income earned all around the world. Such a system may lead to double or multiple taxation as the same income may already has been subject to taxation from source. To alleviate such a tax burden upon US citizens and US registered corporations, the Internal Revenue Code (IRC) provides foreign tax credit. The foreign tax credit (FTC) provisions are enacted primarily to mitigate the heavy burden of double taxation for US corporations operating abroad who are subject to taxation in both the United States and foreign countries.[1] These provisions were originally designed to produce uniformity of tax burdens among US taxpayers, irrespective of whether they were engaged in business abroad or in the United States.[2] A secondary objective of the foreign tax credit provisions was to encourage, or at least not to discourage, American foreign trade.[3]

However, the United States does not impose additional tax on foreign income when the foreign tax rate is higher than the US rate. Conversely, if the tax rate on the foreign sourced income is lower than the US tax rate, the FTC causes the overall tax on the foreign income to approximate the US rate. Taxpayers have an annual choice of electing FTC or deducting foreign taxes. Taxpayers may claim a credit in one year and a deduction the following year, or vice versa. Attaching a completed Form 1116

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or 1118 to a US tax return constitutes an election to take the FTC. An election by one member of a consolidated group binds all the corporations joining in the consolidated return. In the absence of an election, taxpayers may deduct foreign taxes meeting the requirements for deductibility under IRC Sections 162 & 164. Foreign taxes not qualifying for credits are deductible in the same year qualifying foreign income taxes are creditable. Taxpayers electing FTC may not take a deduction for any portion of the qualified foreign taxes for the taxable year. However, a computation of a net operating loss carryback or carryover may properly include a deduction for foreign income taxes.

The election to credit or deduct foreign taxes is not permanently binding. A taxpayer may change from a credit to a deduction or a deduction to a credit without permission at any time within the ten-year statute of limitations provided in Section 6511(d)(3)(A). The ten-year period of limitations runs from the date prescribed by law (including extensions) for filing the return for the year in which such taxes were actually paid or accrued. Thus, for example, a calendar year corporate taxpayer can change its election to deduct or credit 2014 taxes by filing an amended return for 2014 at any time up to September 15, 2025. However, if a domestic corporation files an amended return under Section 6511(d)(3)(A) to change from a credit to a deduction for a year in which it computed a Section 902 or 960 credit, it will need to back out the taxes deemed paid because they are not deductible and reduce its foreign source income by the amount of the Section 78 gross-up.

A qualified foreign tax is creditable when paid or accrued depending on the taxpayer's method of accounting. IRC Section 905(a) allows cash basis taxpayers to claim credits for foreign taxes on the accrual basis. For accrual basis taxpayers, IRC Section 986 generally calls for the conversion of foreign taxes into US dollars based on the average exchange rate for the year of the actual payment.

Special conversion rules apply where:

- taxes are paid more than two years after the taxable year to which taxes relate;
- taxes are paid before the year to which the taxes relate;
- taxes are subsequently adjusted.

For cash-basis taxpayers, taxes are converted into US dollars based on the exchange rate on the date of payment. Taxes accrue when all events

Table 13.1 Summary of IRC sections authorizing and limiting the FTC

IRC sections	*Description*
901	Allows direct credit for taxes paid to a foreign country by a US taxpayer based on realized net income
902	Allows deemed paid or indirect credit for foreign taxes based on the proportion of taxes paid by a corporation on its distributed earnings and profits
903	Allows direct credit for taxes (typically foreign withholding taxes based on gross receipts) and paid "in lieu of" the generally imposed net income tax
904	Limits the amount of credit available in each year, including carryovers of credit
905	Provides guidelines on foreign tax adjustments, redeterminations and proof of credits
906	Allows the foreign tax credit for non-resident alien individuals and foreign corporations engaged in a trade or business in the United States
907	Contains credit limitation for foreign oil and gas income
909	Foreign tax credit splitter
960	Allows an indirect credit for deemed distributions

occur that fix the amount of the tax. Treasury Regulation Section 1.461-4(g)(6)(iii)(B) states that economic performance is not generally required (Table 13.1).

13.2 Direct Foreign Tax Credit

The first step in an FTC examination is to assess the taxpayer's eligibility for the credit. Taxpayers subject to US taxation on foreign sourced income are generally entitled to the FTC. The following taxpayers are eligible to direct FTC:

- US citizens, US domestic residents
- Non-resident aliens and foreign corporations are eligible for FTC relating to qualified taxes paid on foreign source income effectively connected with a US trade or business[4]
- Exempt organizations with unrelated business taxable income[5]
- Estates and trusts[6]
- Domestic insurance companies[7]
- Partners in partnerships[8]
- Shareholders of regulated investment companies[9]

- 10 % domestic corporate shareholders of controlled foreign corporations, non-controlled foreign corporations and passive foreign investment
- Shareholders of foreign Investment companies[10]
- Shareholders of S corporations[11]

13.2.1 Eligible Foreign Taxes

Only foreign income, war profits, and excess profits taxes qualify for FTC

To be creditable, a foreign tax must be:

- a tax: a compulsory payment to a foreign government,[12] and
- an income tax, or a tax in lieu of an income tax
- an income tax in the US sense is a tax on net gain.[13]

Treasury Regulations Section 1.901-2(a)(3) defines the term "predominant character" as follows:

> The predominant character of a foreign tax is that of an income tax in the US sense if, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies.

A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements.

(i) The realization requirement

A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed upon or subsequent to the occurrence of events ("realization events") that would result in the realization of income under the income tax provisions of the IRC.

(ii) The gross-receipt requirement

Pursuant to Section 1.901-2(b)(3)(i), a foreign tax satisfies the gross receipts requirement "if, judged on the basis of its predominant character, it is imposed on the basis of gross receipts."

(iii) The net income requirement

Pursuant to Section 1.901-2(b)(4)(i), a foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts to permit:

(a) recovery of the significant costs and expenses attributable to such gross receipts; or
(b) recovery of such significant costs and expenses computed under a method that is likely to approximate or be greater than recovery of such significant costs and expenses.

Section 1.901-2(b)(4)(i), further provides:

> A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be if the Internal Revenue Code applied, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery. A foreign tax law that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for non-recovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain.

Thus, the important factor is whether the other country is attempting to reach some net gain, not the form in which it shapes the income tax or the name it gives. In certain situations a levy can in reality be directed at net gain even though it is imposed squarely on gross income. That would be the case if it were clear that the costs, expenses, or losses incurred in making the gain would, in all probability, always (or almost so) be the lesser part of the gross income. In that situation there would always (or almost so) be some net gain remaining, and the assessment would fall ultimately upon that profit. A levy can in reality be directed on net gain even though it is imposed squarely on gross income, or be directed on net gain or income[14] even through it is, by its terms, imposed squarely on the difference between two values.[15]

Not all foreign payments qualify for FTCs. The following are examples of payments not creditable as taxes: penalties, interest, fines and custom duties, compulsory loans, amounts reasonably certain to be refunded, credited, rebated, abated, or forgiven. Likewise, soak-up taxes are not creditable. A soak-up tax means that the US taxpayer is liable for the tax only to the extent that the tax is creditable.

13.3 Section 903- Taxes "In Lieu of" Income Taxes

For any tax to qualify as "in-lieu-of," the foreign country must have a general income tax law that would apply to the taxpayer but for the in-lieu-of tax,[16] and the general income tax is not imposed on the taxpayer because of the in-lieu-of. Put differently, a foreign tax is imposed as a substitute for, and not as an addition to, a generally applicable income tax. Further, it is immaterial that the base on which the tax is imposed has nothing to do with the net income.

Revenue Regulations 1.903-1(b)(1) provides:

"A comparison between the tax burden of the substitute tax and the tax burden that would have obtained under the generally imposed income tax is irrelevant".

A tax "in lieu of" an otherwise generally imposed tax on income must be a tax within the meaning of Regulation 1.901–2(a)(2) and meet the substitution requirements of Regulation 1.903–1(b).

13.4 Indirect Foreign Tax Credit

Section 902 provides a US domestic of a foreign subsidiary with an "indirect" or "deemed paid" credit on its domestic income tax return to reflect foreign taxes paid by its subsidiary. The credit protects domestic corporations that operate through foreign subsidiaries from double taxation of the same income: taxation first by the foreign jurisdiction, when the income is earned by the subsidiary, and second by the United States, when the income is received as a dividend by the parent. Congress first established the indirect tax credit in 240(c) of the Revenue Act of 1918, allowing a domestic parent to receive a credit for a portion of the foreign taxes paid by its subsidiary during the year in which the subsidiary issued a dividend to the parent. Later on, in order to equalize the tax treatment between

domestic corporations that operate through foreign subsidiaries and those that operate through unincorporated foreign branches, Section 240 (c) was amended to permit a domestic corporation to claim credit for taxes its subsidiary paid in years other than those in which the dividend was issued.

Section 902 limits a domestic parent's credit to the amount of tax paid by the subsidiary attributable to the dividend issued.

Section 902(a) deems a domestic corporation, which receives a dividend from a foreign corporation in which it owns at least 10 % of the voting stock to have paid a proportionate share of the foreign corporation's foreign income taxes. The domestic corporation may be able to claim an FTC for the deemed amount under Section 902. Section 960 provides a parallel rule allowing a deemed paid credit for taxes paid or accrued with respect to a Subpart F inclusion. Under both Sections 902 and 960, the domestic corporation must include any deemed paid foreign taxes in gross income as an additional dividend (the "Section 78 gross-up").

Example:

- Ally, Inc. a domestic corporation owns 50 % of Betta, Inc. a foreign corporation located in Geneva (Switzerland).
- In FY2014, Ally, Inc. received dividends of $200,000 from Betta, Inc.
- Betta, Inc has paid foreign taxes of $400,000 on its E&P, which amounted to $2,000,000.

Questions:

(a) Compute Ally, Inc deemed-paid foreign taxes;
(b) Compute Ally, Inc indirect foreign tax credit.

Solutions:

(a) Deemed-paid foreign taxes = [(dividend received/E&P) × foreign taxes paid]
[($200,000/2,000,000) × 400,000] = $40,000

(b) Indirect FTC = actual dividend received + deemed-paid foreign taxes
$200,000 + 40,000 = $240,000.

Sections 902, 960, and 78 do not apply in a year in which a taxpayer deducts foreign taxes. If a domestic corporation receives a dividend or includes Subpart F income in such a year it will not be treated as having paid a portion of the foreign corporation's taxes and cannot claim a deduction for those taxes. Any taxes that would have been deemed paid if the domestic corporation had elected to credit foreign taxes, however, disappear and cannot be claimed as a credit in a later year.

Indirect credit is a computed amount of credit related to an actual or deemed distribution to an eligible corporate shareholder. The amount of the credit is proportionate to the amount of foreign income taxes the corporation making the distribution paid on its earnings and profits (E&P). The term indirect (or deemed paid) credit refers to the fact that the foreign income tax is paid by the foreign subsidiary. Indirect credits result from either:

- Dividends received (cash or property) from a foreign affiliate per IRC Section 902;
- Deemed dividends reported under IRC Section 951 from a controlled foreign corporation per IRC Section 960.

As long as the US shareholder meets the ownership requirements of IRC Section 902(b) or 960(a)(1), it may claim deemed paid credits for taxes paid by a second- or third-tier corporation. For taxable years beginning after August 5, 1997, indirect credits are also available for fourth-, fifth-, or sixth-tier foreign corporations that are controlled foreign corporations. In order to claim FTC from a lower tier, a US shareholder must meet all of the following conditions. The first-tier foreign corporation must own at least 10 % of the voting stock of the second-tier foreign corporation. The US shareholder must own indirectly at least 5 % of the voting stock of the lower tier corporation. The other corporation may not be below the third tier (or, for post-1997 years, the sixth tier).

To compute an indirect credit from a lower tier, use the same formula that is used to compute an indirect credit from a first-tier subsidiary (see IRC Section 902(b)).

13.4.1 Eligibility for Section 902

The indirect credit is generally available only to US corporations receiving dividends from a foreign corporation. Under certain conditions, (IRC §§ 962 and 1248(b)) an individual can elect to be treated as a corporation,

and thus qualify for the indirect credit, with respect to certain liquidating distributions taxable under IRC § 1248 and certain deemed-paid dividends from a CFC taxable under Subpart F.

Only US domestic corporations qualify for indirect FTC under Section 902.

13.4.2 Requirements

There are several prerequisites to claiming an indirect credit from a first-tier foreign corporation: (i) the US shareholder must elect to claim the FTC.; (ii) the US shareholder must own at least 10 % of the voting stock of the first-tier foreign corporation; (iii) the US shareholder must have an actual or deemed dividend; (iv) the foreign corporation must have paid an income tax; (v) the US shareholder must include in income the IRC Section 78 gross-up.

The 2004 Job Act has clarified the eligibility requirements for indirect FTC by adding IRC Section 902(c)(7), which provides that stock owned directly or indirectly by or for a partnership is treated as owned proportionately by its partners.

13.4.3 Credit Computation Deemed Paid

The Tax Reform Act of 1986 completely revised the deemed paid foreign tax credit rules contained in IRC Section 902. The regulations became final on January 6, 1987.

While the majority of dividends are sourced from the pools required to be kept after the Tax Reform Act of 1986 (post-1986 pools), it is still necessary to be aware of the rules applicable to dividends sourced from pre-1987 years for two reasons:

- Distributions of pre-1987 E&P or E&P accumulated before there was a 10 % US shareholder are still characterized under the old rules.
- While the general theory of indirect credit has not changed, the mechanics of the computations are different.

13.4.4 Pre-1987 Credit Computation

The formula for deemed paid FTC for distributions sourced from pre-1987 years is:

Foreign Tax × Dividend = FTC

Under the pre-1987 law, the FTC calculation uses annual accumulated profits. There are specific rules to follow regarding the years to which the dividends apply and the order of the application. Dividends reduce the E&P of a specific year on a last in first out basis. If a dividend is paid out of the accumulated profits of more than one year, separate computations are necessary for each year.

Prior to 1987, taxpayers were able to use the annual computations to cycle their earnings and distributions in order minimize US tax. Subsidiaries with E&P deficits must carry back deficits and reduce the profits of earlier years per Revenue Rule 74–550. This may result in the permanent loss of credit for the foreign taxes paid in a carryback year. To eliminate the timing advantages and mitigate the harshness of the net operating losses carryback rule, the computation for years after 1986 combines all post-1986 earnings and deficits.

13.4.5 Post-1986 Credit Computation

The formula for deemed paid foreign tax credit (FTC) for distributions sourced from the post-1986 pools is:

FTC (902) = Foreign tax paid × (dividends received/accumulated profits – Foreign Tax paid)

For tax years after 1997, accrual basis taxpayers generally use the average exchange rate for the year (see Section 986(c)).

For pre-1997 taxes and taxes paid more than two years after the year to which they relate, use the spot rate on the foreign tax payment date.

Refunds are translated at the rate used to translate the original payment (see Section 986(a) and Reg. 1.905-3T(b)(2)). Use the last-in-first-out approach for lump sum refunds related to different payments (see Reg. 1.905-3T(b)(3)).

Distributions that exceed the post-1986 earnings reduce the pre-1987 accumulated profits, on a separate year basis, using the latest year first.

The indirect credit formula is the same for dividends from lower tier subsidiaries. The computations of the earnings and tax pools of lower tier subsidiaries are similar to those required of the first-tier foreign corporation. Foreign taxes attributable to distributions from lower-tier subsidiaries increase the tax pools of upper-tier subsidiaries (the distributions are already in their E&P). The following summary highlights the rules applicable to distributions sourced from post-1986 pools when there are multi-tier foreign subsidiaries involved.

Earnings are recorded in the functional currency of the lower-tier subsidiary (see IRC Section 986(b)).

E&P is adjusted to US accounting and tax standards (see IRC Section 964(a)).

The E&P pool is reduced for prior year but not for current year dividends.

The tax pool includes current year taxes and is reduced by all post-1986 indirect credits on dividends and inclusions paid in prior years.

13.4.6 Determination of the Foreign Corporation Accumulated E&P

Under IRC Section 902(c)(1), the earnings and profits of a foreign corporation, for the purpose of computing the indirect credit, shall be computed in accordance to US rules for computing earnings and profits under Subpart F and under the currency translation rules of Code Section 986. The regulations under Code Section 964(a), provide that the foreign corporation shall prepare a profit and loss statement from the account books used to report to shareholders, with adjustments necessary to conform with US accounting principles and tax accounting standards.[17] However, the foreign corporation does not need (i) to adjust its earnings and profits for the accelerated depreciation it may have taken in computing its taxable income; (ii) unless the adjustment is material, it does not need to make an adjustment in its books of account to conform those books with accepted US accounting principles and accepted tax accounting practices; (iii) take a deduction, in computing their earnings and profits, for any illegal bribe, kickback, or other payment that would be unlawful if made by a US person.

13.4.7 Substantiation Requirements

IRC Section 905(b) requires that a taxpayer substantiate its FTC. Substantiation includes, but is not limited to, the following items:

- Translated tax returns and payment receipts
- A copy of relevant foreign tax law;
- Audited financial statements on US tax and GAAP basis;
- Translated examination reports;
- Relevant tax treaties.

For guidance on evidence that is acceptable to establish the creditability of foreign taxes, see Regulation 1.905–2 and Revenue Rule 67–308, 1967–2 C.B. 254. In order to prove that the taxes claimed are proper, the taxpayer must supply the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy of:

- Receipts for each claimed tax payment;
- Returns that are the basis of any tax accruals.

13.5 Section 904: FTC Limitation

The FTC limitation is tantamount to the parent corporation's pre-credit home-country tax multiplied by the ratio of foreign source income to total taxable income.

FTC allows the US taxpayer a dollar-for-dollar credit against a taxpayer's US tax liability. The limitation on the amount of credit assures that the US tax liability is reduced only on foreign sourced income. IRC Section 904 categorizes foreign income and limits the FTC to the amount of the US income tax attributable to the foreign sourced taxable income in each category.

The limitation is:

US Tax on worldwide income × (Foreign Source taxable income/ worldwide taxable income)

The relationship between the limitation and the FTC is illustrated in the following table:

If the IRC Section 904(a) limitation	*Then the taxpayer may use*:
Increases	More FTCs
Decreases	Less FTCs

13.5.1 Classifying Income into Categories

FTC limitations are computed based on various "baskets" of income. Within each "basket" of income, foreign taxes paid in higher explicit tax rate countries can be credited against income generated in lower explicit tax rate countries. Since the Job Act of 2004, foreign income has been classified in two baskets: (i) passive basket; and (ii) general basket.[18] The 2004

tax act did not eliminate the special treatment of oil income, which, in effect, is given a separate basket under Code Section 907. The income and foreign taxes from one category (basket) cannot be combined with the income and foreign taxes from another category. Treatment of dividends from non-controlled Section 902 corporations varies depending upon dates of payment and earnings. For dividends paid prior to 2003, dividends from each such corporation are placed in a separate basket. Under IRC Section 904(d)(2)(B)(ii)(II) foreign source passive taxable income is removed from the passive income basket of a taxpayer if that income has been subject to an average effective tax rate above the top US marginal rate applicable to that taxpayer. This is known as the "High-Tax Kick-Out Rule."

All dividends paid after 2002 out of pre-2003 earnings are placed in a single basket, regardless of the number of corporations making such distributions. Finally, dividends paid out of post-2002 earnings are treated on a look-through basis and assigned to baskets based on the underlying nature of the payor's activities. For this purpose, dividends are generally deemed paid out of earnings on a last-in-first-out basis.

13.5.2 Carryback and Carryover of Excess Credits

Taxpayers unable to fully use all of their available credits due to the FTC limitation may carry unused credit back two years and forward for five years.[19] There is no credit carryback or carryover to years in which taxes are deducted. Any unused foreign taxes that are eligible for carryback or carryover to a year that foreign taxes are deducted are absorbed as though the taxpayer had elected to take the credit for foreign taxes paid in that year. Excess credit is not deductible in any year, even if creditable taxes are deducted that year.

Example:
Thai, Inc. a US Corporation has reported the following:

- Worldwide taxable income: $ 5,000,000.
- US taxable income: 3,000,000.
- Foreign source income: 2,000,000.
- Foreign tax withheld by foreign tax authorities: 300,000
- US tax before foreign tax credit: 600,000

- **Question**: (i) Compute Thai Inc., FTC limitation, and (ii) Compute its US net tax liability.
- **Solution:**
  - FTC limitation = (300,000/3,000,000) × 600,000 = $60, 000
  - Thai Net US Tax Liability = $600,000 – 60,000 = $540,000

13.5.3 Statute of Limitations on Carryback Years

If unused foreign tax credits are carried back, the statute of limitations for the year to which the carryback is utilized will not close until one year after the statute has expired for the year in which the carryback originated (see IRC Section 6501(i)).

13.5.4 Recapture Rules (Sections 904(f) and (g))

The overall foreign loss (OFL) recapture rules in Section 904(f) were enacted in 1976, and provide generally that if a taxpayer has a foreign loss in one year that reduces US taxable income, it must recapture the benefit in later years in which it has foreign source income by treating all or part of that income as US source income. The effect of resourcing foreign as US source income is to reduce the numerator of the FTC limitation fraction and thus potentially the allowable FTC for the year. The theory behind the rule is that in the earlier year a foreign loss reduced a taxpayer's US source income and US tax liability, and in the later year, the taxpayer should not be able to reduce its US tax liability a second time through the use of FTCs.

IRC Section 904(f)(1) provides that when US-source income is reduced in a given tax year because of an OFL, foreign source income of the same basket in subsequent years is re-characterized as US source income until the OFL is fully offset. The effect of such re-characterization is to reduce the foreign tax credit limitation in the year of recapture. Further, IRC Section 904(f)(3) provides that if a taxpayer disposes of certain property used or held for use predominantly without the United States in a trade or business, gain is recognized on that disposition and treated as foreign source income, regardless of whether the gain would otherwise be recognized, to the extent of any overall foreign loss account in the separate category of foreign source taxable income generated by the property. On

the other hand, IRC Section 1.904(f)-2(d) provides separate rules for dispositions in which gain is recognized irrespective of Section 904(f)(3) and dispositions in which the gain would not otherwise be recognized.

The 2012 final regulations provides among other things that:[20]

> If a taxpayer has capital gains or losses or qualified dividend income, as defined in Section 1(h)(11), the taxpayer shall make adjustments to such capital gains and losses and qualified dividend income to the extent required under Section 904(b)(2) and §1.904(b)-1 before applying the provisions of §1.904(f)-1.[21]

13.5.5 Recapture of overall foreign losses

In a taxable year in which a taxpayer elects the benefits of IRC Section 901 or Section 30A, IRC Section 904(f)(1) the recapture amount is the amount of foreign source taxable income subject to re-characterization in a taxable year in which recapture of an overall foreign loss is required under paragraph (a) of this section. Under IRC Section 904(f)(1), the recapture amount equals the lesser of (i) the aggregate amount of maximum potential recapture in all overall foreign loss accounts or (ii) 50 % of the taxpayer's total foreign source taxable income. If the aggregate amount of maximum potential recapture in all overall foreign loss accounts exceeds 50 % of the taxpayer's total foreign source taxable income, foreign source taxable income in each separate category with an overall foreign loss account is re-characterized in an amount equal to the Section 904(f)(1) recapture amount, multiplied by the maximum potential recapture in the overall foreign loss account, divided by the aggregate amount of maximum potential recapture in all overall foreign loss accounts. The maximum potential recapture in an overall foreign loss account in a separate category is the lesser of the balance in that overall foreign loss account or the foreign source taxable income for the year in the same separate category as the loss account. If, in any taxable year, in accordance with Sections 164(a) and 275(a)(4)(A), a taxpayer deducts rather than credits its foreign taxes, recapture is applied to the extent of the lesser of:

(i) the balance in the overall foreign loss account in each separate category; or
(ii) foreign source taxable income (net of foreign taxes) in each separate category.

Example
Y Corporation is a domestic corporation that does business in the United States and abroad. On December 31, 2007, the balance in Y's general category overall foreign loss account is $500, all of which is attributable to a loss incurred in 2007. Y has no other loss accounts subject to recapture. For 2008, Y has US source taxable income of $400 and foreign source taxable income of $300 in the general category and $900 in the passive category. Under paragraph (c)(1) of this section, the amount of Y's general category income subject to re-characterization is the lesser of the aggregate maximum potential recapture or 50 % of the total foreign source taxable income. In this case, Y's aggregate maximum potential recapture is $300 (the lesser of the $500 balance in the general category overall foreign loss account or $300 foreign source income in the general category for the year), which is less than 50 % of Y's total foreign source taxable income ($1200 × 50 % = $600). Therefore, pursuant to paragraph (c) of this section, $300 of foreign source income in the general category is re-characterized as US source income. The balance in Y's general category overall foreign loss account is reduced to $200 in accordance with §1.904(f)-1(e)(2).

13.5.6 Dispositions where gain is recognized irrespective of Section 904 (f) (3)

(i) Foreign source gain.

If a taxpayer recognizes foreign source gain in a separate category on the disposition of property under IRC Section 904(d)(1), and there is a balance in a taxpayer's overall foreign loss account that is attributable to a loss in such separate category after the application of IRC Section 904(c), an additional portion of such balance shall be recaptured. The amount to be recaptured is the lesser of such balance or the full amount of the foreign source gain recognized on the disposition that was not previously re-characterized.

(ii) US source gain.

If a taxpayer recognizes US source gain on the disposition of property under IRC Section 904(d)(1), and there is a balance in a taxpayer's overall foreign loss account that is attributable to a loss in the separate

category to which the income generated by such property is assigned after the application of IRC 904(c), an amount of the gain shall be treated as foreign source and an additional portion of such balance equal to that amount shall be recaptured in accordance with IRC Sections 904 (a) and (b). The amount of gain treated as foreign source and the amount of overall foreign loss recaptured is the lesser of the balance in the overall foreign loss account or the full amount of the gain recognized on the disposition.

13.5.7 Separate limitation loss and the separate limitation loss account

Section 1.904(f)-8 provides rules for re-characterizing the balance in any separate limitation loss account under the general re-characterization rule of Section 904(f)(5)(C). Separate limitation income is determined by taking into account any adjustments for capital gains and losses and qualified dividend income, as defined in Section 1(h)(11), under Section 904(b)(2) and §1.904(b)-1.

A taxpayer's separate limitation loss as defined in IRC Section 904 (b)(3) is added to the applicable separate limitation loss accounts at the end of its taxable year to the extent that the separate limitation loss reduces separate limitation income in one or more other separate categories in that taxable year or in a year to which the loss has been carried back.

Computation of the recapture of overall domestic losses[22]

For purposes of this Section and §§1.904(g)-2 and 1.904(g)-3, the term domestic loss means the amount by which the US source gross income for the taxable year is exceeded by the sum of the expenses, losses, and other deductions properly apportioned or allocated to such income, taking into account any net operating loss carried forward from a prior taxable year, but not any loss carried back. If a taxpayer has any capital gains or losses or qualified dividend income, as defined in Section 1(h)(11), the amount of the taxpayer's domestic loss that offsets foreign source income must be determined taking into account adjustments under Section 904(b)(2).

Any taxpayer that sustains an overall domestic loss under IRC 904(c) of must establish an overall domestic loss account for such loss with respect to each separate category of the taxpayer in which foreign source income is offset by the domestic loss. The balance in each overall domestic loss account represents the amount of such overall domestic loss subject to recapture in a given taxable year. When a domestic loss is carried back or

For example, if a taxpayer incurs a domestic loss in the 2007 taxable year that is carried back to the 2006 qualified taxable year and offsets foreign source income in 2006, so that the resulting overall domestic loss is treated as sustained in the 2007 taxable year. If a taxpayer incurs a domestic loss in a pre-2007 taxable year, that is carried forward to a post-2006 qualified taxable year and offsets foreign source income in the post-2006 year, and the resulting overall domestic loss is treated as sustained in the post-2006 year. If any portion of any overall domestic loss of another taxpayer is allocated to the taxpayer in accordance with §1.1502-9 (relating to consolidated overall domestic losses) the taxpayer adds such amount to its applicable overall domestic loss account. If the taxpayer has capital gains or losses or qualified dividend income, the amount by which a domestic loss is considered to reduce foreign source income in a taxable year equals the Section 904(f)(5)(D) amount determined under §1.904(b)-1(h)(1)(iii), regardless of the amount of domestic loss that was determined before taking any Section 904(b)(2) adjustments into account.

carried forward as part of a net operating loss, and offsets foreign source income in a carryover year, the resulting overall domestic loss is treated as sustained in the later of the year in which the domestic loss was incurred or the year to which the loss was carried.

A taxpayer recaptures an overall domestic loss as provided in this Section. Recapture is accomplished by treating a portion of the taxpayer's US source taxable income as foreign source income. The re-characterized income is allocated among and increases foreign source income in separate categories in proportion to the balances of the overall domestic loss accounts with respect to those separate categories. As a result, if the taxpayer chooses the benefits of Section 901, the taxpayer's foreign tax credit limitation is increased.

For the purposes of determining the amount of an overall domestic loss subject to recapture, the taxpayer's taxable income from US sources is computed in accordance with the rules set forth in §1.904(g)-1(c)(4). US source taxable income is determined by taking into account adjustments for capital gains and losses and qualified dividend income in a similar manner to the adjustments made to foreign source taxable income under Section 904(b)(2) and §1.904(b)-1, following the principles of §1.904(b)-1(h)(1)(i).

Consolidated application of Section 904(f) and (g)

A group may apply IRC Section 904(f) and (g) for a consolidated return year in accordance with that Section, subject to the following rules:

(i) The group computes its consolidated separate limitation income (CSLI) or consolidated separate limitation loss (CSLL) for each separate category under the principles of §1.1502-11 by aggregating each member's foreign-source taxable income or loss in such separate category computed under the principles of §1.1502-12, and taking into account the foreign portion of the consolidated items described in §1.1502-11(a)(2) through (a)(8) for such separate category;
(ii) The group applies Section 904(f)(5) to determine the extent to which a CSLL for a separate category reduces CSLI for another separate category or consolidated US-source taxable income;
(iii) The group applies Section 904(g)(2) to determine the extent to which a CDL reduces CSLI.
(iv) To the extent provided in Section 904(f), the amount by which a CSLL for a separate category (the loss category) reduces CSLI for another separate category (the income category) will result in the creation of (or addition to) a CSLL account for the loss category with respect to the income category. Likewise, the amount by which a CSLL for a loss category reduces consolidated US- source taxable income will create (or add to) a consolidated overall foreign loss account (a COFL account). To the extent provided in Section 904(g), the amount by which a CDL reduces CSLI will result in the creation of (or addition to) a consolidated overall domestic loss (CODL) account for the income category reduced by the CDL;
(v) In the case of a COFL account for a loss category, Section 904(f)(1) and Section 904(f)(3) re-characterize some or all of the foreign-source income in the loss category as US source income. In the case of a CSLL account for a loss category with respect to an income category, Section 904(f)(5)(C) and Section 904(f)(5)(F) re-characterize some or all of the foreign-source income in the loss category as foreign-source income in the income category. In the case of a CODL account, Section 904(g)(3) re-characterizes some of the US-source income as foreign-source income in the separate category that was offset by the CDL. The COFL account, CSLL account, or CODL account is reduced to the extent income is re-characterized with respect to such account;
(vi) neither Section 904(f)(3) (in the case of a COFL account) nor Section 904(f)(5)(F) (in the case of a CSLL account) applies at the time of a

disposition that is an intercompany transaction to which §1.1502-13 applies. Instead, Section 904(f)(3) and Section 904(f)(5)(F) apply only at such time and only to the extent that the group is required under §1.1502-13 (without regard to Section 904(f)(3) and Section 904(f)(5)(F)) to take into account any intercompany items resulting from the disposition, based on the COFL or CSLL account existing at the end of the consolidated return year during which the group takes the intercompany items into account.

The following examples illustrate the principles under IRC 904(b)(6)(i).

Example 1

(i) On June 10, year 1, S transfers non-depreciable property with a basis of $100 and a fair market value of $250 to B in a transaction to which Section 351 applies. The property was predominantly used without the United States in a trade or business within the meaning of Section 904(f)(3). B continues to use the property without the United States. The group has a COFL account in the relevant loss category of $120 as of December 31, year 1.

(ii) Because the contribution from S to B is an intercompany transaction, Section 904(f)(3) does not apply to result in any gain recognition in year 1.

(iii) On January 10, year 4, B ceases to be a member of the group. Because S did not recognize gain in year 1 under Section 351, no gain is taken into account in year 4 under §1.1502-13. Thus, no portion of the group's COFL account is recaptured in year 4. For rules requiring apportionment of a portion of the COFL account to B

Example 2

(i) The facts are the same as in paragraph (i) of Example 1. On January 10, year 4, B sells the property to X for $300. As of December 31, year 4, the group's COFL account is $40. (The COFL account was reduced between year 1 and year 4 due to unrelated foreign-source income taken into account by the group.)

(ii) B takes into account gain of $200 in year 4. The $40 COFL account in year 4 re-characterizes $40 of the gain as US source. See Section 904(f)(3).

Example 3

(i) On June 10, year 1, S sells non-depreciable property with a basis of $100 and a fair market value of $250 to B for $250 cash. The property was predominantly used without the United States in a trade or business within the meaning of Section 904(f)(3). The group has a COFL account in the relevant loss category of $120 as of December 31, year 1. B predominantly uses the property in a trade or business without the United States.

(ii) Because the sale is an intercompany transaction, Section 904(f)(3) does not require the group to take into account any gain in year 1. Thus, under paragraph (b)(5)(i) of this Section, the COFL account is not reduced in year 1.

(iii) On January 10, year 4, B sells the property to X for $300. As of December 31, year 4, the group's COFL account is $60. (The COFL account was reduced between year 1 and year 4 due to unrelated foreign-source income taken into account by the group.)

(iv) In year 4, S's $150 intercompany gain and B's $50 corresponding gain are taken into account to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation. All of B's $50 corresponding gain is re-characterized under Section 904(f)(3). If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's $100 basis in the property and would have $200 of gain ($60 of which would be re-characterized under Section 904(f)(3)), instead of a $50 gain.

Consequently, S's $150 intercompany gain and B's $50 corresponding gain are taken into account, and $10 of S's gain is re-characterized under Section 904(f)(3) as US source income to reflect the $10 difference between B's $50 re-characterized gain and the $60 recomputed gain that would have been re-characterized.

Anti-abuse rules for becoming or ceasing to be a member of a group

If a corporation becomes a member and ceases to be a member, and a principal purpose of the corporation becoming and ceasing to be

a member is to transfer the corporation's OFL account, SLL account, or ODL account to the group or to transfer the group's COFL, CSLL or CODL account to the corporation, appropriate adjustments will be made to eliminate the benefit of such a transfer of accounts. Similarly, if any member acquires assets or disposes of assets (including a transfer of assets between members of the group and the departing member) with a principal purpose of affecting the apportionment of accounts under IRC 904 (c)(2)(i) of this Section, appropriate adjustments will be made to eliminate the benefit of such acquisition or disposition.

The overall domestic account

An ODL account, in contrast, can only be created in a credit year. If a US loss offsets foreign source income in a deduction year, the loss would not be a domestic loss that could be added to the taxpayer's ODL account. As a result, the taxpayer would not be able to recapture the detriment of having a US loss offset foreign source income in a later year by resourcing US as foreign source income in that later year. If the taxpayer elects the FTC in the later year, this means that it will have less foreign source income and a lower FTC limitation.

13.6 Alternative Minimum Tax—Foreign Tax Credit

Taxpayers are also entitled to foreign tax credits when calculating alternative minimum tax.

When calculating the AMT 904 limitation, the pre-credit tentative minimum tax is the tax against which such credit is taken for the taxable year and all prior taxable years beginning after December 3, 1986. Additionally, IRC 904 is applied on the basis of alternative minimum taxable income instead of taxable income and the determination of whether any income is high-taxed income is to be made on the basis of the tentative minimum tax rate determined in IRC 55(b)(1). IRC 59(a)(1).

The alternative minimum tax foreign tax credit for any taxable year is limited to 90 % of tentative minimum tax (before consideration of alternative minimum tax net operating loss deduction and IRC 57(a)(2)(E)). IRC 59(a)(2)(A).

Alternative minimum tax foreign tax credits in excess of the IRC 904 limitation have the same two-year carryback and five-year carry-forward periods. However, because the amounts used in the IRC 904 limitation formula are different (pre-credit tentative minimum tax vs. regular tax

and alternative minimum taxable income vs. regular taxable income), the credit carryback and carryforward have to be separately maintained for alternative minimum tax purposes.

In the case of a taxpayer other than a corporation, the pre-credit tentative minimum tax is the amount determined under the first sentence of IRC 55(b)(1)(A)(i). In the case of a corporation, the pre-credit tentative minimum tax is the amount determined under IRC 55(b)(1)(B)(i). IRC 59(a)(3).

An election under IRC 59(a)(4) can be made for the first taxable year beginning after December 31, 1997 to simplify the IRC 904 limitation for purposes of the Alternative Minimum Tax foreign tax credit. The IRC 904 limitation shall be based on the proportion of the taxpayer's foreign sourced taxable income for regular tax purposes (but not greater than the taxpayer's alternative minimum taxable income) bears to the taxpayer's alternative minimum taxable income. IRC 59(a)(4).

13.7 Section 905—Re-determination Rules

Section 905(c) governs situations in which the amount of foreign taxes claimed as credits under § 901 or § 902 are subsequently adjusted, increased, or refunded. There is a need for § 905(c) because of the "relation back doctrine" that is applied to accrual foreign taxes and the "contested taxes" doctrine.

In general, if a US person pays or accrues a foreign tax and claims an FTC and if the amount of that foreign tax liability subsequently changes, Section 905(c) provides a mechanism for correcting the amount of FTC claimed or available to be claimed. A change in foreign tax liability that triggers the application of Section 905(c) is referred to as a "foreign tax redetermination" (FTR) and includes a difference between the amount of foreign taxes accrued (in functional currency) and the amount claimed as a credit, a failure to pay accrued taxes within two years, and a refund of foreign tax. If an FTR occurs, the taxpayer must re-determine its US tax liability for the year to which the change in foreign tax liability relates or, if the FTR relates to taxes paid by a foreign subsidiary, the US shareholder may be required to adjust the foreign subsidiary's earnings and tax pools in the year the FTR occurs.

13.7.1 Events Constituting Foreign Tax Redeterminations Are

(i) Taxes, when paid, differ from taxes accrued;
(ii) Accrued taxes are not paid within two years of the end of the year to which the tax relates.

1. If the taxes accrued are not paid within this two-year period, the foreign tax is re-determined to eliminate any accrued, but unpaid, tax.
2. Subsequent payments of the tax that was eliminated under this rule are treated as additional redeterminations of the tax. In the case of a foreign tax directly paid by the US taxpayer, the redetermination is made with respect to the year to which the tax originally relates. If the tax was paid by a CFC, then the subsequent payment is treated as an additional foreign tax in the year for which § 902 / § 960 credits were claimed.
3. Special currency translation rules are applicable to additional taxes covered by the two-year rule.

(iii) Taxes paid are refunded by the foreign tax authority.

The regulations define a "foreign tax redetermination" as a "change in the foreign tax liability that may affect the amount of a taxpayer's foreign tax credit." Regulation § 1.905-3T(c). Thus, it appears that there must be an adjustment to the foreign tax liability, not some other item that affects the FTC. The regulations also provide a currency-related adjustment of less than the lesser of 2 % of the foreign taxes or $10,000 are not taken into account under this rule.

13.7.2 Consequences of a Redetermination

(i) US taxpayer's direct credits. The redetermination of a domestic taxpayer's foreign taxes that have been credited under § 901 generally results in an adjustment to the US taxpayer's liability for the year in which the foreign tax credits affected by the redetermination were originally claimed. The US taxpayer must report the redetermination of the liability on pursuant to the reporting rules set out in the Temporary Regulations.

Treasury Regulation § 1.905-4T(b). The one exception for redetermination of a US taxpayer's direct tax credits is where the redetermination results solely from a difference between exchange rates between the date when the taxes were accrued and the date when the taxes were paid and where the total adjustment is less than 2% of the total taxes credited from that foreign country in the year.

(ii) Where a redetermination is required by § 905(c), the statute of limitations on assessing a deficiency resulting from the redetermination remains open until the taxpayer reports the redetermination.[23] It is unclear what time period limits the IRS's assessment of the deficiency

after receiving the notice of the redetermination, since the statute simply requires payment "on notice and demand by the Secretary."[24]

(iii) Scope of the Reopening of the Statute of Limitations. It has been stated that the extended statute of limitations under § 905(c)(3) only permits the IRS additional time to assess deficiencies that are "caused by factors which are not ascertainable either at the time of the computation of the credit originally claimed or within the period of limitations provided by Section 6501(a) of the Code." Revenue Ruling 72-525, 1972-2 C.B. 443, which follows Texas Co (Caribbean) Ltd. v. Commissioner.[25]

Thus, these authorities held that a computational error in the FTC could not be adjusted by the IRS under the extended statute of limitations granted by § 905(c).

13.7.3 Reporting the Redetermination

The taxpayer generally must report each redetermination separately on an amended return, with new Form 1116/Form 1118, and a statement under penalties of perjury with the information required by Temporary Treasury REgulation § 1.905-4T(c). If the redetermination increases the US taxpayer's liability, the filing must be made by the due date (with extensions) for the original return for the year in which the redetermination occurs. However, the status of the statute of limitations for the original credit year does not limit the taxpayer's requirement to report under § 905(c).

If the redetermination reduces US tax liability, it may be reported at any time within the 10-year statute of limitations for seeking a refund under § 6511(d)(3)(A). The ten-year statute on seeking a refund for additional taxes paid may limit the claim for refund at a certain point (see § 6511(d)(3)). Generally, if foreign taxes are re-determined multiple times for a single year, multiple amended returns must be filed reporting the redeterminations. However, multiple redeterminations as to a single taxable year that occur within two years may be combined on a single statement if that would be timely reporting of both redeterminations.[26]

If a redetermination affects a year that is under examination by the Large and Mid-Size Business (LMSB), the Taxpayer must notify its examiner, generally within 120 days of the latest of the (1) foreign event triggering § 905(c), (2) the opening exam conference, or (3) the opening letter for the exam. However, if the event occurs more than 180 days after the later of the opening conference or opening letter, then notification of

Exam in lieu of filing an amended return is optional for the taxpayer; also, the Examiner may require the taxpayer to file an amended return under the normal procedures instead.

If the taxpayer fails to report an FTC redetermination in a timely manner, § 6689 prescribes a penalty equal to 5 % of the deficiency for each month (or part of a month) that the report is late. The maximum penalty is 25 % of the deficiency. There is an exception for failures due to reasonable cause and not wilful neglect.[27]

13.7.4 Currency Translation Rules

(i) General rule. Translate foreign taxes, and any adjustments thereto, at the average exchange rate for the year to which the foreign taxes relate.[28] Thus, payments of foreign tax are generally translated at the average exchange rate for the assessment of year. The payment, therefore, does not cause a change in foreign rax that must be reported under § 905(c).

1. Exception—two-year rule. If foreign taxes are not paid within two years of the end of the assessment year, they must be reversed under § 905(c) until paid. The payment of the taxes then becomes a new foreign tax redetermination that is translated at the spot rate on the date of payment.[29]
2. Exception—estimated tax payments. Estimated tax payments made before the beginning of the foreign tax year to which they relate are translated at the spot rate on the date of payment.[30] In this case, the actual accrual of liability will give rise to an adjustment to foreign tax under § 905(c) to the extent exchange rates differ. This may fall into the de minimis rule for direct credits, or may be treated as a pooling adjustment at a CFC level.
3. Exception—spot rate election (§ 986(a)(1)(D)). For years after 2004, the taxpayer may elect to make a one time election to translate all foreign income taxes into dollars at the spot rate on the date of payment.[31] The election may apply to all foreign income taxes of the taxpayer, or only for foreign taxes attributable to Qualified Business Units (QBUs) with a dollar functional currency. The election is binding and may be revoked only with consent of the Commissioner refers to the Internal Revenue Commissioner in the United States.

   a. The election can be beneficial to tie withholding taxes on royalties, dividends, etc. paid to the US taxpayer to the rate on which

the dividend, royalty, etc., is translated into dollars. This sort of use of the election would be limited to "the dollar QBUs only" approach.

b. The election could also apply more broadly to all § 901 and § 902 credits. However, since a non-dollar QBU's profit and loss is translated at the average exchange rate for the year under § 987, it typically would be better to use the default rule that translates the QBU's taxes at the same average exchange rate.

(ii) Translation of refunds (§ 1.905-3T(b)(3)). Refunds of foreign tax are translated at the exchange rate for the year to which the refunds relate (including deemed refunds as a result of the two-year rule). Thus, a refund received many years after the fact will be translated at the exchange rate of the original assessment year. This rate may be far different from the exchange rate in the current year. E&P is also adjusted at the same exchange rate.

(iii) § 988 consequences of receiving the refunded currency (§ 1.905-3T(b)(5)).

1. If the tax is denominated in a non-functional currency, then the units of refunded currency take a tax basis equal to their translated value under the rules above. Thus, the refunded units have a built-in currency gain or loss under § 988. This gain or loss would typically be recognized as the units are disposed of—reversing some of the currency effects of receiving a refund at a non-market exchange rate.
2. Query whether the business needs exception should apply to the § 988 gain or loss on the refunded units of currency.

13.8 Section 906

A non-resident alien individual or a foreign corporation engaged in trade or business within the US during the taxable year is allowed a credit under Section 901 for the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year (or deemed, under Section 902, paid or accrued during the taxable year) to any foreign country or possession of the USA with respect to income effectively connected with the conduct of a trade or business within the USA. However, the credit allowed is not allowed against any tax imposed by Section 871 (a) (relating to income of non-resident alien individual not connected with US

business) or 881 (relating to income of foreign corporations not connected with United States business). For the purposes of Section 902, any income, war profits, excess profits, taxes paid or accrued (or deemed paid or accrued) to any foreign country or possession of the United States with respect to income effectively connected with the conduct of a trade or business within the United States shall not be taken into account, and any accumulated profits attributable to such income are not be taken into account.[32] Further, no credit is allowed under this Section against the tax imposed by Section 884.[33]

13.9 Section 907

IRC Section 907 provides a limitation on the amount of foreign taxes available as a credit under IRC Section 901 that were paid or accrued on foreign oil and gas extraction income (FOGEI) and foreign oil-related income (FORI). These limitations must be computed separately from the limitations for taxes on other foreign income. IRC § 907 was enacted in 1975 and final regulations, effective for taxable years beginning after December 31, 1982, were issued in 1991. Section 907 limits the creditable foreign taxes assessed on foreign oil and gas extraction to the maximum US tax rate. The basic premise of the statute is to prevent excess foreign tax credits, available because of the very high taxes imposed on FOGEI by producing countries, from offsetting US tax on other foreign source income. IRC Section 907 also limits, in more restricted situations, the creditability of foreign taxes imposed on foreign oil-related income (FORI), which encompasses activities downstream from the well, including transportation of the crude oil and gas from the well to the place of sale and processing of the oil and gas.

The Emergency Economic Stabilization Act of 2008 makes Section 907(a) Foreign Tax Credit Limitation Applicable to both FOGEI and FORI.

Under new IRS regulations, the rules for oil and gas companies to pay taxes on overseas income were tightened as of 2009. The new regulations eliminate the distinction between FOGEI and FORI from transportation and refining and the new regulations apply the FOGEI foreign tax credit limitation under IRS Code Section 907 to income from oil and gas production and sales.

Any unused foreign oil and gas taxes, which under Section 907(f) are allowed as carryovers under Section 904(c) of such Code is treated in the same manner as if such taxes were unused taxes under such Section 904(c) with respect to foreign oil and gas extraction income.

13.10 Section 909

US federal income tax law has generally treated a taxpayer as having paid a foreign tax if, under foreign law, the taxpayer was legally liable for the foreign tax: the so-called "technical taxpayer" rule. As a consequence, under pre-Section 909 law, the time when the foreign tax is deemed paid under foreign law (and accordingly, the time at which a taxpayer may be entitled to claim a US foreign tax credit for that tax) may differ from the time when the underlying income is taken into account for US federal income tax purposes. In response to perceived deficiencies in this rule,[34] the Treasury Department published proposed regulations in 2006 that, if finalized, would have modified the technical taxpayer rule to address the allocation of foreign taxes paid by a group that filed consolidated returns under foreign law, and to address foreign tax credits taken by the owner of a "reverse hybrid" (the "2006 Proposed Regulations"). The IRS announced, in the notice, that it does not intend to finalize the portion of the 2006 proposed regulations that relates to the foreign taxes and income of reverse hybrids, and is re-evaluating the remainder of the 2006 Proposed Regulations.

Section 211 of the Education Jobs and Medicaid Assistance Act (EJMAA) enacted on August 10, 2010, added Section 909 to the Code to address situations where foreign income taxes have been separated from the related income. Section 211(c)(1) of EJMAA provides that Section 909 applies to foreign income taxes paid or accrued (including foreign income taxes paid or accrued by Section 902 corporations) in post-2010 taxable years. Section 211(c)(2) of EJMAA provides that Section 909 also applies to pre-2011 taxes, but only for the purposes of applying Sections 902 and 960 to periods after Dec. 31, 2010. That is, Section 909 is not retroactive and applies to foreign taxes that were accrued or paid in taxable years beginning on or before December 31, 2010. Section 909(a) provides that if there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by a taxpayer, such tax shall not be taken into account for federal tax purposes before the taxable year in which the related income is taken into account by the taxpayer. Section 909(b) provides special rules with respect to a "Section 902 corporation," which is defined in Section 909(d)(5) as any foreign corporation with respect to which one or more domestic corporations meets the ownership requirements of Section 902(a) or (b) (a "Section 902 shareholder" of the relevant Section 902 corporation).

If there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by a Section 902 corporation, the tax will not be taken into account for purposes of Section 902 or 960, or for purposes

of determining earnings and profits under Section 964(a), before the taxable year in which the related income is taken into account by such Section 902 corporation or a Section 902 shareholder. Thus, the tax is not added to the Section 902 corporation's pool of "post-1986 foreign income taxes" (as defined in Section 902(c)(2) and Treasury Regulation Section 1.902-1(a)(8)), and its pool of "post-1986 undistributed earnings" (as defined in Section 902(c)(1) and Treasury Regulation Section 1.902-1(a)(9)) is not reduced by such tax. Accordingly, Section 909 suspends foreign income taxes paid or accrued by a Section 902 corporation at the level of the payor Section 902 corporation.

In the case of a partnership, Section 909(a) and (b) apply at the partner level, and except as otherwise provided by the secretary, a similar rule applies in the case of an S corporation or trust.

On December 6, 2010, the IRS issued Notice 2010-92, which provides guidance on several aspects of Section 909. The Notice identifies four types of "Pre-2011 Splitter Arrangements" that will be the sole arrangements giving rise to suspended legacy yaxes.

13.11 Section 960

Corporate US shareholders are entitled to a foreign tax credit for their share of the foreign income taxes paid by a CFC with respect to E&P underlying a Subpart F inclusion.[35] However, IRC Section 960(c)[36] limits the foreign taxes deemed paid with respect to IRC Section 956 investments in US property. Under IRC Sections 951 and 956, a CFC's investment in US property may be Subpart F income to the US parent. Under IRC Section 960(c), for acquisitions of US property[37] after December 31, 2010, the amount of foreign taxes deemed paid is limited to the lesser of (i) the foreign taxes deemed paid with respect to the US shareholder's IRC Section 956 inclusion or (ii) the hypothetical amount of foreign taxes deemed as computed under the provision (the "hypothetical credit"). Prior to the enactment of IRC Section 906(c) US. Corp. was be able to claim deemed paid credit under Section 902 associated with the Section 956 inclusion amount.

13.12 Foreign Tax Credit Generation

Foreign tax credit generator refers to certain foreign tax credit arbitrage transactions aimed at producing foreign tax credit, often throughout a formalistic approach of the rules, without sound substance. It consists

of structured arrangements aiming to generate inappropriate foreign tax results. To combat these arrangements, the IRS published Notice 98-5 on January 20, 1998.

In the United States, the amount of tax at stake in 11 foreign tax credit generator transactions has been estimated at USD 3.5 billion.[38]

Notice 98-5 announced that Treasury and the IRS intended to issue regulations that would apply an economic profit test to address abusive tax-motivated transactions that generated foreign tax credits. The Notice explained that these abusive transactions "generally are structured to yield little or no economic profit relative to the expected US tax benefits". Notice 98-5 has identified two classes of transactions that created a potential for tax abuse: (1) abusive arrangements where "foreign tax credits are effectively purchased by a US taxpayer in an arrangement where the expected economic profit from the arrangement is insubstantial compared to the foreign tax credits generated" and (2) "cross-border tax arbitrage transactions that permit effective duplication of tax benefits". The notice described five examples of abusive arrangements pursuant to the two classes of abusive transactions. Generally, the notice explained that the anticipated regulations would "emphasize an objective approach to calculating expected economic profit and credits, and that the regulations will require that expected economic profit be determined over the term of the arrangement, properly discounted to present value."

Notice 98-5 was withdrawn on March 15, 2004, for the stated purpose that the Treasury Department and the IRS did not intend to issue regulations in the form described in Notice 98-5. Notice 2004-19, 2004-1 C.B. 606, Mar. 15, 2004.37 It explained that the IRS would "challenge the claimed tax consequences of such transactions under the following principles of existing law: the substance over form doctrine, the step transaction doctrine, debt-equity principles, Section 269, the partnership anti-abuse rules of § 1.701-2, and the substantial economic effect rules of § 1.704-1." As a follow-up to Notice 2004-19, the IRS issued temporary regulations that proscribed a partner's foreign tax credits to be "proportionate to a partner's distributive share of the partnership income to which such taxes relate."[39]

One of the most commonly used schemes to generate a foreign tax credit uses a hybrid transfer of an equity instrument. The most common way to create a hybrid transfer of an equity instrument is with a sale and repurchase agreement concerning shares, where the transaction is treated as a sale and a repurchase of the shares in one country, while in the other country it is treated as a loan with the shares serving as collateral.[40]

Notes

1. Burnet v. Chicago Portrait Co., 285 US 1, 9 (1932); F.W. Woolworth Co. v. Commissioner, 54 T.C. 1233, 1257 (1970).
2. H. Rept. 1337, 83d Cong., 2d Sess. 76 (1954).
3. H.R. Rept. 767, 65th Cong., 2d Sess. (1918), 1939-1 C.B. (Part 2) 86, 93; Commissioner v. American Metal Co., 221 F.2d 134, 136 (2d Cir. 1955), affg. 19 T.C. 879 (1953).
4. IRC section 906.
5. IRC section 515.
6. IRC section 642(a)(2).
7. IRC section 841
8. IRC sections 901(b)(5) and 702.
9. IRC section 853.
10. IRC section 1247(f).
11. IRC section 1373(a).
12. Under the regulations, if a foreign levy serves both as a tax and as a charge for an economic benefit as two separate levies, the portion of the levy operating as a tax is eligible for consideration as an income tax. The other portion is treated as a payment for a specific benefit and not a tax.
13. Biddle v. Commissioner, 302 US 573, 579 (1938).
14. Bank of America I, 198 Ct. Cl. at 274, 459 F.2d at 519.
15. PPL Corporation & Subsidiaries v. CIR, 135 T.C N0. 15, September 9, 2010.
16. Treas. Reg. section 1.903-1(b).
17. IRC section 312(n) listed the requested adjustments.
18. IRC Section 904(d).
19. IRC section 904(c).
20. Department of Treasury- Internal revenue service 26 CFR Part 1 [TD 9595]- RIN 1545-BH13.
21. IRC §1.904(b)-1(h).
22. §1.904(g)-2.
23. See Pacific Metals Co. v. Commissioner, 1 T.C. 1028 (1943).
24. § 905(c)(3).
25. Texas Co (Caribbean) Ltd. v. Commissioner, 12 T.C. 925 (1949).
26. See Temporary Treasury Regulation § 1.905-4T(b)(1)(vi) (providing example of filing requirements and timing).
27. See Temporary Treasury Regulation § 301.6689-1T(d).
28. § 986(a)(1)(A).

29. See § 986(a)(1)(B)(i) & § 986(a)(2).
30. See § 986(a)(1)(B)(ii).
31. See § 1.905- 3T(b)(1)(ii)(D).
32. IRC section 906 (b)(5).
33. IRC section 906 (b)(6).
34. For example, in *Guardian Industries v. United States*, 65 Fed. Cl. 50 (Ct. Cl. 2005); aff'd, 477 F.3d 1368 (Fed. Cir. 2007), the IRS challenged a transaction in which a US parent of a Luxembourg unitary group claimed a foreign tax credit through its Luxembourg holding company, which was treated as disregarded from its US parent for US federal income tax purposes. Under Luxembourg law, the holding company was solely liable for the tax of the entire unitary group, and the taxpayer asserted that it was entitled to claim a US foreign tax credit for the entire amount of Luxembourg tax that was paid, even though some of the income on which that tax was incurred remained in the holding company's subsidiaries (and outside the scope of the US tax net until it was distributed).

    The taxpayer in Guardian Industries was successful both at trial and on appeal. For a further discussion of the Guardian Industries case, see the Sullivan & Cromwell LLP, "Guardian Industries v. United States Sustains Taxpayer's Claim for Direct Foreign Tax Credit" (Apr. 25, 2005).
35. IRC section 960.
36. The Act is commonly referred to as the Education Jobs and Medicaid Assistance Act of 2010, although the Senate in its haste neglected to insert a title in the actual legislation.
37. US. property means any property that is: (i) tangible property located in the United States; (ii) Stock of a domestic corporation; (iii) any obligation of a US person, including any obligation that the CFC is deemed to hold by reason of its being a pledger or guarantor of such obligation; and (iv) any right to the use in the United States of a patent, copyright, invention, model, design, secret formula or process, or any other similar right, which is acquired or developed by the CFC for use in the United States.
38. OECD (2012): Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, p. 6.
39. 2004-20 I.R.B. 903, 69 Fed. Reg. 21405-01, 21406.
40. OECD (2012): Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, p. 9.

CHAPTER 14

The Subpart F Regime

14.1 Introduction

US corporations are subject to two levels of taxation: first the corporation is subject to federal corporate income based on its net profit, and second, the dividends distributed by a corporation to its shareholders is subject to tax at the hands of the shareholders, whether individuals or corporations. Very often, the second level of taxation occurs whenever a corporation distributes dividends up to its shareholders. There is an exception to this general rule, known as anti-deferral rules. In the 1950s and 1960s, this opportunity for deferral created an incentive for US investors to operate and invest in foreign companies incorporated or organized in low-or no-tax jurisdictions. The Kennedy administration sought to curb the practice through the enactment of Subpart F regime. Subpart F of the Internal Revenue Code (IRC) was enacted in order to deter United States taxpayers from using related foreign-bases companies located in tax haven countries to accumulate earnings that could have been accumulated just as easily in the United States. However, these rules established more than half a century ago have become counterproductive. The US Tax Code encourages multinationals to keep profits overseas. Foreign profits held overseas by US corporations to avoid taxes at home nearly doubled between 2008 and 2013 to top $2.1 trillion. This represented an increase of up to 93 % between 2008 and 2013.[1]

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As cited by federal financial filings for companies listed in the Russell 1000 index of US corporations:

> US multinational firms have established themselves as world leaders in global tax avoidance strategies.[2]

Examples of accumulated offshore profits at the end of 2013 include:[3] – General Electric: $110 billion; Microsoft: $76.4 billion; Pfizer: $69 billion; Apple: $54.4 billion; Exxon Mobil: $48 billion; Citigroup: $43.8 billion; Google: $38.9 billion; Goldman Sachs: $22 billion; Walmart: $19 billion; McDonald's: $16 billion.

In 1961, the Kennedy administration proposed to tax US shareholders on income currently earned by Controlled foreign Corporations (CFC), save in developing countries. (i) prevent tax haven abuse; (ii) reduce the deficit in the international balance of payments; and (iii) equalize the tax treatment of US taxpayers operating abroad and those operating domestically. Subpart F rules attempt to prevent (or negate the tax advantage from) deflection of income, either from the United States or from the foreign country in which earned, into another jurisdiction which is a tax haven or which has a preferential tax regime for certain types of income. Thus, the rules targeted income resulting from artificial arrangements between related corporations that exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad. Chief among these rules is the Subpart F regime. Subpart F income is defined under IRC Sections 952–954.

The Kennedy administration, through a compromise work, set up four sets of anti-deferral regimes directed at US persons earning income through foreign corporation. The four regimes were:

- The foreign personal holding company;
- The controlled foreign company;
- The foreign investment company; and
- The passive foreign investment company.

Besides these four core regimes, the Kennedy administration added that the two penalty regimes of general application were also applicable to foreign corporations: (i) the accumulated earning tax, and (ii) the personal holding company tax. The framework put in place would also remain unchanged, though from time to time Congress added layer after layer of complexity without clear or sound policies.

In 2004, the Bush administration, through the American Jobs Creation Act of 2004, concluded that the Subpart F regime needed an overall review. The Job Act repealed: (i) the foreign personal holding company; (ii) the foreign investment company, and one penalty regime—the personal holding company tax. To be accurate, the foreign personal holding company was repealed a distinct regime to become a component of the foreign based company. These changes to the anti-deferral regimes become effective as of January 1, 2005.

14.2 The Accumulated Earning Tax

C Corporations are subject to a double level of taxation: (i) first, at the level of the C corporation upon corporation current earnings and profits (E&P) at the current fiscal year, and (ii) second, at the hand of shareholders when the corporations repatriate dividends. To avoid the double level of taxation, some corporations would delay or avoid distributing dividends to their shareholders.

The accumulated earnings tax is a congressional attempt to deter use of a corporate entity to avoid personal income taxes. The purpose of the tax "is to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual stockholders will become liable" for taxes on the dividends received. The accumulated earnings tax is established by Sections 531–537 of the IRC of 1954.

IRC Section 532, which defines the corporations to which the tax shall apply provides:

> The accumulated earnings tax imposed by Section 531 shall apply to every corporation formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting E&P to accumulate instead of being divided or distributed.

However, not all corporations or business entities are subject to this penalty regime. IRC Section 531(b) exempt the following entities:

1. A personal holding company;[4]
2. A corporation exempt from tax under subchapter F;[5] or
3. A passive foreign investment company;[6]
4. S corporations.[7]

For the service to trigger the penalty regime under the accumulated earning tax, the IRS must establish the following prima facie elements:

- Tax avoidance motive: the corporation was formed (or availed of) for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting E&P to accumulate instead of being divided or distributed.
- It has accumulated E&P in excess of the reasonable needs of its business.
- It is not exempt from the tax.

14.2.1 Tax Avoidance Motive

A prerequisite for the imposition of IRC Section 531 tax is that the corporation has been formed or availed of for the purpose of avoiding the income tax on its shareholders. As the purpose involves a state of mind or intent, the service must look at the surrounding facts and circumstances in each individual case to determine whether the purpose of the accumulated earnings was to allow the shareholders to avoid income tax or for some other purpose.

IRC Section 532 establishes a rebuttable presumption of tax motive, which can be rebutted by the taxpayer by a preponderance of evidence. Section 533 (a) provides that:

> For purposes of Section 532, the fact that the E&P of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

IRC Section 533 goes on to state that the fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders. Treasury Regulation 1. 533-1(c) defines a mere holding or investment company as follows:

> A corporation having practically no activities except holding property and collecting the income therefrom or investing therein shall be considered a holding company within the meaning of Section 533(b). If the activities further include, or consist substantially of, buying and selling stocks,

securities, real estate, or other investment property (whether upon an outright or marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of Section 533(b).

14.2.2 Accumulation of Earning beyond Reasonable Business Needs

The Accumulated Earning Tax does not provide a comprehensive definition of what is considered reasonable business needs. Thus, whether a particular ground or grounds for the accumulation of E&P indicate that the E&P have been accumulated for the reasonable needs of the business or beyond such needs is dependent upon the particular circumstances of the case.

However, Treasury Regulation 1.537-2 (b) provides a non-exhaustive list of circumstances whereby a corporation's profit is deemed to meet reasonable business needs:

1. To provide for bona fide expansion of business or replacement of plant;
2. To acquire a business enterprise through purchasing stock or assets;
3. To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue;
4. To provide necessary working capital for the business, such as, for the procurement of inventories;
5. To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation; or
6. To provide for the payment of reasonably anticipated product liability losses.[8]

Conversely, accumulations of E&P to meet any one of such objectives may indicate that the E&P of a corporation are being accumulated beyond the reasonable needs of the business. Such accumulations include:

1. Loans to shareholders, or the expenditure of funds of the corporation for the personal benefit of the shareholders;
2. Loans having no reasonable relation to the conduct of the business made to relatives or friends of shareholders, or to other persons;

3. Loans to another corporation, the business of which is not that of the taxpayer corporation, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer corporation and such shareholder or shareholders are in control of both corporations;
4. Investments in properties, or securities which are unrelated to the activities of the business of the taxpayer corporation; or
5. Retention of E&P to provide against unrealistic hazards.

Further, accumulations have been justified as a result of various forms of contingencies including the following:

- An actual or potential lawsuit.
- Apossible liability arising out of some contractual obligation.
- Possible business reversal resulting from the loss of a customer.
- Accumulations to guard against competition has been justified in some cases.
- An accumulation to provide funds to finance a self-insurance plan. This includes key men/women, as well as the more common types of risk insurance.
- Accumulations to provide a retirement plan for employees.
- And for financing of corporate operations and debt retirement:
- A corporation cannot be required to resort to the borrowing of funds under any circumstances. Therefore, the current operations of the business or planned expansion may be financed fully by retained earnings.
- An accumulation to retire a corporate indebtedness has in most cases been determined to be a reasonable need of the business, depending upon the reason the debt was created in the first place.
- The examiner should determine if the debt to be retired by the accumulation was bona fide and was incurred in connection with the trade or business.

14.2.3 Computation of the Amount of the Accumulated Earnings Tax

The accumulated earnings tax is a 15 % additional tax imposed on C corporations. Any corporation within a chain of corporations can be subject to accumulated earnings tax. A subsidiary corporation can be subject to accumulated earnings tax even though the parent corporation is not subject to the tax and vice versa. The accumulated earnings tax is computed

on the corporation's accumulated taxable income for the taxable year or years in question. The accumulated taxable income is the corporation's taxable income with various adjustments. These adjustments are made primarily for the purpose of arriving at an amount that corresponds more closely to economic reality and thus measures more accurately the corporation's dividend-paying capacity for the year.

IRC Section 535(a) provides that the term "accumulated taxable income" means the taxable income, adjusted, minus the sum of the dividends paid deduction (as defined in Section 561) and the accumulated earnings credit.

Generally, a corporation's accumulated taxable income is calculated as follows:
Corporation's regular taxable income

- Certain federal taxes;
- Excess charitable deductions;
- Dividends received deductions;
- Net operating losses;
- Certain capital gains and losses;
- Dividends paid to shareholders;
- Accumulated earnings credit.

14.2.4 Accumulated Earnings Credit

IRC Section 535, which defines "accumulated taxable income" also provides for a credit for that portion of the E&P retained for the reasonable needs of the business, with a minimum lifetime credit of $100,000. Finally, IRC 537 provides that "reasonable needs of the business" include "reasonably anticipated" needs.

The accumulated earnings credit is the greater of the following two amounts:

1. $250,000 (or $150,000 for personal service corporations) less the amount of accumulated E&P at the end of last tax year; or
2. The amount of current year E&P that are retained for reasonable business needs in excess of dividends paid to the shareholders, less the net capital gains deducted in calculating accumulated taxable income.

14.2.5 Tax Planning

There are several ways a corporation can avoid paying this additional tax. It can:

- Pay dividends to shareholders during the tax year (or within 2½ months after the close of the tax year);
- Issue consent dividends to shareholders (consent dividends are treated just like regular dividends to the recipient for income tax purposes, but they do not need to be actually paid out by the corporation);
- Retain earnings for reasonable business needs and document them in a “specific, definite, and feasible” plan; or
- Do not keep an accumulated earnings balance that exceeds $250,000 (or $150,000 for personal service corporations).

14.3 Personal Holding Company

A personal holding company (PHC) is a C corporation in which five or fewer persons own at least half of its stock and in which at least 60 % of its income is made from investing. The aim of the PHC tax the sheltering of certain types of passive income in a corporation. The PHC tax is imposed on the undistributed income of those C corporations that serve as vehicles to shelter passive income.

A corporation qualifies as a PHC if it meets (i) the ownership test (five or fewer individuals, directly or indirectly, control more than half of stock value) and (ii) the income test (at least 60 % of adjusted ordinary gross income is passive, investment-type income), the corporation is a PHC and must file a PHC return (Schedule PH). However, no PHC tax is payable unless there is undistributed PHC income.

14.3.1 PHC Income

PHC income generally consists of the following passive income:

- Dividends;
- Interest minus certain amounts excluded under Internal Revenue Code 543(a)(1) and Internal Revenue Code 543(b)(2)(C);
- Royalties minus certain expenses allowed under Internal Revenue Code 543(b)(2)(B);
- Annuities;
- Rents subject to specific income requirements;

- Compensation received for the use of corporate property from shareholders who own at least 25 % of the value of the stock of the corporation, subject to limits;
- Amounts received under a personal service contract if someone other than the corporation designates the individual performing the services, and the person designated owns (directly or indirectly) at least 25 % of the value of the corporation's stock at least some time during the taxable year;
- Income from estates and trusts;
- Mineral, oil, gas, and copyright royalties subject to specific income requirements.

The following corporations are statutorily exempt from being classified as PHCs, even if the above two requirements are met:

- Tax-exempt companies;
- Banks and savings and loan associations;
- Life insurance companies;
- Surety companies;
- Foreign personal holding companies;
- Certain lending or finance companies;
- Certain small business investment companies operating under the Small Business Investment Act of 1958;
- Certain companies in bankruptcy.

14.3.2 Advantages and Disadvantages of PHCs

A PHC presents the following advantages: (i) it can provide people with an opportunity to avoid estate taxes, and (ii) it can help their heirs avoid probate. However, a PHC has certain drawbacks: (i) it can lead to extra tax liability, an additional tax on top of the corporate income tax, (ii) set-up can be a complex process.

14.3.3 Computation of the PHC's Adjusted Ordinary Gross Income

In general, a PHC's adjusted ordinary gross income is the corporation's gross income, minus:

- Gains from the sale or disposition of capital assets;
- Gains under Internal Revenue Code 1231(b);

- Certain foreign income;
- Certain expenses allowed against rental income;
- Certain expenses allowed against royalty income;
- Certain interest income.

14.3.4 Tax Planning

A C corporation can properly monitor its undistributed income and avoid any unwanted personal holding corporation. Several tax planning devices can be considered:

- Increasing the number of business owners. Since the PHC tax applies only to C corporations in which more than 50 % of the value of stock is owned by five or fewer individuals during the last half of the tax year, a C corporation can avoid PHC status by ensuring that the top five owners in the company held own less than 50 % of the value of the outstanding stock.
- Increase/or decrease the adjusted ordinary income upon which the personal holding company tax is levied. Given that a C corporation is subject to the PHC tax if at least 60 % of the corporation's adjusted ordinary gross income consists of PHC income, one straight tax planning would consist of changing the relationship between the corporation's operating income and its passive investment income. To increase adjusted ordinary income consider the following: (i) accelerate sales and bill at year-end, (ii) decrease cost of goods sold by deferral of purchases or other expenses at year-end, (iii) invest in other business activities that result in additional gross receipts that are not PHC income.

By contrast, if a C corporation aims to decrease accumulated PHC income, it may consider: (i) cashing in some securities and reinvesting the funds in stocks that have growth potential but do not regularly pay dividends, (ii) paying dividends to stockholders, or (iii) limiting its passive investments.

- If the expectation is that the business entity will generate a large amount of PHC type income, owners may want to consider forming a limited liability company (LLC) rather than a C corporation, or implementing other strategies to minimize PHC income.

14.4 The Controlled Foreign Company Regime (CFC)

14.4.1 Deemed Received Dividend

For a US shareholder of a foreign corporation to be taxable under IRC Section 951, three conditions must be met: (i) the foreign corporation must qualify as a controlled foreign company (CFC) for an uninterrupted period of 30 days or more during the taxable year; (ii) the shareholder must qualify as a US shareholder (owns 10 % or more of the voting stock of a foreign corporation; and (iii) the US shareholder must own its shares of stock in the CFC on the last day of the taxable year that the foreign corporation qualifies as a CFC. A "US Person" is generally defined as:

- a citizen or resident of the United States;
- a domestic partnership;
- a domestic corporation;
- any estate (other than a foreign estate, within the meaning of §7701(a)(31)), and
- any trust if: (i) a court within the United States is able to exercise primary supervision over the administration of the trust; and (ii) one or more US persons have the authority to control all substantial decisions of the trust.

If the prerequisite requirements are satisfied, a US shareholder is taxable on its pro rata share of IRC Section 951 income of a CFC if it directly owns shares of the CFC or if it owns the shares indirectly through its ownership of some other foreign entity. Under IRC Section 951, a foreign corporation will be classified as a "controlled" foreign if it satisfies either the voting control test or the ownership test.

That is, a CFC is a foreign corporation more than 50 % of which, by vote or value, is owned by US persons owning a 10 % or greater interest in the corporation by vote (US shareholders).

A foreign corporation satisfies the voting control test if US shareholders own more than 50 % of the combined voting power of all classes of its voting stock on any day during its taxable year. In computing for the more than 50 % voting control test, the direct, the indirect ownership rules under IRC Section 958(a) and the constructive ownership rules under

IRC Section 958(b) are taken into account. Under the indirect ownership rule contained in Code Section 958(a), stock owned directly or indirectly by or for a foreign entity shall be treated as owned proportionally by its shareholders, partners, or beneficiaries. More, under the constructive ownership (IRC Section 958), taxpayers are treated, for certain limited purposes, as the owners of stock held by certain trusts, corporations, and other legal entities and by certain close relatives.

The constructive ownership rules under IRC Section 958, which cross-referenced to IRC Section 318, can be summed up as follows:

1. Individuals are treated as the owner of shares of stock owned, directly or indirectly, by their spouse, children, grandchildren, and parents, except that stock owned by a foreign individual will not be treated as owned by a US citizen or resident.50 Thus an individual who directly owns 25 % of the stock of a corporation, with the remaining 75 % owned by his wife and children, will be treated as the owner of 100 % of the stock of the corporation, assuming that the wife and children are US citizens or residents. The wife and children also will be treated as the owner of 100 % of the stock of that corporation.
2. Stock owned, directly or indirectly, by or for a partnership or an estate will be treated as owned proportionally by its partners or beneficiaries. Similarly, stock owned, directly or indirectly, by or for a trust shall be treated as owned by its beneficiaries in proportion to their actuarial interest in such trust.
3. Stock owned, directly or indirectly, by a corporation will be treated as owned by the shareholders of that corporation in proportion to their direct and indirect ownership interests in the corporation, but only to the extent that the shareholders own, directly or indirectly, at least 10 % or more of the value of the stock of that corporation.
4. Stock owned by partners of a partnership, by beneficiaries of an estate or trust, or by persons owning 50 % or more of the shares of a corporation shall be treated as owned by the partnership, estate, trust, or corporation, except that stock owned by a person that is not a US person shall not be treated as owned by a US person.
5. In applying the rules set forth in paragraphs (2) and (3) above, if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 % of the voting stock of a corporation, it shall be treated as owning all of the stock of that corporation.
6. A person owning an option to buy a share of stock is treated as the owner of that share.

US taxpayers have tried to do whatever it takes to walk out of the string of the voting test requirements through several tax planning schemes. To defeat all these maneuvering, Treas. Reg. Section 1.957-1, provides that any arrangement to shift formal voting power away from US shareholders will be ignored in determining whether the voting control test is met unless actual voting power is transferred. More, a foreign corporation will be a CFC if US shareholders have the power to elect, appoint, or replace a person who has powers traditionally exercised by a board of directors of a domestic corporation. Treasury Regulations Section 1.957-1 has two parts.

The first part of Regulation § 1.957-1(b)(2) which deals with of the voting power that provides:

> Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained. The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power to such stock for purposes of Section 957. For example, if there is any agreement, whether express or implied, that any shareholder will not vote his stock or will vote it only in a specified manner, or that shareholders owning stock having not more than 50 % of the total combined voting power will exercise voting power normally possessed by a majority of stockholders, then the nominal ownership of the voting power will be disregarded in determining which shareholders actually hold such voting power, and this determination will be made on the basis of such agreement.

The second part of Regulation 1.957-1(b)(2), which sets forth the "tri-test" to be applied where there are separate classes of voting stock provides:

> (W)here United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person or persons on whose behalf it is exercised or, if not exercised, will be disregarded (1) If the %age of voting power of such other class of stock is substantially greater than its proportionate share of the corporate earnings, (2) If the facts indicate that the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and (3) If a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a controlled foreign corporation under Section 957.

Under IRC Section 951, only US taxpayers owning more than 10 % would have to declare their deemed received dividends.

To avoid double taxation of US taxpayers share of CFC's E&P, actual distribution from the corporation to a US shareholder are tax-free to the extent attributable to amounts already taxed under IRC Section 951(a). Similar tax-free treatment applies to constructive distributions resulting from an investment of the CFC's earnings and profit (E&P) in US property under IRC Section 956 to the extent those constructive distributions are attributable to amounts already taxed as Subpart F income under IRC Section 951(a)(1)(A).

14.4.2 CFC Look-through Rules

The look-through rule under IRC Section 954(c)(6) provides that dividends, interest, rents, and royalties that one CFC receives or accrues from a related CFC shall not be treated as foreign personal holding company income. The look-through rule applies only if the source of the payment from the related CFC is not from Subpart F income or income that is effectively connected with a US trade or business. CFCs are deemed to be related if (i) they are controlled by the same person(s) or, (ii) if one CFC controls or is controlled by another CFC. Control is determined by ownership of more than 50 % of the CFC's stock by vote or value. On December 18, 2014, the President Barack Obama signed the Tax Increase Prevention Act of 2014, which extended IRC Section 954(6). The extension provides some tax planning opportunities for intercompany transactions between related CFCs without triggering deemed inclusions of undistributed taxable income to the US shareholders. In so doing, it enables the payment of dividends from lower-tier CFCs while allowing more discretion in the timing of repatriating CFC earnings to US shareholders.

14.4.3 Sale of CFC Assets

If a US shareholder disposes of shares of a foreign corporation that is, or within the preceding five years was, a CFC, such a disposition is subject to the provisions of IRC Section 1248. A US shareholder of a CFC, therefore, is subject to ordinary income treatment, to the extent of the CFC's earnings and profit. The E&P attributable to the shares sold or transferred constitutes the basis for the application of the dividend rule of IRC Section 1248. The rules under IRC 1248 have been extended to cover sale of lower-tier subsidiaries by upper-tier subsidiaries. A US Taxpayer qualifies for foreign tax credit under IRC Sections 902 and 78. There are

two methods for calculating the gain: (1) the "simple case" method[9] and (2) the "complex case" method.[10]

- The simple case method

The simple case method requires the following conditions to be met:

(i) On each day in which the US person held the block of stock, the foreign corporation was a CFC and was not an Foreign Personal Holding Company (FPHC) or Foreign Investment Company (FIC);
(ii) The foreign corporation had only one class of stock and the same number of shares outstanding during every day in the US person's § 1248 holding period of the stock;
(iii) The foreign corporation was not a less developed country corporation;
(iv) During the US person's holding period, the foreign corporation did not make any distributions out of its E&P, other than distributions that are considered under § 316, as modified by § 959, to be made out of its E&P accumulated during the US person's holding period when the foreign corporation was a CFC;
(v) In respect of any lower-tier CFCs, the four conditions in (i)–(iv) above are satisfied and the US person owns, within the meaning of § 958(a)(2), the same percentage of shares of the lower-tier corporation during each day in its holding period of the upper-tier corporation's stock.

Under the simple case method, the first step is to determine the E&P of the foreign corporation accumulated in any taxable year included the US person's holding period. Generally, this is equal to the E&P of the foreign corporation determined under § 964 for each year in the shareholder's holding period, reduced by any distributions from such E&P. However, § 1248 E&P does not include amounts that have already been subject to US tax as ECI. The simple case method assumes as a condition to its application that all distributions are considered under §§ 316 and 959 to be made out of E&P accumulated during the US person's holding period. Thus, accumulated E&P for the relevant years is simply reduced by the amount of distributions to determine the E&P for each year. Thus, the calculation of § 1248 E&P is made by (1) taking the sum of the CFC's accumulated E&P for the taxable years during the shareholder's holding period and (2) multiplying this sum by the percentage of the CFC's stock held by the US person during its holding period. If the US person holds stock for less than an entire year, the E&P taken into account for the § 1248 calculation for that year is prorated based on the number of

days in the year in which the US person holds stock in the CFC . The E&P included in the § 1248 calculation must also be reduced to reflect the CFC's earnings that have been previously taken into account under subpart F. In simple cases, Treasury Regulation § 1.1248-2(e)(3) provides that, if the US person included an amount under § 951 during its holding period of the block stock, the amount of § 1248 E&P attributed to the block is reduced by the following amount:

1. The E&P other attributed to the block of stock without taking into account any Subpart F inclusions, minus the excess of (2) the amount included by the shareholder under § 951 with respect to the block during the holding period, over (3) the distributions previously excluded by the shareholder pursuant to § 959. The E&P previously taxed as Subpart F income continued to be excluded from § 1248 E&P after it was reclassified from the § 959(c)(2) PTI account to the § 959(c)(1) PTI account.

Example 1: Treasury Regulation § 1.1248-2(e)(4):
On May 26, 1965, Green, a United States person, purchases at its fair market value a block of 25 of the 100 outstanding shares of the only class of stock of CFC F. He sells the block on January 1, 1968. In respect of the block, Green did not include any amount in his gross income under Section 951. F uses the calendar year as its taxable year and does not own stock in any lower-tier corporation referred to in paragraph (c)(5)(i) of this section. All of the conditions of paragraph (c) of this section are satisfied in respect of the block. The E&P accumulated by F (computed under paragraph (d) of this section) are $10,000 for 1965, $13,000 for 1966, and $11,000 for 1967. The E&P of F attributable to the block are $7,500, determined as follows:
Sum of E&P accumulated by F during period block was held:

For 1965 (219/365 × $10,000)	$6000
For 1966	$13,000
For 1967	$11,000
Sum	$30,000
Multiplied by: number of shares in block (25), divided by total number of shares outstanding (100)	25 %
E&P attributable to block	$7500

Example 2: Treasury Regulation § 1.1248-2(e)(4) [(US Shareholder Has Subpart F Inclusion)]:
Assume the same facts as in example (1) except that in respect of the block Green includes in his gross income under Section 951 the total amount of $2,800 for 1965 and 1966, and because of such inclusion the amount of $2,300 which was distributed to Green by F on January 15, 1967, is excluded from his gross income under Section 959(a)(1). Accordingly, the E&P of F attributable to the block are $7,000, determined as follows:

Earnings and profits attributable to the block, as computed in example (1) $7,500

Minus:

Excess of amount included in Green's gross income under Section 951 ($2,800), over portion thereof which resulted in an exclusion

under Section 959(a)(1) ($2300)	$500
Earnings and profits attributable to block:	$7000

Example 3: Treasury Regulation § 1.1248-2(e)(4)[(Lower-Tier Foreign Corporation)]:
Assume the same facts as in example (1) except that on each day beginning on January 1, 1966 (the date CFC G was organized) through January 1, 1968, F owns 80 of the 100 outstanding shares of the only class of G stock. Since, by reason of his ownership of 25 shares of F stock, Green owns within the meaning of Section 958(a)(2) the equivalent of 20 shares of G stock (25/100 of 80 shares), G is a lower-tier corporation referred to in paragraph (c)(5)(i)(a) of this section. If Green had sold the 20 shares of G stock on January 1, 1968, the date he actually sold the block of F stock, the conditions of paragraph (a)(2) of § 1.1248-1 would be satisfied in respect of the G stock, and, accordingly, the conditions of paragraph (c)(5)(ii) of this section must be satisfied. Assume further that such conditions are satisfied, that G uses the calendar year as its taxable year, and that the E&P accumulated by G (computed under paragraph (d) of

this section) are $19,000 for 1966 and $21,000 for 1967. The E&P of F and of G attributable to the block are $15,500, determined as follows:

Sum of E&P accumulated by G for period Green owned G stock within the meaning of Section 958(a)(2) ($19,000 plus $21,000) 40,000

Multiplied by:

Number of G shares deemed owned within the meaning of Section 958(a)(2) by Green (20), divided by total number of G shares

outstanding (100)	20 %
Earnings and profits of G attributable to block	$8000

Earnings and profits of F attributable to block, as determined

in example (1)	$7500
Total E&P attributable to block	$15,000

- Complex case method

If the required conditions for applying the simple case method are not met, then the E&P attributable to the block of stock shall be determined under the "complex case" method. Under this method, E&P of the foreign corporation is determined on an annual basis and allocated to the shareholder based on the shareholder's weighted average %age ownership of the CFC during the year. The same process is then repeated so as to "tier up" the E&P of lower-tier foreign corporations. This annual calculation is necessary to take into account fluctuating levels of ownership of the CFC. Like the simple case method, the complex case method determines the corporation's E&P as under § 964. However, the regulations note that the E&P of the foreign corporation for a taxable year for purposes of applying the complex case method may differ from E&P under § 316 or the "simple case" method in its treatment of distributions. Under Treas. Reg. § 1.1248-3(b)(2)(i), the foreign corporation's

E&P is adjusted to remove any income taxable as ECI under § 882. Further adjustments are made to reduce the accumulated E&P for the year by any distributions made during the year, whether the distributions are made from current E&P or from accumulated E&P in prior years. For purposes of the complex case method, a distribution in excess of current E&P will result in an E&P deficit for the year in which the distribution is made.

Example 1: Treas. Reg. § 1.1248-3(b)(3)(ii)
X Corporation, which uses the calendar year as its taxable year, was organized on January 1, 1965, and was a controlled foreign corporation on each day of 1965. The amount of X's E&P accumulated for 1965 (computed under this paragraph without regard to the adjustment for distributions under this subparagraph) is $400,000, of which $100,000 is distributed by X as dividends during 1965. The amount of X's E&P accumulated for 1965 (computed under this paragraph) is $300,000 (that is, $400,000 minus $100,000).

The result would be the same even if X was not a controlled foreign corporation on each day of 1965.

Example2: Treas. Reg. § 1.1248-3(b)(3)(ii)
Assume the same facts as in example (1). Assume further that the amount of X's E&P accumulated for 1966 (computed under this paragraph without regard to the adjustment for distributions under this subparagraph) is $150,000, and that X distributes the amount of $260,000 as dividends during 1966. Since $150,000 of the distribution is from E&P accumulated for 1966 (computed without regard to the adjustment for distributions under this subparagraph), and since $110,000 is from E&P accumulated for 1965, the E&P of X accumulated for 1966 are a deficit of $110,000 (that is, $150,000 minus $260,000). However, the E&P accumulated for 1965 are still $300,000 for purposes of computing in the manner prescribed in paragraph (c) of this section a person's tentative ratable share.

- Credit for foreign taxes.

If a domestic corporation includes an amount in its gross income as a dividend under Section 1248(a) upon a sale or exchange of stock in a foreign corporation, and if on the date of the sale or exchange the US domestic corporation owns directly at least 10 % of the voting stock of the first-tier corporation: (i) the foreign tax credit provisions under Sections 901 through 908 apply in the same manner and subject to the same conditions and limitations as if the first-tier corporation on such date distributed to the domestic corporation as a dividend that portion of the amount included in gross income under Section 1248(a) which does not exceed the E&P of the first-tier corporation attributable to the stock under § 1.1248-2 or § 1.1248-3, as the case may be, and (ii) if on such date such first-tier corporation owns directly 50 % or more of the voting stock of a lower-tier corporation the foreign tax credit provisions of Sections 901 through 905 apply in the same manner and subject to the same conditions and limitations as if on such date (a) the domestic corporation owned directly that %age of the stock in the second-tier corporation which such domestic corporation is considered to own by reason of the application of Section 958(a)(2), and (b) the second-tier corporation had distributed to the domestic corporation as a dividend that portion of the amount included in gross income under Section 1248(a) which does not exceed the E&P of the second-tier corporation attributable to such stock under § 1.1248-2 or § 1.1248-3. However, a credit shall not be allowed in respect of taxes which are not actually paid or accrued. if the amount included in gross income under Section 1248(a) upon the sale or exchange of the stock in a first-tier corporation is less than the sum of the E&P of the first-tier corporation attributable to such stock under § 1.1248-2 or § 1.1248-3, plus the E&P of the second-tier corporation attributable to such stock under § 1.1248-2 or § 1.1248-3, then the amount considered distributed to the domestic corporation as a dividend shall be determined by multiplying the amount included in gross income under Section 1248(a) by:

- The percentage that (a) the E&P of the first-tier corporation attributable to such stock under § 1.1248-2 or § 1.1248-3, bears to (b) the sum of the E&P of the first-tier corporation attributable to such stock under § 1.1248-2 or § 1.1248-3, plus the E&P of the second-tier corporation attributable to such stock under § 1.1248-2 or § 1.1248-3, and

– The percentage that (a) the E&P of the second-tier corporation attributable to such stock under § 1.1248-2 or § 1.1248-3, bears to (b) the sum referred to in subdivision (i)(b) of this subparagraph.

Example 1
On June 30, 1964, domestic corporation D owns 10 % of the voting stock of controlled foreign corporation X. On such date, D sells a share of X stock and includes $200 of the gain on the sale in its gross income as a dividend under Section 1248(a). X does not own any stock of a lower-tier corporation referred to in paragraph (a)(3) of § 1.1248-3. D uses the calendar year as its taxable year and instead of deducting foreign taxes under Section 164, D chooses the benefits of the foreign tax credit provisions for 1964. If D had included $200 in its gross income as a dividend with respect to a distribution from X on June 30, 1964, the amount of the foreign income taxes paid by X which D would be deemed to have paid under Section 902(a) in respect of such distribution would be $60. Thus, in respect of the $200 included in D's gross income as a dividend under Section 1248(a), and subject to the applicable limitations and conditions of Sections 901 through 905, D is entitled under this paragraph to a foreign tax credit of $60 for 1964.

Example 2
On June 30, 1965, domestic corporation D owns all of the voting stock of foreign corporation Y, and Y (the first-tier corporation) owns all of the voting stock of foreign corporation Z (a second-tier corporation). On such date, D sells a block of Y stock and includes $400 of the gain on the sale in its gross income as a dividend under Section 1248(a). The E&P attributable under § 1.1248-3 to the block are $600 from Y and $1800 from Z. D uses the calendar year as its taxable year and instead of deducting foreign taxes under Section 164, D chooses the benefits of the foreign tax credit provisions for 1965. For purposes of applying the foreign tax credit provisions, Y is considered under subparagraph (3) of this paragraph

to have distributed to D a dividend of $100 ($400 × 600/2400) and Z is considered to have so distributed to D a dividend of $300 ($400 × 1800/2400). If D had included $100 in its gross income as a dividend with respect to a distribution from Y on June 30, 1965, the amount of foreign income taxes paid by Y which D would be deemed to have paid under Section 902(a) in respect of such distribution is $80. If D had owned the stock in Z directly, and if D had included $300 in its gross income as a dividend with respect to a distribution from Z, the amount of foreign income taxes paid by Z which D would be deemed to have paid under Section 902(a) in respect of such distribution is $120. Thus, in respect of the $400 included in D's gross income as a dividend under Section 1248(a), and subject to the applicable limitations and conditions of Sections 901 through 905, D is entitled under this paragraph to a foreign tax credit of $200 ($80 plus $120) for 1965.

- Exceptions

Under Section 1248(g), this Section and §§ 1.1248-2 through 1.1248-8 do not apply to: (1) distributions to which Section 303 (relating to distributions in redemption of stock to pay death taxes) applies; or (2) any amount to the extent that the amount is, under any other provision of the IRC, treated as:

- a dividend;
- gain from the sale of an asset which is not a capital asset; or
- gain from the sale of an asset held for not more than one year.

Gain from a sale or exchange to which Section 1248 applies may be reported under the instalment method if such method is otherwise available under IRC Section 453. In such case, the income (other than interest) on each instalment payment shall be deemed to consist of gain which is included in gross income under Section 1248 as a dividend until all such gain has been reported, and the remaining portion (if any) of such income shall be deemed to consist of gain to which Section 1248 does not apply.

Example
Jones contracts to sell stock in a controlled foreign corporation for $5,000 to be paid in ten equal payments of $500 each, plus a sufficient amount of interest so that Section 483 does not apply. He properly elects under Section 453 to report under the instalment method gain of $1,000 which is includible in gross income under Section 1248 as a dividend and gain of $500 which is a long-term capital gain. Accordingly, $150 of each of the first 6 instalment payments and $100 of the seventh instalment payment are included in gross income under Section 1248 as a dividend, and $50 of the seventh instalment payment and $150 of each of the last three instalment payments are long-term capital gain.

The cases of US partnership or foreign partnerships selling CFC assets have been clarified through some revenue rulings.

– Partnerships Holding CFC Stock

In the case of a domestic partnership holding CFC stock, the IRS ruled in Revenue Regulation 69-124 that the partnership is a US person, and accordingly, a § 1248 shareholder. Sale of CFC stock by the partnership is a § 1248 event on an entity basis.

In the case of a foreign partnership holding CFC stock, Treasury Regulation § 1.1248-1(a)(4) provides that the US partners are treated as selling their proportionate share of CFC stock on an aggregate basis. As a result, domestic partners that indirectly own at least 10 % will have their share of sales proceeds re-characterized as a § 1248 dividend.

If the partners sell their interests in the partnership holding CFC stock, § 751 treats the gain as ordinary to the extent of the partner's pro rata share of gain that would have been a § 1248 dividend if the stock were sold by the partnership. The current IRS position appears to be that the gain is ordinary, but not a § 1248 dividend.[11]

– Distribution by US corporations of certain foreign corporations

If a US domestic corporation , which is a CFC distributes stock of a foreign corporation in a distribution to which Section 311 (a), 337, 355 (c)(1), or 361 (c)(1) applies, then, notwithstanding any other provision of this subtitle, an amount equal to the excess of the fair market value of such stock over its adjusted basis in the hands of the domestic corporation shall be included in the gross income of the domestic corporation as a dividend to the extent of the E&P of the foreign corporation attributable to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock was held by such domestic corporation while such foreign corporation was a CFC.

The final regulations under Section 1248(f) provide exceptions to the operative rule of Section 1248(f)(1) requiring a domestic corporation (distributing corporation) that distributes stock of certain foreign corporations under Sections 337, 355(c)(1), or 361(c)(1) to include in income the Section 1248 amount in the foreign stock distributed. The Section 1248 amount is the amount by which the fair market value of stock in a CFC that is held by a US shareholder exceeds that shareholder's basis in the stock, but limited to the extent of the E&P of the foreign corporation attributable to such stock. The final regulations allow a distributee that is a Section 1248 shareholder of the distributed foreign corporation to make adjustments to the tax basis and holding period of the distributed stock to preserve the Section 1248 amount. If these adjustments are made, then the Section 1248 amount attributable to the distributed foreign corporation's stock does not have to be included in the distributing company's income.

14.4.4 Compatibility of CFC Rules with International Laws

Practical conflicts arise between CFC legislation and international obligations in many parts of the world. Such conflicts may arise in particular from international tax treaties or from the obligations as a member in an economic organization, such as the European Union.[12] In countries where international laws override domestic laws, a mere application of domestic CFC rules suffices to trigger a conflict between the two norms—pacta sunt servanda. The United States does not fall into this category as domestic law passed after the entry into force of international agreements takes precedence (the last-in-time doctrine). Overall, the USA has applied cautiously its doctrine as it seeks always open debate with treaty partners whenever an issue is singled out.

- Compatibility between CFC rules and double tax treaties

In its 1998 report (harmful tax competition) the Organisation for Economic Co-operation and Deveopment (OECD) has backed up countries' efforts to adopt CFC rules as a mean to counteract harmful tax competition.[13] Although the commentaries to the OECD Model Tax Convention speak in favor of a position under which CFC rules are regarded as independent from tax treaties, the arguments brought forward for such a position are rather formalistic and seem to be contrary to the general principles underlying the OECD model and the spirit of tax treaties.[14] By and large, two different methods are used to define if income is transferred for tax reasons: (i) the transactional approach and (ii) the jurisdictional approach. According to the transactional approach passive income is subject to CFC taxation. That is, passive income (i.e., interest, dividends, rents, royalties) received from companies established in low-tax countries can be subject to CFC taxation whereas the income could well have been taxed at a comparable tax rate in the shareholders' countries. With such unexpected outcome, the CFC rules become counterproductive as to its intended purpose or tax avoidance. On the other hand, the jurisdictional approach focuses on companies established in tax havens. Though it might seem fair to justify the CFC rules in this scenario, the debate is more complex than it appears at first sight. Identifying a tax heaven when the country or jurisdiction does not hold out as such becomes subjective: first, tax authorities should give careful consideration to the selection of criteria on the basis of which such identification is made, and, second, tax authorities should make sure that the criteria they use are not discriminatory.[15] More, substantial business reasons may justify the location of a particular CFC within a tax heaven. This may lead to an economic double tax situation as the same income is taxed more than once but in the hands of different taxpayers.

For the very first time, in its 1992 version of the OECD Model Convention commentary, the OECD holds the view that CFC rules do not conflict with double tax treaties,[16] that the substance-over-form principle is applicable. However, there is a flaw in the OECD reasoning: it relies on the fact that it pointed out that the specific obligations arising from a tax treaty must be respected by the contracting states when they apply CFC rules. In 2003, the OECD made additional comments under article 7 (1), and article 10 (1) and (5).

> The article does not limit the right for the shareholder state to tax its residents on their share of the profits in a CFC.

However, the OECD failed to clarify whether article 10 on dividends or article 21 on other income should be used when CFC income is classified as a deemed dividend. The matter was left to the tax authorities and/or the courts to clarify. In two cases, the highest courts in France and Finland differed in their conclusions. In March 2002 the Finnish supreme administrative court held that the Finnish CFC rules were not in conflict with the Finland–Belgium double tax treaty.[17] B contrast, the French administrative high court held in 2002 that the French supreme administrative court[18] gave its ruling whereby the France–Switzerland tax treat, prevented the application of CFC rules. The facts under the Schneider case can be summed up as follows:

A French corporation owned 100 % of Paramer, a Swiss corporation in the canton of Geneva.

- Schneider tax returns for fiscal years 1985 and 1986 were audited by the French tax administration. As result of the audit, Schneider was required by the French tax administration to pay an extra tax under Section 209B. After unsuccessfully opposing this extra tax, Schneider brought the case to trial.
- The Paris low tax court judges held in favor of the French tax administration.
- Schneider lodged an appeal against the decision, with two arguments: (i) the safe haven clause under Section 209B-II and (ii) Section 7-1 of the France-Switzerland tax treaty.
- The French tax high court agreed with Schneider that Section 209 B violated Article 7-1 of the France–Switzerland double tax treaty.

Almost six years later, on April 3, 2008, the Swedish supreme administrative court reiterated the view that the Swedish CFC rules are compatible with the Swedish–Swiss tax treaty of 1987. Interestingly enough, the court disregarded the wording of the treaty to reach an outcome by application of the " lex posterior derogat legi priori " principle, ignorant of the clear wording of the aforementioned tax treaty.

Far away from the EU sphere, Brazilian courts, among the others in landmark cases EAGLE I of October 19, 2006 (Case no. 101-95.802) and EAGLE II of December 17, 2008 (Case no. 101-97.070) decided that the Brazilian CFC rules are incompatible with tax treaties.

- Compatibility between the CFC rules and the EU fundamental principles

The debate becomes even more fierce with regard to EU principles. From an economic point of view, the use of CFC legislation is an obstacle to the objective of creating a single market.[19] In Cadbury Schweppes (Case C-196/04), the European Court of Justice held that UK CFC rules were incompatible with the EU freedom of establishment.[20]

14.5 Subpart F Income

Under IRC Section 952(a), Subpart F Income is the sum of the following:

- Insurance income (IRC §953);
- Foreign base companies (IRC §954);
- International boycott income (IRC §999)
- Illegal bribes, kickbacks, or similar payments; and
- Income from certain ostracized foreign countries.

However, certain incomes are excluded from the Subpart F regime. These include:

- US source income that is effectively connected with a US trade or business is excluded from the definition of subpart F income;
- Foreign source income that is effectively connected with a US trade or business may be included in Subpart F income.

The taxable Subpart F income subject to tax is deemed taken out of the E&P of the CFC, as defined under US domestic rules. Any Subpart F income that is not included due to a current year E&P limitation is included in future years when a sufficient amount of untaxed E&P is generated.

14.5.1 Certain Insurance Income (IRC Section 953)

These include income that:

- Is attributable to the issuing or (reinsuring) of an insurance or annuity contract; and
- Would be taxed under subchapter L of this chapter if such income were the income of a domestic insurance company.

In determining whether a captive insurance company is a CFC for purposes of taxing its shareholders under Subpart F on its related person insurance income, the more-than-50 % test is replaced with a 25 %-or-more test. Put differently, Subpart F Insurance income has lower ownership thresholds of 25 % relative to the general ownership threshold of 50 %; there is no stock threshold requirement.

14.5.2 Foreign Base Companies

Foreign base company income is made up of several types. It shall be noticed that the Job Act of 2004 has made the former "Foreign Personal Holding Company" a component of the foreign base company income.

14.5.2.1 Foreign Personal Holding Company Income (IRC Section 954(c))

Foreign personal holding company income is one type of Subpart F income that is subject to current US tax. This category includes interest, dividends and rents, and royalties. It also includes gains from the sale of property that produces passive income or that is held for investment, gains from commodities transactions, and gains from foreign currency transactions, as well as certain other income that is, in effect, the equivalent of interest or dividends. Because of its passive nature, such income often is highly mobile and can be easily deflected.

- Dividends, interest, royalties, rents, and annuities

"Interest" includes any amount treated as interest under Code or Treasury regulations, including stated and unstated interest, original issue discount, and related person factoring income treated as interest under Code Section 864(d)(1) and (6). The regulations also provide that exempt interest is included in FPHC income. However, under IRC Section 954(h) certain items of income have been excluded. For instance, qualified banking or financing income of an eligible CFC will not constitute FPHC items from this category that are likely to have been received by a CFC in the ordinary course of its business or that otherwise do not seem to present a serious threat of tax avoidance.

- net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise

to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits ("REMICs");

- net gains from commodities transactions;

Gains from commodity transactions include gains derived from the purchase or sale of rights or obligations relating to a commodity. Thus, gains derived from forward or futures contracts, from actual delivery of a commodity, from notional principal contracts indexed to commodity prices, or from dealings in commodity options would constitute FPHC income. However, gains from certain sales of commodities would be excluded from FPHC income if they arise out of a commodities hedging transaction. Likewise, commodity gains that derive are excluded.

- Net gains from certain foreign currency transactions

Gains from certain foreign currency transactions constitute Subpart F income. However, several exceptions apply for certain commodity gains and foreign exchange gains arising from normal business operations. Taxpayers may elect to include net currency gains or losses in another category of FPHC income if the gain or loss relates to income in that other category. For example, the taxpayer may elect to treat a currency gain relating to the sale of inventory as FBCSI rather than FPHC income, thereby producing a better result under the separate basket limitation rules of Code Section 904(d). Alternatively, taxpayers may elect to treat all net foreign currency gains and losses (with some exceptions) as FPHC income, including, for example, business-related currency losses that otherwise would be excluded from FPHC income.

- Income that is equivalent to interest

Included in this category are a grab bag of items, most of which reflect payments due to the time value of money. Under specified circumstances, the category includes factoring income (other than amounts included in the first category of FPHC income as interest), income derived from notional principal contracts (e.g., interest-rate swaps), imputed interest arising from a delay in making payment for services, and commitment fees paid to a lender to provide financing (whether or not the financing is actually provided).

- Income from notional principal contracts

Taxpayer Relief Act of 1997, is income from notional principal contracts, such as interest-rate swaps. This income, like interest, is highly mobile and easy to shift to a tax haven.

- Payments in lieu of dividends

Taxpayer Relief Act of 1997 is payments in lieu of dividends. The latter category is necessary to prevent taxpayers from avoiding Subpart F by "lending" dividend-producing stock to some person and receiving payments from that person in lieu of the dividends paid on that stock.

- Amounts received under personal service contracts

American Jobs Creation Act of 2004. It provides that FPHC income includes income derived by a corporation from a personal service contract, including the sale of such a contract, if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or the individual who is to perform the services is designated (by name or by description) in the contract. This provision is designed to prevent entertainers, athletes, professionals, and other self-employed taxpayers from avoiding US tax by deflecting income derived from their services to a foreign corporation.

- CFC look-through rule

In 2006, Congress enacted Section 954(c)(6) on a temporary basis. Under the CFC look-through rule, dividends, interest (including factoring income that is treated as equivalent to interest under Section 954(c)(1)(E)), rents, and royalties, received by one CFC from a related CFC, are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither subpart F income nor effectively connected with a US trade or business.

For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person (or persons) that control the other CFC. Ownership of more than 50 % of the CFC's stock (by vote or value) constitutes control for these purposes. Although this provision expired on December 31, 2009, Section 264 of the American Jobs and Closing Tax Loopholes Act (H.R. 4213) which passed the House on May 28, 2010, and is now under consideration in the Senate, extends these provisions for one year.

14.5.2.2 Foreign Base Company Sales Income (IRC Section 954(d))
Foreign base company sales income (FBSCI) generally involves a CFC which is organized in one jurisdiction, used to buy goods, typically from a manufacturer in another jurisdiction, and then sells the goods to a related CFC for use in a third jurisdiction, while retaining the income resulting from those transactions.

FBCSI is income of a CFC from the sale of personal property that is purchased from, or on behalf of, or sold to, or on behalf of, a related person where the property is both manufactured and sold for use outside the CFC's country of incorporation. FBCSI consists of income derived by a CFC in connection with: (i) the purchase of personal property from a related person and its sale to any person; (ii) the sale of personal property to any person on behalf of a related person; (iii) the purchase of personal property from any person and its sale to a related person; or (iv) the purchase of personal property from any person on behalf of a related person. In each of the situations described in items (i) through (iv), the property must be both manufactured outside the CFC's country of incorporation and sold for use outside of that same country for the income from its sale to be considered FBCSI. If the CFC manufactures the property that it sells, the sales income generally will not be subject to FBCSI rules. FBCSI rules are intended to prevent the deflection of income from the jurisdiction in which the goods are manufactured to a low-tax jurisdiction. Thus, when the manufacturing is carried on by related corporations, FBCSI rules often will apply. Further, FBCSI provisions contain a branch rule, which provides that, even when both the manufacturing and sales activities are conducted by the CFC, FBCSI rules may apply if the sales and manufacturing activities are conducted in separate tax jurisdictions and the effective rate of tax imposed on the sales income is significantly lower than the rate that would be imposed on such income if the sales income were subject to tax in the jurisdiction where the manufacturing activities occurred.

- Manufacturing exception

The manufacturing exception that is implicit in the statue is expressly stated in Treasury Regulations, which provide that FBCSI does not include income of a CFC derived in connection with the sale of personal property manufactured, produced, or constructed by the CFC, in whole or in part, from personal property that it has purchased. Thus, if at all stages in the acquisition, production, and disposition of the property from or to unrelated persons, only one CFC holds title to the property (although others may be involved in manufacturing the property to be sold), then

the FBCSI rules will never apply. This is because there will have been no sale to, from, or on behalf of a related person. A CFC can qualify for the manufacturing exception if it meets one of the three tests. The first two are physical manufacturing tests: the substantial transformation test and the substantial activity test. The third test, the substantial contribution test, was added by the 2008 regulations and is discussed in detail below. Under the substantial transformation test, a CFC is considered to have manufactured a product if it purchases and "substantially transforms" personal property prior to its sale. This requirement involves, for example, the transformation of raw materials into a finished product, such as processing and converting wood pulp into paper or the transformation of steel rods to screws.

Under the substantial activity test, a CFC is considered to have manufactured a product through the assembly or conversion of component parts, provided the activities are substantial in nature and generally considered to constitute the manufacture, production or construction of property. Under this second test, a safe harbour presumes the CFC will have manufactured a product if its conversion costs account for at least 20 % of the total cost of goods sold (i.e., direct labor and factory burden). Conversion costs exclude costs for packaging, repackaging, labellng, and minor assembly operations, as these activities are not considered to constitute manufacturing activities.

In *Bausch & Lomb, Inc. v. Commissioner*, the Tax Court held that sunglass assembly operations performed by two CFCs satisfied the second test (i.e., the substantial activity test).

Each CFC had a trained and skilled workforce that engaged in a range of activities necessary to assemble sunglass parts into finished sunglasses. Accepting testimony from an industry expert that the sunglass industry would recognize the operations of the CFCs as the manufacturing of "quality sunglasses," the Court found that the CFCs had manufactured the personal property that they subsequently sold.

In 2009, the regulations governing the manufacturing exception were liberalized to make it much easier for a foreign affiliate to claim the exception. As explained by the Joint Committee on Taxation, the 2009 regulations provided:

> A CFC can qualify for the manufacturing exception if it meets one of three tests. The first two [are] physical manufacturing tests: the substantial transformation test and the substantial activity test. The third test [is] the substantial contribution test.[21]

- Branch rules

Special branch rules may apply in cases in which a CFC carries on purchasing, selling, or manufacturing activities outside its country of organization through a branch or similar establishment (referred to hereafter as a "branch"). If the branch is treated as a separate corporation under the sales branch rules, purchasing and sales income derived by the branch generally will be foreign base company sales income. Similarly, if there is a manufacturing branch that is treated as a separate corporation, purchasing and sales income derived by the remainder of the CFC and foreign sales branches of the CFC generally will be foreign base company sales income. The branch rules address situations in which income derived by selling activities has been separated from income derived by manufacturing activities for purposes of obtaining a lower tax rate on the sales income. The rules apply, however, only if the use of the branch has substantially the same tax effect as if it were a separate corporation. Whether use of the branch has substantially the same tax effect as if it were a separate corporation is determined under regulations, and is based on a tax rate disparity test.

Under the sales branch rule, the tax rate disparity test assumes that the manufacturing operation is retained by the CFC and evaluates whether the selling activities have been shifted to a selling branch to obtain a lower tax rate on the selling income.

While Section 954(d)(2) expressly provides a branch rule for purchasing or sales activities occurring outside the CFC's country of organization, it does not expressly provide a manufacturing branch rule, which is provided only in regulations. Under the regulations, if the conduct of manufacturing activities by or through a branch located outside the CFC's country of organization has the same tax effect as if such branch were a separate corporation, then the branch and the remainder of the CFC will be treated as separate corporations for purposes of determining whether the CFC has foreign base company sales income. Whether use of the branch has substantially the same tax effect as if it were a separate corporation is determined based on a tax rate disparity test. This test assumes that the selling operation is retained by the CFC, and compares the tax rate imposed on the sales income by the CFC's country of organization to the tax rate that would have been charged had the sales income been recognized in the country where the manufacturing branch is located.

The tax rate disparity tests differ slightly under the two branch rules. Under the sales branch rule, the sales branch is treated as a separate corporation if the effective tax rate on its sales income is less than 90 % of,

and at least 5 percentage points less than, the effective tax rate that would apply to that same income if it had been earned in the CFC's country of incorporation (i.e., where the manufacturing income is earned). Thus, the test examines whether the tax rate of the branch is too low in comparison with the CFC.

In contrast, under the manufacturing branch rule, the manufacturing branch is treated as a separate corporation if the effective tax rate on the CFC's sales income is less than 90 % of, and at least 5 percentage points less than, the effective tax rate that would apply to such sales income in the country in which the branch is located. Thus, the test examines whether the tax rate of the CFC is too low in comparison with the manufacturing branch. In each case, several distinct assumptions are made in determining the allocation of income to the branch and to the non-branch income of the CFC.

- Contract manufacturing

Historically, the IRC and regulations did not expressly address the application of the FBCSI rules to contract manufacturing arrangements. However, based on IRS rulings, the first of which was Revenue Ruling 75-7, taxpayers relied on the manufacturing activities of a contract manufacturer, and attributed these activities to the hiring company (in this context, a hiring CFC)—the principal in a contract manufacturing arrangement—for the purposes of the manufacturing exception to Subpart F.

In Revenue Ruling 75-7, the hiring CFC owned the raw materials, work-in-progress, and finished goods, controlled the timing and quantity of production, as well as the manufacturing process, and had both the risk of loss and the right to profit (after payment of the contract manufacturer's conversion fee) with respect to the commercialization of the finish goods. The IRS ruled that the manufacturing exception was satisfied but also that the CFC was deemed to have a manufacturing branch in the country in which the corporate contract manufacturer was organized. The ruling did not treat this deemed manufacturing branch as a separate corporation from the CFC under Treasury Regulation Section 1.954-3(b)(1)(ii) because the manufacturing was undertaken in a jurisdiction with a lower tax rate than that of the selling corporation. Thus, there was no tax rate disparity with respect to the deemed manufacturing branch.

In *Ashland Oil Co. v. Commissioner* and *Vetco, Inc. v. Commissioner*, taxpayers challenged whether the IRS was correct in asserting that a hiring CFC's contract manufacturing arrangement with a corporate contract manufacturer gave rise to a manufacturing branch in the country in which the contract manufacturer was located. The Tax Court held in each

case that, it would not deem a corporate contract manufacturer, whether related to the CFC or not, as a branch of the hiring CFC. The effect of these decisions was to position taxpayers to claim the benefit of attribution for purposes of the manufacturing exception, without the imposing constraint of an implied manufacturing branch – and thus the requisite application of the tax rate disparity test—for the purposes of the FBCSI rule.

Proscribed by Ashland and Vetco from deeming a manufacturing branch in situations where the taxpayer relies on attribution, the IRS ultimately issued Revenue Ruling 97-48 and revoked Revenue Ruling 75-7, stating that it would no longer permit attribution of the activities of a contract manufacturer to a CFC for purposes of Section 954(d). Commentators widely criticized Revenue Ruling 97-48 as an incorrect application of relevant law, and it is generally understood that taxpayers continued to rely on the manufacturing exception based on attribution. Proposed regulations were issued in 1998 that would have required the selling corporation, itself, to perform manufacturing activities for purposes of the manufacturing exception. However, these regulations were withdrawn shortly thereafter. In addition to attribution, some taxpayers have relied on the so-called "its" argument as a means of qualifying contract manufacturing arrangements under the manufacturing exception.

This position relies on the plain language of the statute that FBCSI includes "the purchase of personal property from a related person and its sale to any person". Thus, a CFC that purchases personal property that is then transformed into a different product before its subsequent sale does not derive FBCSI on the subsequent sale because the manufactured product is not the same—without regard to the activities or contributions of the CFC in the transforming the personal property—as the property originally purchased by the CFC. The so-called "naked its" position refers to a hiring CFC that has no functional substance and which makes little or no contribution towards the manufacturing performed by the contract manufacturer.

- 2008 regulations

On December 24, 2008, the Treasury Department and IRS issued final, temporary, and proposed regulations concerning FBCSI rules. The preamble to the regulations rejects the "its" position and states the government's view that this position "is contrary to existing law, and represents an incorrect reading of Section 954(d)(1)." In addition, the regulations do not revoke the IRS's position on attribution as stated in Revenue Ruling 97-48, but rather expand the definition of manufacturing to include a third category of manufacturing activities, referred to as the nonphysical activities.

These new regulations are generally applicable to taxable years of CFCs beginning after June 30, 2009, and for tax years of US shareholders in which or with which such tax years of the controlled foreign corporations end. However, subject to certain conditions, the taxpayer may choose to apply these rules retroactively with respect to its open tax years.

- New contract manufacturing rules

Under the new contract manufacturing regulations, the income of a CFC earned as the principal in a contract manufacturing arrangement is not subject to current taxation as Subpart F income, provided the CFC makes a substantial contribution, through its own employees, to the manufactured property that it sells. To qualify for the manufacturing exception, the personal property must have undergone a physical manufacturing process. However, it is not necessary for any of the CFC's direct employees to perform the actual physical manufacturing activities. Rather, the CFC can meet the manufacturing exception by making a substantial contribution through the "nonphysical" manufacturing activities of its employees.

To meet the substantial contribution test, the specific categories of activities potentially performed by the CFC's employees include: (i) oversight and direction of manufacturing activities or process pursuant to which the property is manufactured, produced, or constructed; (ii) performance of activities that are considered in, but that are insufficient to satisfy, the "substantial transformation" or "substantial activities" tests; (iii) material selection; (iv) vendor selection; (v) control of raw materials, work-in-process, and finished good; (vi) management of manufacturing costs or capacities; (vii) control of manufacturing related logistics; (viii) quality control; and (ix) direction of the development, protection, and use of trade secrets, technology, product design, and design specifications, and other intellectual property used in manufacturing the product.

Of these categories, there is no single overriding or controllng factor. Instead, it is a facts and circumstances determination that depends on the economic importance of the activity to the manufacture of the product. In addition, the ownership of the raw materials is not relevant in the determination, such that there is no distinction between toll (consignment) and traditional contract manufacturing. In general, the location of the manufacturing activity will be where the CFC makes its contribution through its employees. The CFC cannot satisfy the substantial contribution test on the basis of anyone in an agency relationship with the CFC; rather, its own employees, as that term is defined for US federal tax purposes, must

conduct the relevant activities. Similarly, the activities of a person employed by the CFC's Disregarded Entity (DRE) are only taken into account if that person is considered an employee of the DRE under the US Federal tax definition of "employee." There are no safe harbour provisions, and both the substantial contribution and branch manufacturing analyses are made on a product-by-product basis. Furthermore, mere contractual rights, legal title, tax ownership, and assumption of economic risk of loss are not considered when determining whether there is substantial contribution.

- New branch rules

For purposes of applying the branch rule, the temporary regulations provide guidance for determining the location of manufacturer, and the rules for applying the tax rate disparity test in cases involving multiple manufacturing and sales branches.

The cornerstone of the temporary regulations is that a CFC performing manufacturing activities in multiple locations will be considered as having a single manufacturing location for purposes of applying the tax rate disparity test. If any single location independently satisfies any of the manufacturing tests, that location is treated as the manufacturing location. If there are multiple locations that independently satisfy either of the physical manufacturing tests, or substantial contribution test, the location of manufacturing is the location with the lowest effective tax rate. If there are multiple locations but no single location independently satisfies a manufacturing test, but together they provide a substantial contribution to the manufacture of the product, then the manufacturing location will be deemed to be the location of sale or purchase if a "demonstrably greater" amount of the CFC's activities contributing to the manufacture of the product occur in jurisdictions with no tax rate disparity (as that term is used in this context) relative to the sale and purchase location than occur in other jurisdictions.

In the first case (i.e., the manufacturing location is deemed to be the location of sale or purchase), no FBCSI will result. In the latter case (the location of manufacture is the location with excessive tax rate disparity, as that term is used in this context, relative to the sales and purchase location), FBCSI may result. For the purposes of the branch rule, the location in which activities take place is where the relevant personal are when they perform such activities, not the location of the employing company.

The interaction of the branch rules with the substantial contribution test may subject certain transactions to current taxation under Subpart F that had not previously been so taxed.

These transactions involve the purchase of personal property from an unrelated person followed by its sale to an unrelated person. Under the new branch rule, a CFC that (i) purchases from, and sells to, unrelated persons, (ii) has employees whose activities render a substantial contribution to the manufacture of the personal property outside the country of the CFC's incorporation, is deemed to have a manufacturing branch. In this case, the manufacturing branch must be evaluated under the tax rate disparity test to determine if the CFC has foreign base company sales income.

14.5.2.3 Foreign Base Company Services Income (IRC Section (IRC Section 954(e).

Foreign base company services income is another category of Subpart F income that applies to active income that can be deflected to a low-tax jurisdiction through related party transactions, in this case, through the performance of services. FBCSI consists of income from services performed outside the CFC's country of incorporation for or on behalf of a related party (Section 954(e)). This includes "substantial assistance" contributing to the performance of services by a CFC that has been furnished by a related person or persons. Substantial assistance consists of assistance furnished (directly or indirectly) by a related US person or persons to the CFC if the assistance satisfies an objective cost test. For the purposes of the objective cost test, the term "assistance" includes, but is not limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies provided directly or indirectly by a related US person to a CFC. The objective cost test will be satisfied if the cost to the CFC of the assistance furnished by the related US person or persons equals or exceeds 80 % of the total cost to the CFC of performing the services.

US property held by CFCs: a US shareholder that owns stock in a CFC on the last day of the taxable year must include in its gross income the amount determined under Section 956 with respect to such shareholder for such year (but only to the extent not previously taxed) (a "Section 956 inclusion"). The Section 956 inclusion for any taxable year is generally the lesser of (i) the excess of such shareholder's pro rata share of the average of the amounts of US property held (directly or indirectly) by the CFC as of the close of each quarter of such taxable year over the amount of previously taxed income from prior section 956 inclusions with respect to such shareholder, or (ii) such shareholder's pro rata share of the applicable earnings of such CFC.

The US property held (directly or indirectly) by a CFC must be measured as of the close of each quarter in the taxable year. The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the CFC's E&P, reduced by any liability to which the property is subject.

For the purposes of Section 956, US property generally is defined to include tangible property located in the United States, stock of a US corporation, an obligation of a US person, and the right to use certain intellectual property in the United States. Specified exceptions are provided for, among other things, obligations of the United States, US bank deposits, certain export property, certain trade or business obligations, stock or debt of certain unrelated US corporations, and certain deposits or receipts of collateral or margin by, and certain repurchase or reverse repurchase agreement transactions entered into by or with, a securities or commodities dealer in the ordinary course of the dealer's business.

14.5.2.4 Income from Countries Subject to International Boycotts (IRS Section 999)

During the mid-1970s the United States adopted two laws that sought to counteract the participation of US citizens in other nation's economic boycotts or embargoes. These "anti-boycott" laws are the 1977 amendments to the Export Administration Act (EAA) and the Ribicoff Amendment to the 1976 Tax Reform Act (TRA), which is found in Section 999 of the IRC. Under IRC Section 999, US persons with operations in or related to a "boycotting country," or with the government, a company or a national of a boycotting country, must file Form 5713. Even if a taxpayer does not participate in an international boycott, the taxpayer may have a reporting obligation under §999. Form 5713 is due with the income tax return, including extensions. A copy is required to be filed with the IRS Center in Ogden, Utah, if a taxpayer does not file electronically.

A taxpayer is considered to have operations in a boycotting country if it has an operation that is carried out, in whole or in part, in a boycotting country, either for or with the government, a company or a national of a boycotting country. A taxpayer is considered to have operations "related to" a boycotting country if it has operations that are carried on outside a boycotting country for the government, a company, or a national of the non-boycotting country if the taxpayer knows or had reason to know that specific goods or services produced by the operation are intended for use in a boycotting country, or for use in

forwarding or transporting to a boycotting country. The term "operations" means all forms of business and commercial activities, whether or not income is produced. These activities include selling, purchasing, leasing, licensing, banking, financing, extracting, processing, manufacturing, producing, constructing, transporting, and performing activities related to these activities.

The Treasury Department has issued detailed guidelines to clarify the provisions of IRC Section 999. This section highlights several key points. Taxpayers that participate in international boycotts may be subject to penalties that reduce their foreign tax credit, the benefits of foreign sales corporations, and the deferral available to US shareholders of controlled foreign corporations. A boycott involves entering into certain agreements as a condition of doing business in a country. The agreement requires a person to refrain from doing business in (or hiring employees from) another country or with other persons that do business in (or hire employees from) the other country. Not all instances of boycott participation are subject to a penalty. The refusal by one country to buy goods from another country is acceptable under the boycott provisions (this is a primary boycott). A boycott that requires the cessation of business with another country as a condition of doing business is not acceptable (this is a secondary boycott). A boycott that requires the cessation of business with a US person engaged in trade in a country or company which is the object of a boycott or that requires the cessation of business with a company whose employees are of a particular nationality, religion, or race or to remove directors of a particular nationality, religion, or race is not acceptable (this is a tertiary boycott). There are several types of international boycott: (i) primary boycott; (ii) secondary boycott; and (iii) tertiary boycott. Secondary and tertiary boycotts are reportable on the Form 5713 (International Boycott Report).

- A primary boycott consists of restrictions on the import or export of goods from a specific country, and is not reported in Form 5713.
- A secondary boycott is where a country refuses to deal with a company because that company (or a related corporation) deals with a boycotted nation, even if no products of the boycotted nation are involved in the transaction.
- A tertiary boycott is where a country refuses to deal with a US company that does no business with the boycotted nation, but which has dealings with other companies that deal with the boycotted nation.

- *Boycott Countries*

The Treasury Department periodically publishes a list of countries that may require boycott participation. The countries identified in the most recent notice are: Iraq; Saudi Arabia, United Arab Emirates, Republic of Yemen, Oman, Qatar, Kuwait, Lebanon, Libya, Syria.

Other countries may also require boycott participation. When a non-listed country requires boycott participation, International Examiners (IEs) will summarize their findings in a memorandum and forward it to the Director, International Large and Mid Size Businesses (LMSBs), Manager, International Programs, Internal Revenue Service. The Director of International Programs will take steps to update the Treasury Department list of countries.

- *Participation in a Boycott*

IRC §999 provides that a taxpayer cooperates with an international boycott if the taxpayer agrees to refrain from:

- Doing business with a boycotted nation;
- Doing business with anyone who does business with a boycotted nation;
- Doing business with any company whose management consists of people of a particular nationality, race or religion;
- Hiring people of a particular nationality, race or religion;
- Shipping or insuring products bound for the boycotting nation if the shipper or insurer does not cooperate with the boycott.

To constitute participation in a boycott, a taxpayer must agree to certain prescribed conduct as a condition for doing business with a boycotting country. An agreement can be specific or can be inferred by conduct. The agreement terms must require the taxpayer to "comply" with the boycotting country, not merely state the boycotting laws of the country "apply."

Penalties and Loss of Tax Benefits

IRC §999 sets forth penalties and loss of tax benefits for participation in certain international boycotts. Section 999 penalties tailor those taxpayers with DISC (domestic international sales corporation), FSC (foreign sales corporation), foreign subsidiary deferral, and/or foreign tax credit benefits. Where the taxpayer participates in or cooperates with an international

boycott, such taxpayer is not entitled to any foreign tax credit for foreign income taxes imposed on income from the operation. If the participating entity is a CFC, income earned from the operation is taxed directly to the US shareholder instead of being deferred, even if subpart F rules do not apply to the income. In addition, taxpayers may lose a portion of the deferral of taxation of IC-DISC income and exclusion of extraterritorial income from gross income. Penalties for wilfully failing to file Form 5713 are a $25,000 fine, imprisonment for no more than one year, or both.

Agreement

Usually, there must be an oral or written agreement entered into as a condition of doing business in a boycotting country. The agreement must require a prohibited action as specified in IRC Section 999(b)(3)(A). The words "abide by" and "comply with" often indicate the existence of an agreement.

The focus of the statute is on boycotts. Accordingly, the following are not subject to a penalty:

- Agreement to refrain from doing business with non-US persons or non-boycotted country persons;
- Agreement providing that goods delivered under it are acceptable only on a delivered-in-a-boycotting-country-basis (even if blacklisted companies probably cannot meet the conditions of the contract);
- A contract that has the boycotting country specifically name the companies that will be subcontractors under the contract;
- Agreement providing that a specific number of nationals of the boycotting country will sit on the board of directors;
- Agreement specifying that nationals of the United States or any other country will be employed on the project or that a particular percentage of the employees on a particular project will be nationals of the boycotting country;
- Agreement that goods destined for a boycotting country will not be shipped on board a vessel owned, leased, operated, or chartered by a boycotted country national or that such vessel will not call at the ports of a boycotted country in route to the boycotting country (this exception is based on the risk of loss or confiscation of the goods);
- Agreement that shipment of goods will occur on a particular vessel, or vessels of a particular country.

The following are subject to a penalty:

- Agreement to refrain from doing business with a blacklisted US company (whether or not that company engages in trade with a boycotted country);
- Agreement to refrain from doing business with a blacklisted US company as a condition of doing business in a non-boycotting country at the request of a boycotting country,
- Agreement to pick subcontractors for a boycotting country project from a whitelist (a list excluding blacklisted companies);
- Agreement to refrain from doing business based on the race, nationality, or religion of the company's ownership or management;
- Agreement by a company to provide a certificate stating that its board of directors does not contain any boycotted country nationals;
- Agreement to refrain from employing individuals of a particular religion;
- Agreement not to ship goods on a blacklisted ship or, generally, on a ship owned, leased, or operated by a government, company, or national of a boycotted country.

Where there is no agreement, actual adherence to the terms of a boycott will not constitute an agreement to participate in an international boycott. This distinction is fine, but critical. For example, penalties apply to the agreement to provide a certificate of national origin or ethnicity, not the mere provision of such information.

14.5.2.5 Illegal Bribes, Kickbacks, and Similar Payments

Under IRC Section 162 (c) no deduction shall be allowed for any payment made, directly or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment constitutes an illegal bribe[22,23] or kickback or, if the payment is to an official or employee of a foreign government, the payment is unlawful under the Foreign Corrupt Practices Act of 1977. The burden of proof in respect of the issue, for the purposes of this paragraph, as to whether a payment constitutes an illegal bribe or kickback (or is unlawful under the Foreign Corrupt Practices Act of 1977) shall be upon the Secretary to the same extent as he bears the burden of proof under Section 7454 (concerning the burden of proof when the issue relates to fraud).

14.6 Passive Foreign Investment Company (PFIC)

IRC Section 1297 defines a Passive Foreign Investment Company (PFIC) as a foreign corporation with 50 % or more of its assets being passive and/or more than 75 % of its income being passive. Passive income is interest, dividends, capital gains, and passive assets are assets that generate passive income. A US taxpayer investing in a PFIC shall report its taxable earnings from the PFIC on a current basis. To that end, the US investor will need to obtain sufficient information from the PFIC. This can be achieved in two different ways:

1. The PFIC provides the investor with a PFIC Statement which reports to its annual pro rata portion of the PFIC's taxable ordinary income and long term capital gain. The PFIC Statement also reports any distributions made to the investor during the year along with a statement that the PFIC will allow the IRS to inspect its books and records, whenever necessary. The PFIC Statement must be signed by an authorized representative of the PFIC. The US investor can utilize the information on the PFIC Statement to make an election to treat the PFIC as a Qualified Electing Fund (QEF Election). By making the QEF election, the US taxpayer relinquishes its ability to defer reporting taxable income from the PFIC until distributions are made.

Under Treasury Regulation §1.1295-3(f), a shareholder may request the consent of the Commissioner to make a retroactive QEF election for a taxable year if:

1. The shareholder reasonably relied on a qualified tax professional, within the meaning of Treasury Regulation §1.1295-3(f)(2);
2. Granting consent will not prejudice the interests of the United States government, as provided in Treasury Regulation §1.1295-3(f)(3);
3. The request is made before a representative of the IRS raises upon audit the PFIC status of the company for any taxable year of the shareholder; and
4. The shareholder satisfies the procedural requirements of Treasury Regulation §1.1295- 3(f)(4).

The procedural requirements include filing a request for consent to make a retroactive election with, and submitting a user fee to, the Office

of the Associate Chief Counsel (International). Treasury Regulation §1.1295-3(f)(4)(i). Additionally, affidavits signed under penalties of perjury must be submitted that describe:

1. The events that led to the failure to make a QEF election by the election due date;
2. The discovery of the failure;
3. The engagement and responsibilities of the qualified tax professional; and
4. The extent to which the shareholder relied on the professional.

For PFICs which are regulatory traded on a recognized exchange, the US taxpayer can elect for marked to market on the last day of the tax year.

If the aforementioned elections are not available or made, the US investor is required to allocate any gain or excess distribution realized or received from the PFIC over the entire holding period of the PFIC stock, calculate a tax liability in each of the years at the highest marginal tax rate in effect and calculate an interest charge on the tax liability.

Notes

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2. Edward D. Kleinbard (03/31/2011): The Global Tax Avoidance Dance, Huffpost-Business.
3. Erika Eichelberger and Dave Gilson (Feb. 6, 2015): How US Companies Stash Billions Overseas—Tax-Free, Mother Jones.
4. IRC Section 542.
5. IRC Sections 501 and following.
6. IRC Section 1297.
7. IRC Section 1363(a).
8. IRC Sections 172(j), § 1.172-13(b)(1), and § 1.537-1(f).
9. Treasury Regulation § 1.1248-2.
10. Treasury Regulation § 1.1248-3.
11. See TD 9345 (2007).
12. ICC (2013): ICC Statement on Controlled Foreign Corporations (CFC) Rules, p. 3.
13. Sara Anderson (2006): CFC rules and double tax treaties, JÖNKÖPING University, p. 11.

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15. ICC (2013): ICC Statement on Controlled Foreign Corporations (CFC) Rules, p. 2.
16. Lang, Michael CFC Regulations and Double Taxation Treaties p. 53.
17. KHO 596/2002.
18. Felix Lessambo (July 2002): French CFC: The end of a Legislatively Controversial Rule, BNA-Tax Planning International, Financing, Volume 2, Number 7, pp. 15–8. Schneider case [Case no. 232276, RJF 10/2002].
19. ICC (2013): ICC Statement on Controlled Foreign Corporations (CFC) Rules, p. 4.
20. Felix Lessambo (2010): Fundamentals of European Union Laws, Dorrance publishing, p. 115.
21. The 2009 regulations were made effective for taxable years that began after June 30, 2009. In addition, the IRS allowed taxpayers to apply the new test retroactively to any open taxable year. 2/2/2009 "Guidance Regarding Foreign Base Company Sales Income," 2009-5 I.R.B., T.D. 9438, http://www.irs.gov/pub/irs-irbs/irb09-05.pdf.
22. IRC section 162.
23. Bribery is called differently in different countries: *la mordida* ("the bite") in Mexico, *bustarella* ("little envelope") in Italy, *pot-de-vin* ("jug of wine") in France, *Madesu-ya-bana* ("the bowl of chili") in the Democratic Republic of Congo.

CHAPTER 15

Taxation of Derivatives

15.1 Introduction

A derivative is a bilateral executory contract (a contract under which either or both parties must perform in the future, by delivering property or money) with a limited term (lifespan), the value of which is determined by reference to the price of one or more fungible securities, commodities, rates (such as interest rates), or currencies (an underlier).[1] Derivative securities markets have since the 1990s, with the United States and Canada trading more than half of the $96.67 trillion contracts outstanding in 2007. A financial "derivative" is a broad term covering a variety of different financial instruments, all of which share the common property that their value is dependent upon an underlying asset. Derivatives can take numerous forms, including options, swaps, futures, forwards, and structured debt obligations. Derivatives can also be traded in two different ways: some are traded through standardized instruments over exchanges, while others are traded privately through individualized contracts, also called "over-the-counter," "bilateral," or "bespoke" derivatives.[2] Derivatives have been used by taxpayers in the past to take advantage of "economic imperfections in the tax law" and lower their taxes. They can be used to create more highly leveraged trading positions than otherwise permitted under current law, including by putting up significantly less collateral for a derivative trade than permitted for a direct purchase of a security.[3]

Derivatives improve the efficiency of financial markets and, by permitting more financial risks to be hedged, may permit some borrowers greater

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access to sources of funds. Derivatives are a double-edged sword in that (i) they can be used to manage risk, and (ii) they can become financial weapons of mass destruction if used solely for speculative purposes. Managing derivatives positions has been shown to be challenging since only a small amount ("margin") is needed to establish a position. That may hide the full extent of a firm's or bank's financial obligations.

Among the players are commercial banks, investments banks, and hedge funds.

Derivative securities (forwards, futures, options, and swaps) are securities whose value depends on the value of an underlying asset but whose payoff is not guaranteed with cash flows from these assets. The underlying asset may be a single security, commodity, or currency, interest rate or other asset. Banks and other market participants have seen in the derivative market the opportunity of overall distribution of risks among various participants. Moreover, banks see the derivative market as a means to increase liquidity and access to capital. That is because credit derivative swaps, for instance, allow banks and other financial institutions to pass on risks from making loans. The term "credit derivative" encompasses an array of transactions whose value is determined by an underlying entity's creditworthiness, the most common of which is the credit default swap (CDS). The total notional amount of CDS in the market was about $34.4 trillion at the end of 2006. To quote an example among many Wall Street derivative players, Goldman Sachs's trading in derivatives generated between $11.3 billion and $15.9 billion of its $45.17 billion in net revenue between 2006 and 2009. Credit derivative swaps, equity swaps, and interest rates swaps were among the most traded.

Prior to the Wall Street Reform and Consumer Protection Act of 2010, the swap market was not standardized. Market fundamentalists, among them the former head of the Federal Reserve, Alan Greenspan, preached that the swap market was able to self-regulate. With the failure and bail-out of main Wall Street swaps' players (e.g., AIG), Congress has, through the aforementioned Act, framed and shaped the swap market. The Wall Street Reform and Consumer Protection Act of 2010 significantly amends over-the-counter (OTC) derivatives. However, the full extent or scope of the new law will be revealed in time, after completion of the mandated rulemaking by the government-agencies involved. The swap market jurisdiction, for instance, is still split between the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). The SEC has jurisdiction over a portion of the equity swap and a portion of a

credit default swap, whereas the CFTC jurisdiction covers the commodity swaps, foreign exchange swaps, interest rate swaps, CDS index swaps, and equity index swaps. Most of the regulatory and prudential efforts, under the new law, target two classes of entity: (i) swap dealers and security-based swap dealers, and (ii) major swap participants and major security-based swap participants, which are both required to clear most of their standardized swaps with a central counterparty. However, the new law provides an exemption from mandatory clearance for derivatives end users.

Another big change that affects the derivatives market is mandatory reporting: swap dealers and major swap participants are required to disclose to the SEC or the CFTC information concerning (i) the terms and conditions of their swaps; (ii) their swap trading operations, and (ii) their financial integrity protections. Furthermore, all non-cleared swaps agreements must be reported to a Swap Data Repository. Beside their disclosure and reporting obligations, swap dealers and major swap participants have to keep and maintain their daily trading record as to each transaction for audit purposes. When entering into swap agreement with a layperson or a counterparty which is not a swap dealer, swap dealers and major swap participants must disclose in a clear and understandable language: (i) the material risks and characteristic of each swap agreement; (ii) the source and amount of any compensation; (iii) any incentives or conflicts of interests; (iv) the clearinghouse for cleared swaps; (v) the daily mark of the swap dealer or major swap participant, for non-cleared swaps. Swap dealers and major swap participants are subject to prudential capital and margin requirements to be determined by either the SEC or the CFTC under their specific jurisdictions.

15.2 Forward Contracts

A forward contract is an agreement between financial or banking institutions and their corporate clients to buy and sell an asset at a certain future time, for a certain price. The parties enter into a forward because the future (spot) price or interest on the underlying asset is uncertain. Fearing that the future spot price will fluctuate against them in the future, they pay a financial institution to arrange a forward contract for them.

The underlying assets are often non-standardized. That is, each forward contract seems to be different from another one. However, with the development of a secondary market of forward contracts, an effort has been made to "standardize" basic or most common used forward contracts

entered into by traders. The existence of such a secondary market has enticed many bank managers to invest and trade in forward contracts. Very often bank manager trade on securities that provide a predictable cash income, such as stock indexes.

Example: –Net Cash-Settled, Forward Contract for Stock
On December 1, 2008, when XYZ stock is trading at $100/share, Party A, the forward seller, enters into a net cash-settled forward contract with Party B, the forward buyer, for the forward sale of one share of XYZ stock at a forward price of $106 on December 31, 2009.[4] If the price of XYZ stock on the settlement date is above the forward price, the contract requires Party A to pay Party B the excess of the market price over $106. If the price is below $106 on December 31, 2009, Party B is required to pay Party A the amount by which $106 exceeds the market price.

- Tax Regime

The execution of a forward contract in respect to an underlying stock has no tax consequences. If a forward contract is settled by delivery of the underlying asset, the taxpayer delivering the asset must recognize a gain or loss based upon the difference between the price received and the taxpayer's basis in the asset. The gain or loss bears the same character as the underlying asset.[5] Usually, a forward contract is settled by cash payment. However, if a forward contract is sold, prior to the pre-agreed date, gain or loss therefrom is deemed a capital asset in the hands of the selling taxpayer. If the character of the income recognized by a party to a forward contract is a capital gain or loss, the income is normally sourced based upon the residence of the taxpayer.[6] However, the character of gain or loss recognized by a forward seller may be affected by the tax straddle and short sale rules of Sections 1092 and 1233, respectively.

15.3 Futures Contracts

A futures contract is an agreement between two parties to buy and sell (at time O) a standardized asset for cash in the future, for a certain price. A futures contract is different from the forward contract in that (i) the

delivery date is usually not specified as the contract's price is adjusted daily based upon the price of the underlying asset; (ii) futures contracts are traded on an organized market (e.g., NYFE, CBT); (iii) a futures contracts is a default risk free in that if a counterparty defaults on a futures, the exchange steps in and assumes the defaulting party's position and payment obligation; (iv) the terms of a futures contract is set forth by the market organization.

Some authors define a futures contract merely as a forward contract that is standardized and traded on an organized futures exchange.[7] That is because, under the futures contracts, buyer and sellers do not complete the trade by themselves. The process is supervised by a clearinghouse department of the exchange, which ensures that each party has met his obligations under the contract. Bank managers trade on these markets as either speculators and hedgers based upon their strategies and studies of the underlying assets.

- Tax Regime

A futures contract traded on domestic and same foreign futures exchanges are generally treated as "Section 1265 Contract" in the hand of the investors. Under Internal Revenue Code (IRC) Section 1256(b), the term 'Section 1256 contract' means:

- Any regulated futures contract;
- Any foreign currency contract;
- Any non-equity option;
- Any dealer equity option; and
- Any dealer securities futures contracts.

The term 'Section 1256 contract' shall not include any securities or option on such a contract unless such contract or option is a dealer securities futures contract. Section 1256 contract held by the taxpayer at the end of the taxable year shall be treated as sold for its fair market value on the last business day of such taxable year (and any gain or loss shall be taken into account for the taxable year). Put differently, IRC Section 1265 requires taxpayers to treat each Section 1265 contract as if it were sold (and re-purchased) for its fair market value on the last day of the year. Furthermore, it imposes a mark-to-market timing regime on instruments within its scope. Any gain or loss with respect to Section

1256 contract is treated as short-term capital gain or loss – to the extent of 40 % of the gain or loss-, and the remaining 60 % is treated as long-term gain or loss.

This special “60/40” rule does not apply to certain transactions: (i) hedging transactions, (ii) Section 1256 contract that is part of a mixed straddle if the taxpayer makes the election, (iii) Section 1256 contract held by a dealer in commodities or by a trader in commodities that makes the mark-to-market election under IRC Section 475(d)(1).

15.4 Options

An option contract is a contract that gives the holder of the option the right, but not the obligation, to buy or sell an underlying asset, at a pre-agreed price, within a pre-agreed period of time. There are two basic types of option: a call option and a put option.

The forms and terms of options can vary greatly. A “European style” option, for example, can be exercised by the buyer only on a specified date, while an “American style” option can be exercised by the buyer any time prior to the final date on which the option expires. The option buyer pays the option seller a “premium” for the option, which can vary with the terms of the option. This premium is usually paid at the start of the option and is the potential profit for the option seller. Options also have a “strike price,” which is the price specified in the option contract at which the buyer may purchase the underlying property when exercising the option. The final day on which an option may be exercised is generally called the “exercise date” or “maturity date.” Options are often priced using the Black–Scholes model, which takes into account several factors including the volatility of the price of the underlying assets, the duration of the option, and the strike price as compared to the market price of the underlying assets.[8]

- A call option is the option that gives the holder (purchaser) the right to buy the underlying security or asset from the option writer or the seller, by a certain date referred to as the expiration date or the exercise date or the maturity, for a certain price called the exercise or strike price. A warrant is a call option that is written by a corporation on its own stock.

Example: European-Style, Net Cash-Settled Call Option
Party A purchases a European-style, net cash-settled call option on a single share of XYZ stock from Party B (the issuer) on December 1, 2008, when XYZ is trading at $100 per share.[9] The option requires Party B to pay Party A the amount (if any) by which the market price of XYZ on the settlement date exceeds $110. Suppose the value of XYZ stock on the settlement date is $150. Party B would pay Party A $40. Conversely, if the value of XYZ is $105 on the settlement date, the option would expire unexercised. In either case, Party A would have paid a non-refundable premium for the option.

- A put option gives the holder of the option the right to sell the underlying security or asset to the option writer (or seller) by a certain date, for a pre-specified price.

Two scenarios are also possible with put options. In the first, the exchange rate when the option expires is above the strike price, and the holder has no interest in selling at the strike price because he can do better on the market. The premium he paid initially is therefore lost. In the second, the exchange rate on expiration of the option is below the strike price, and it is therefore in the holder's interest to exercise this option, because he can sell the currency at the strike price, which is advantageous.

Example: Physically Settled, European-Style Put Option
Party A purchases a physically settled, European-style put option on a single share of XYZ stock from Party B (the issuer) on December 1, 2008, when XYZ is trading at $100 per share.[10] The option gives Party A the right (but not the obligation) to sell one share of XYZ stock to investor B on December 31, 2009, for $100. (This is an "at-the-money" put option; that is, one where the strike price equals the market price for XYZ stock at inception.) Party A is betting that the price will fall. If the price of a share of XYZ is below $100 on the settlement date, Party A will exercise his or her right to require Party B to buy one share for a price that exceeds its market value. Conversely,

Party B is betting that the price will increase, and Party A will not exercise the option. In that case, Party B will profit to the extent of the premium Party B collected when Party B issued the option to Party A. Suppose the price of one share of XYZ on the settlement date is $90. Party A will exercise his option and require Party B to purchase a share for $100. Since A can acquire the share for $90 and immediately sell it to B for $100, A profits by $10 (less the amount of option premium that A paid to B).

Other varieties of option include: collar, barriers, caps and floors.

- Collar

A collar is a combination of two contracts to obtain a very specific profit diagram. There are two ways to create a collar. The first involves buying a call option and selling a put option, while the second involves buying a put option and selling a call option. In both cases, the company guarantees that its purchase or selling price of US currency will not go beyond a range between the two strike prices of the options in the collar. The price of this structure is generally equivalent to the amount paid to buy one of the options less the price received for selling the second option.

- Barriers

These options have the same characteristics as standard options but include barriers. The barrier can be above or below the actual currency price and may be knock-in or knock-out.

- Caps and floors

Caps and floors: OTC contracts are often referred to as interest rate options. An interest rate cap will compensate the purchaser of the cap if interest rates rise above a predetermined rate (strike rate) while an interest rate floor will compensate the purchaser if rates fall below a predetermined rate.

Option contracts are different from both the forward contract and the futures contract in that (i) the option holder has the right to exercise the option or not to exercise it at all. He or she is not compelled to buy or sell

as under the forward and the futures contracts. (ii) the option holder must pay to the option writer or the seller an up-front fee referred to as the call premium, whereas parties into a forward or futures contracts entered into these contracts free of any premium. Option contracts are traded as future contracts on an organized exchange. There are three types of options trade: stock options, stock index options, and options on futures contract. The SEC is the main regulator of the option contracts. The CFTC regulates only options on futures contracts. In the 1990s, banks and other financial institutions developed a new form of option contracts known as "exotic options". Those options were written for the purpose of hedging very specific risks, and were traded OTC.

- Exotic options

Exotic options are OTC derivatives trade by major banks or financial institutions. Exotic options include a variety of financial instruments such as: barrier options, convertible reset option, digital option, quantity adjusting option (or quanto), differential option (or Diff option), rainbow option, etc. These options allow the writer to manage only the specific risks they intend to hedge against.

- Barrier options

Is an option contract that may only be exercised when the underlying asset reaches some barrier price. There are four basic types of barrier options that have slightly different payoff structures. Barrier options sometimes come with a rebate paid at the time of the event or at the expiration date.

- Digital option

A digital option is an option whose payout is characterized as having only two potential values: (i) a fixed payout when the underlying price is above the strike price) or (ii) zero payout.

- Quantity adjusting options (quanto)

A quanto is an option which has an underlier denominated in one foreign currency, but settles in another domestic currency, at a fixed exchange

rate. Quanto options have both the strike price and the underlier denominated in a foreign currency, but the value of the option is determined as the option's intrinsic value in a foreign currency. That intrinsic value is then converted to the domestic currency at the fixed exchange rate.

- Differential options

Differential options are a variant of quanto options with a fixed-floating or floating-floating interest rates. One of the floating rates is a foreign interest rate, but it is applied to a notional amount in the domestic currency.

- Rainbow options

Rainbow options are options whose value are dependent on two or more underlying securities or events. The option holder is allowed to exercise the option based on the change in the two or more securities used as underlying assets.

The price of the rainbow option is dependent on the correlation of the underlying events or assets. One form of rainbow option is the outperforming option, whose value is determined by the differential in performance of two securities or assets.

- Tax regime

In general, gain or loss from options (i.e., on stock) is recognized on a wait-and-see (open transaction) basis. The purchaser capitalizes the cost of his option premium, and the option writer does not immediately include it in income.[11] The amount of gain or loss is determined at the time of a subsequent recognition event; that is, the parties wait and see what happens when the option is exercised or sold (or when it expires unexercised).

Gain or loss recognized by the purchaser of an option is considered to have the same character as the underlying asset that the option relates to.[12] In the case of a purchaser of an option on publicly traded stock as an investment, gain or loss will be capital. However, if the purchaser were a dealer in securities, or a taxpayer using the option as a hedging contract, gain or loss will be treated as ordinary income under IRCSection 1221(a)(7). Thus, US persons typically recognize US-source gain or loss, and non-US persons recognize foreign-source gain or loss.

In the case of termination of an option other than through delivery of the underlying asset, the writer's gain or loss is deemed short-term capital gain or loss, regardless of the terms of the contract. The character of the income recognized by the holder of an option on publicly traded asset is capital gain or loss, the income is normally sourced based on the residence of the taxpayer. Thus, US persons typically recognize US-source gain or loss, and non-US persons recognize foreign-source gain or loss.[13]

15.5 Swaps

Swaps are private agreement between parties to exchange cash flows, at specified intervals. The first known swap contracts were negotiated in the 1980s. Swap markets were developed in order to meet the needs of corporations, financial institutions, and portfolio managers to modify their exposure to a substantial increase in currency and interest-rate volatility that followed the demise of the Bretton Woods fixed exchange rate system. Since then the swap market has sprung exponentially to reach $347.09 trillion in 2007. US commercial banks, investment banks, and insurance companies are the biggest players in the swaps market with an overall total of $95.39 trillion in 2007. Swap market participants include swap facilitators and their clients and customers.

By and large, there are five generic types of swaps:

- Interest rate swaps;
- Currency swaps;
- Credit risk swaps;
- Commodity swaps;
- Equity swaps.

Of the five generics, interest rate swaps are the most commonly used. Bank managers often enter into swaps agreements in order to eliminate or mitigate interest rates inherent to their global positions.

15.5.1 Interest Rate Swaps

Interest rate swaps are contracts whereby one party agrees to pay the other party interest at a fixed rate on a notional principal for a number of years, in exchange for a floating interest rate on the same notional principal for the same periods of time.

The most used is a fixed/floating in which the payment made by a counterparty is based on a variable or floating rate of interest, and the return payment is based on a variable at floating rate, which is reset periodically, according to a benchmark.

Counterparties can also enter into a cross-currency swap whereby payments are made in two different currencies, based on fixed or floating interest rates. In a fixed/floating interest rate swap, the notional is never exchanged; rather, it is used to calculate the payment flows. Once a floating payment is made, the rate is reset to establish the next floating payment based upon the benchmark reference rate agreed on (e.g., LIBOR). This makes a fixed/floating interest rate swap different from a cross-currency swap where the principal amounts are generally exchanged at the spot foreign exchange rate from the outset and then re-exchanged at maturity, at the same rate. The floating interest rate is usually pegged to some short-term interest rate, such as LIBOR; and is referred to as the "reference rate." The fixed interest rate is made of two components: (i) a risk-free yield for the maturity of the swap, and (ii) a swap spread over the risk-free yield which is the basis for pricing the swap. Interest rate swaps are often entered into by counterparties seeking to improve the cost of funding, or to hedge the interest rate risks. Banks invest in fixed/floating interest rate swaps in anticipation of future interest rate increases, in order to make some profits (or spreads).

15.5.2 Currency Swaps

Currency swaps are essentially forward contracts between two parties, tailored to meet their specific needs. Currency swaps consist of exchanging principal and fixed-rate interest payments on a loan in one currency for principal and fixed-rate interest payments on an approximately equivalent loan in another currency. A currency swap agreement requires the principal to be specified in each of the two currencies. The principal amounts are usually exchanged at the beginning and the end of the life of the swaps.

On each settlement date through maturity, the US party pays interest to the foreign counterparty. That interest is based upon a fixed interest rate and is denominated in the foreign currency that was delivered on the origination date to the US party. At maturity, the US party repays the foreign currency principal to the counterparty, along with the last interest payments; and the foreign counterparty repays the US dollar principal including the last interest payment: this is known as a synthetic fixed/fixed currency swap.

Currency swap can also be created with both counterparties receiving a fixed interest rate.

Currency swap can be used to either align assets or liabilities with market expectations or to exploit mispricings among markets, through arbitrage.

15.5.3 Credit Swaps

There are four types of credit swap: the credit default swap (CDS), the first-to-default CDS, the total return swap, and the asset-backed credit-linked note.

- The credit default swap

A CDS is an agreement between two counterparties (the buyer of the protection and the seller of the protection) against default on a loan or a bond. The borrower (or issuer) also called the referenced credit, pays a premium to the seller of the protection in exchange for contingent payment depending on agreed credit events, which may occur during the lifetime of the agreement.

Put differently, a CDS consists of transferring risks that a party is not willing to bear to another party with a desired risk profile. CDSs have been often criticized. Some have argued that they operate as stock absorbers during corporate crises, cushioning against the worst possible losses. The notional amount of CDSs outstanding by the end of 2007 was estimated to exceed $60 trillion. This figure declined sharply to just over $30 trillion at the first half of 2010. Market participants include: commercial banks, broker-dealers, insurance companies, hedge funds, and special purpose vehicles (SPV).

Bank managers enter into CDSs in order to reduce the level of credit risks on their various portfolios. Hedge funds enter the CDS market both as credit protection buyers and credit protection sellers in order to manage their risks, speculate, or acquire synthetic exposure.

Prior to the Wall Street Reform and Consumer Protection Act of 2010, CDSs were traded in OTC markets. The 2010 Act has moved to include CDS deals in an organized market to be defined by regulations.

- First-to-default CDS

The first-to-default CDS allows the insurer to reduce its risk exposure of the loan portfolio to the first loan default. It is an agreement

by which a protection seller would have to compensate the counterparty (the buyer of the protection) by paying it a par and receive the defaulted loan.

- Total return swaps (TRSs)

A TRS is a swap agreement whereby the buyer of the risk receives from the seller of the risk a specified economic value for the reference credit rather of a lump sum notional payment in the event of default. TRSs areoften used as a means to transfer the market risk of an asset off-balance sheet to lower regulatory charges. Total return swaps are different from CDSs in that (i) the market and credit risks are transferred from the seller to the buyer; (ii) no exchange of the principal, no legal change of ownership, and no voting rights passed from the seller to the buyer. The buyer of a TRS receives the cash flows of benefits (or pays the losses) if the value of the underlying asset rises (or falls). To hedge against the credit/or market risks, the seller of the TRS often buys the underlying asset.

- Asset-backed credit-linked notes (CLN)

A CLN is an actual security with a credit derivative (a CDS) embedded in its structure. A CLN is a debt obligation with a coupon and redemption tied to the performance of the loan. An investment bank manager would enter into a CLN if he or she wants to take a liability out the balance sheet. A CLN is different from the TRS in that the principal exchanges hands, though there is no legal change of ownership of the underlying asset.

- Tax regime

Despite their financial importance and recognition, the tax treatment of credit swaps and particularly CDSs remain a mystery. US tax laws provide no clues as to how CDSs should be taxed.

15.5.4 Commodity Swaps

The character of gains or losses realized by a US person selling or exchanging a commodity is largely a function of the taxpayer's status as (i) an investor, (ii) a trader or dealer.

15.5.5 Equity Swaps

An equity swap is a contractual agreement between two counterparties to exchange cash flows from specific assets over a defined period. Put differently, an equity swap is an agreement between counterparties to exchange payments, one of which depends on the value of a selected share or an index. A variant of equity swap is a total return swap, whereby the exchange payments reflect the dividends on the share or index. The notional principal of the swap is not exchanged, instead, it is used to calculate the periodic payments. Equity swaps give investors like investment banks the benefits of stock ownership, without actually owning the stocks. The exact size of the equity swap market is unknown, but according the Bank of International Settlement, the notional value of all equity swaps and forwards approximates $1.7 trillion in 2009. Banks enter into equity swaps any time they need to trade on a basket of foreign shares but face certain restrictions on ownership, or when there is no such restriction, in order to avoid paying withholding tax on dividends to receive from their equity investments. Well-advised investment bank managers often enter into an equity swap with a specific dealer who is not subject to any withholding tax (or capital gains) prior to making their equity investments. The dealer will borrow money to acquire the shares, and enter into a swap agreement whereby he agrees to pay the total return on the shares to the bank manager.

The Internal Revenue Service is currently investigating whether banks, hedge funds, and other financial institutions are using the equity swaps as a device to collect dividends without owning the instruments, and at the same time escape the withholding tax payments.

Example: Equity Swap. In a "Plain Vanilla" Equity Swap
Party A agrees to make ten payments to Party B on December 31 of each of the next ten years, in an amount equal to the sum of: (1) the appreciation, if any, in value of 100 shares of XYZ stock during the year, and (2) dividends paid on 100 shares of XYZ stock during the year.[14] Likewise, Party B agrees to make ten identically timed payments to Party A, in an amount equal to the sum of: (1) the depreciation, if any, in value of 100 shares of XYZ during the year, and (2) a fixed (or floating) rate of interest multiplied by the value of 100 shares of XYZ stock at the beginning of the year. Since the payments are all due on the same day, the parties agree that all payments are netted, and only one party makes a net payment to the other.

The different types of equity swap include: (i) contracts for difference; (ii) debt-for equity swaps.

- Contracts for differences (CFDs)

CFDs, also referred to as synthetic swap allow investors to participate in stock price, stock indexes or exchange without buying or selling the shares themselves. Investment bank managers derives their spread from the difference the opening and the closing value for the contract.

- Debt-for-equity swap

Debt-for-equity swap consists of exchanging debt for a pre-determined amount of equity (stock). The value of the swap is determined usually at current market value rates. However, a management may still offer a higher exchange value to entice share and debt holders to participate in a swap. Debt-for-equity swaps were a fairly common means of acquiring a distressed business in the 1980s and the 1990s.

They are performed when the debtor needs positive net equity or needs to improve its financial conditions by reducing interest-bearing debts. Debt-for-equity wwap is or has been considered as a route by which a company can avoid imminent insolvent liquidation due to a persistent negative cash flows or balance sheet insolvency.

- Tax regime

A swap with respect to publicly traded equity is taxed as a "notional principal contract" under IRC Section 446, which requires that the parties to a notional contract classify all payments thereto as either (i) a "periodic payment", (ii) a "non-periodic payment"; or (iii) a "termination payment".

The characterization of payments as "periodic", "non-periodic", or "termination" is important in that the tax treatments are not the same.

For periodic and non-periodic payment, taxpayer must recognize the ratable daily portions for the taxable year. Whereas for termination payment, taxpayer recognizes income in the year the notional principal contract is either extinguished, assigned, or terminated. Income from a swap contract is generally sourced by reference of the residence of the taxpayer, except for income earned through a US branch. Equity swap also deviates

from the main source-rule in that the dividend equivalent payment is treated as non-US source income, not subject to US withholding tax.

15.6 Credit Derivatives

Credit derivatives derive their value from the creditworthiness of a specified financial instrument such as a corporate bond or stock, or from the creditworthiness of a referenced entity such as a corporation or sovereign nation. In essence, credit derivatives place bets on whether, during a specified period of time, the referenced financial instruments or entities will experience a negative "credit event," such as a bankruptcy, default, or failure to pay. Parties taking the "long" side of the bet wager that no credit event will occur; parties taking the "short" side of the bet wager that the negative credit event will occur. These credit instruments are often described as "synthetic," because they do not contain any tangible assets such as a loan or bond; they simply reference the financial instrument or entity whose credit quality is at issue.[15] Credit derivatives are (i) CDS, (ii) credit index, and (iii) credit index tranche. CDS being already covered, I mainly discuss the two others.

15.6.1 Credit Index

A more complicated form of credit derivative involves a credit index. Credit indices were first invented by JPMorgan Chase and Morgan Stanley in 2001. Each credit index references a basket of selected credit instruments, typically credit default swaps or other types of credit instruments. The value of the index is typically determined by calculating the value of each constituent credit instrument and using a mathematical formula to combine them into a single dollar value for the entire basket. Parties then enter into swaps that reference the index value. The long party bets the index value will increase; the short party bets it will fall. The short buyer of a credit index, as with a credit default swap, typically makes an upfront payment reflecting the value of the index and then makes fixed periodic payments to the long party over a specified timeframe. Those periodic payments are, again, typically referred to as premiums, coupon payments, or credit spreads. When the instrument matures or expires, or a trade otherwise closes, the short party may be required to make a final payment reflecting the change in the value of the instrument. On the other hand, if a credit event takes place during the covered time period, it triggers a

typically substantial payout by the long party to the short party. After the credit event, the defaulting credit instrument is effectively eliminated from the index.

Credit index transactions are typically entered into OTC (meaning outside of a regulated exchange) between a licensed swap dealer and an investor, using standardized documents. Once the initial index swap is executed, as the value changes, either party can trade or unwind its side of the bet. The index's changing value typically reflects the initial index price or premium amount, which is also called the credit spread. The parties holding a swap when the referenced index expires are typically required to make a final payment reflecting the value of the index at the time of expiration.

15.6.2 Credit Index Tranche

A third, still more complicated type of credit derivative involves credit tranches. The credit tranches that were traded by the Chief Investment Office (CIO) typically related to Markit credit indices. Each of the Markit credit indices tracked the value of a specified basket of credit instruments. Instead of requiring bets on the creditworthiness of the entire basket, for some credit indices, Markit offered instruments that enabled parties to place bets on just a portion of the basket, offering four tranches with different degrees of vulnerability to default. The riskiest tranche, called the "equity tranche," was immediately affected by any default at any company in the basket. The next tranche, called the "mezzanine," was affected only by losses that exceeded 15 % of the loss distribution. Those losses usually required one or more defaults to take place. The next tranche, called the "senior" tranche, was affected only by losses that exceeded 25 % of the loss distribution. The last and most secure tranche, the "super senior tranche," was affected only by losses that exceeded 35 % of the loss distribution. Those losses typically required multiple defaults to come into effect.

Credit tranche instruments, like other credit derivatives, typically required the short party to make an upfront payment and periodic payments during the covered time period, although the riskiest tranches often did not require any premiums. These instruments also typically required the parties to make a final payment when the swap expired or the trade otherwise closed. CIO documents show that the CIO traded credit tranches as well as credit indices and credit default swaps.

Notes

1. US Congress (2008): Present Law and Analysis Relating to the Tax Treatment of Derivatives, – Joint Committee on Taxation, p. 2.
2. United States Senate- Permanent Subcommittee on Investigations (2014): Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits, p. 9.
3. Idem, p. 10.
4. US Congress (2008): Present Law and Analysis Relating to the Tax Treatment of Derivatives, – Joint Committee on Taxation, Example 3, p. 6.
5. IRC Section 1234 A.
6. IRC Section 865(a).
7. US Congress (2008): Present Law and Analysis Relating to the Tax Treatment of Derivatives, – Joint Committee on Taxation, p. 6.
8. Idem, p. 12–3.
9. US Congress (2008): Present Law and Analysis Relating to the Tax Treatment of Derivatives, – Joint Committee on Taxation, Example 1, p. 5.
10. US Congress (2008): Present Law and Analysis Relating to the Tax Treatment of Derivatives, – Joint Committee on Taxation, Example 2, p. 5.
11. Rev. Rul. 78–182, 1978-1 C.B. 265.
12. IRC Section 1234(b)(1).
13. IRC Section 865(a).
14. US Congress (2008): Present Law and Analysis Relating to the Tax Treatment of Derivatives, – Joint Committee on Taxation, Example 5, p. 9.
15. US Senate Investigate Committee (2013): The JP Morgan Chase London Whale, p. 99.

CHAPTER 16

The Taxation of Foreign Currency

16.1 Introduction

In general, a foreign subsidiary of a US parent corporation does not keep its records in US dollars (the parent's currency). Therefore, the foreign subsidiary's financial statements must be translated or converted into its parent's currency prior to consolidation of the financial statements. From an accounting viewpoint, US multinational corporations (MNCs) apply the provisions of ASC Topic 830 "Foreign Currency Matters" to convert the financial statements of their foreign subsidiaries and branches into US dollars. However, transactions between or among the taxpayer and/or qualified business units of that taxpayer ("intra-taxpayer transactions") are not IRC Section 988 transactions.

From a tax standpoint, the issue of foreign currency has been dominated by the determination of the entity's functional currency. An entity's functional currency is defined as the currency of the primary economic environment in which it operates. In general, a foreign entity's functional currency is the currency it receives from its customers and spends to pay its liabilities.

Functional currency is determined at the qualified business unit (QBU) level. IRC Section 989(a) defines QBU as a separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records. Under the regulations thereof,[1] corporations are QBUs; partnerships, estates and trusts are QBUs of their partners/beneficiaries; individuals, however, are not QBUs.

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The activities of a taxpayer are a separate QBU if (i) the activities constitute a trade or business and (ii) separate books and records are maintained. Further, a QBU does not need to be self-contained and may have a significant interrelationship with the parent company.[2] However, the QBU's activities cannot be merely ancillary to the taxpayer's trade or business. Activities conducted by agents can also give rise to a QBU.

16.2 Selection of the Functional Currency

Internal Revenue Code (IRC) Section 985 and Treasury Regulation 1. 985-1(c)(2)(i) provide that the determination of a QBU's functional currency depends on facts and circumstances. That is, the Generally Accepted Accounting Principles (GAAP) determination of the functional currency will ordinarily be accepted for tax purposes, if based on substantially similar facts and circumstances. Under Treasury Regulation 1. 985-1(b)(1) some QBUs are required to use the US dollar as their functional currency, including:

- Individuals;
- QBUs with a principal place of business in the United States, or any US possession or other country in which the US dollar is the standard currency;
- QBUs generating income or loss that is effectively connected with the conduct of a US trade or business;
- QBUs that operate primarily in US dollars;
- QBUs that do not maintain books and records in a local currency in which they conduct significant activities.

16.2.1 Separate Books and Records

A separate set of books and records shall include books of original entry and ledger accounts, both general and subsidiary, or similar records. For example, in the case of a taxpayer using the cash receipts and disbursements method of accounting, the books of original entry include a cash receipts and disbursements journal where each receipt and each disbursement is recorded. Similarly, in the case of a taxpayer using an accrual method of accounting, the books of original entry include a journal to record sales (accounts receivable) and a journal to record expenses incurred (accounts payable).

Example:
W is a domestic corporation that manufactures product X in the United States for sale worldwide. All of W's sales functions are conducted exclusively in the United States. W employs individual Q to work in France. Q's sole function is to act as a courier to deliver sales documents to customers in France. With respect to Q's activities in France, a separate set of books and records as described in paragraph (d) is maintained. Under paragraph (c) of this section, Q's activities in France do not constitute a QBU since they are merely ancillary to W's manufacturing and selling business. Q is not considered to have a QBU because an individual's activities as an employee are not considered to constitute a trade or business of the individual.

16.2.2 Dollar Functional Currency

The dollar shall be the functional currency of a taxpayer or QBU for:

- a taxpayer that is not a QBU (e.g., an individual);
- a QBU that conducts its activities primarily in dollars. A QBU conducts its activities primarily in dollars if the currency of the economic environment in which the QBU conducts its activities is primarily the dollar;
- a QBU that has the United States, or any possession or territory of the United States where the dollar is the standard currency, as its residence;
- a QBU that does not keep books and records in the currency of any economic environment in which a significant part of its activities is conducted;
- a QBU that produces income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States.

16.2.3 QBUs Operating in a Hyperinflationary Environment

The functional currency of a QBU that otherwise would be required to use a hyperinflationary currency as its functional currency and that is a

branch of a foreign corporation having a non-dollar functional currency that is not hyperinflationary shall be the functional currency of the foreign corporation. Such QBU's income or loss or earnings and profits shall be determined under § 1.985-3 by substituting the functional currency of the foreign corporation for the dollar. A foreign corporation (or its QBU branch) operating in a hyperinflationary environment is not required to use the dollar as its functional currency if it is not a controlled foreign corporation as defined in Section 957 or 953(c)(1)(B). However, a non-controlled Section 902 corporation, may elect to use the as its functional currency under the procedures set forth in § 1.985-2(c)(3).

16.2.4 Change in Functional Currency

If a QBU is required to change its functional currency to the dollar or chooses or is required to change its functional currency to the dollar for any open taxable year under § 1.985-3(a)(2)(ii), the change is considered to be made with the consent of the Commissioner for purposes of § 1.985-4. A QBU changing functional currency must make some specific adjustments required under the IRC.

16.2.5 Functional Currency of a QBU That Is Not Required to Use the Dollar

The functional currency of a QBU that is not required to use the dollar is the currency of the economic environment in which a significant part of the QBU's activities is conducted, if the QBU keeps, or is presumed to keep, its books and records in such currency. For the purposes of Section 985 and the regulations thereunder, the economic environment in which a significant part of a QBU's activities is conducted shall be determined by taking into account all the facts and circumstances. The facts and circumstances that are considered in determining the economic environment in which a significant part of a QBU's activities is conducted include, but are not limited to, the following:

- the currency of the country in which the QBU is a resident;
- the currencies of the QBU's cash flows;
- the currencies in which the QBU generates revenues and incurs expenses;

- the currencies in which the QBU borrows and lends;
- the currencies of the QBU's sales markets;
- the currencies in which pricing and other financial decisions are made;
- the duration of the QBU's business operations; and
- the significance and/or volume of the QBU's independent activities.

16.3 Foreign Currency Transactions: IRC Section 988

IRC Section 988 provides that gains and losses from currency trades are treated as ordinary income (and taxable at a maximum 35 % federal income tax rate). There is an exception to this rule, however. Section 988 provides an exception for currency positions which are identified by election as excluded from Section 988 ordinary income treatment.

16.3.1 Payables and Receivables

Accruing a payable or receivable is a Section 988 transaction.

Foreign currency transaction gain/loss is generally recognized upon the settlement of payable/receivable, and the amount of the gain or loss is determined by comparing the spot rate on payment date with the spot rate on accrual date.

16.3.2 Debt Instrument

For debt instruments, both the principal amount and the interest payments on Forex (FX) debt can give rise to FX gain/loss. The treatment of these two differ significantly: (i) For the principal: the amount of gain or loss is determined by comparing the spot rate on issue/acquisition date to spot rate on date of settlement (or deemed settlement in a Treasury Regulation 1.1001-3 deemed exchange); (ii) For interests: the amount of FX gain/loss is determined by manner in which interest expense/income is translated.

Taxpayers usually compute interest income/expense on a Non Functional Currency (NFC) debt instrument by translating NFC interest amount at average exchange rate during accrual period. FX gain/loss is computed by comparing NFC: FC exchange rate on interest payment date to average rate used in translation.

16.3.3 Payables and Receivables

Payables & Recivables: Accruing any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account constitues a foreign currency transaction. A payable relating to cost of goods sold, or a payable or receivable relating to a capital expenditure or receipt, is a foreign transaction currency. Generally, a payable relating to foreign taxes (whether or not claimed as a credit under Section 901) would qualify as such. However, a payable of a domestic person relating to accrued foreign taxes of its qualified business unit (QBU branch) is not within the meaning of this paragraph (a)(2)(ii) if the QBU branch's functional currency is the US dollar and the foreign taxes are claimed as a credit under Section 901.

16.3.4 Futures, Forwards, and Options

Entering into foreign exchange futures, forwards, options or other similar contract is a Section 988 transaction if the underlying property is a NFC or some other Section 988 transaction. All gain/loss in respect of a Section 988 derivative is FX gain/loss.

The term "foreign currency gain" means any gain from a Section 988 transaction to the extent such gain does not exceed gain realized by reason of changes in exchange rates on or after the booking date and before the payment date. By contrast, the term "foreign currency loss" means any loss from a Section 988 transaction to the extent such loss does not exceed the loss realized by reason of changes in exchange rates on or after the booking date and before the payment date.

16.3.5 Non-Functional Currency Notional Principal Contracts

Below are examples of foreign currency transactions provides under Treasury Regulation § 1.988-1[3]:

Example 1

On January 1, 1989, X acquires 10,000 Canadian dollars. On January 15, 1989, X uses the 10,000 Canadian dollars to purchase inventory. The acquisition of the 10,000 Canadian dollars is a section 988 transaction for purposes of establishing X's basis in such Canadian dollars. The disposition of the 10,000 Canadian dollars is a section 988 transaction pursuant to paragraph (a)(1) of this section.

Example 2
On January 1, 1989, X acquires 10,000 Canadian dollars. On January 15, 1989, X converts the 10,000 Canadian dollars to US dollars. The acquisition of the 10,000 Canadian dollars is a section 988 transaction for purposes of establishing X's basis in such Canadian dollars. The conversion of the 10,000 Canadian dollars to US dollars is a section 988 transaction pursuant to paragraph (a)(1) of this section.

Example 3
On January 1, 1989, X borrows 100,000 British pounds (£) for a period of 10 years and issues a note to the lender with a face amount of £100,000. The note provides for payments of interest at an annual rate of 10 % paid quarterly in pounds and has a stated redemption price at maturity of £100,000. X's becoming the obligor under the note is a section 988 transaction pursuant to paragraphs (a)(1)(ii) and (2)(i) of this section. Because X is an accrual basis taxpayer, the accrual of interest expense under X's note is a section 988 transaction pursuant to paragraphs (a)(1)(ii) and (2)(ii) of this section. In addition, the acquisition of the British pounds to make payments under the note is a Section 988 transaction for purposes of establishing X's basis in such pounds, and the disposition of such pounds is a section 988 transaction under paragraph (a)(1)(i) of this section.

Example 4
On January 1, 1989, X sells and delivers inventory to Y for 10,000,000 Italian lira for payment on April 1, 1989. Under X's method of accounting, January 1, 1989 is the accrual date. Because X is an accrual basis taxpayer, the accrual of a nonfunctional currency denominated item of gross receipts on January 1, 1989, for payment after the date of accrual is a section 988 transaction under paragraphs (a)(1)(ii) and (2)(ii) of this section.

16.4 IRC Section 988 Election

IRC Section 988(a)(1)(B) provides for an election to treat any foreign currency gain or loss attributable to a forward contract, a futures contract, or option on foreign currency as capital gain or loss rather than ordinary gain or loss. A taxpayer can make the election but only if the contract (i) is a capital asset in the hands of the taxpayer;(ii) is not part of a straddle within the meaning of section 1092(c), and (iii) is not a regulated futures contract or non-equity option with respect to which an election under Section 988(c)(1)(D)(ii) is in effect. A taxpayer elects to treat gain or loss on an FX transaction as capital gain or loss by clearly identifying such transaction on its books and records on the date the transaction is entered into. No specific language or account is necessary for identifying a transaction referred to in the preceding sentence. However, the method of identification must be consistently applied and must clearly identify the pertinent transaction as subject to Section, in his sole 988(a)(1)(B) election. The Commissioner of the Internal Revenue Service, in his sole discretion, may invalidate any purported election that does not comply with the preceding sentence.[4] A taxpayer that has made an election under § 1.988-3(b)(3) must attach to his income tax return a statement which sets forth the following:

- (i) a description and the date of each election made by the taxpayer during the taxpayer's taxable year;
- (ii) a statement that each election made during the taxable year was made before the close of the date the transaction was entered into;
- (iii) a description of any contract for which an election was in effect and the date such contract expired or was otherwise sold or exchanged during the taxable year;
- (iv) a statement that the contract was never part of a straddle as defined in section 1092;[5] and
- (v) statement that all transactions subject to the election are included on the statement attached to the taxpayer's income tax return.

In addition to any penalty that may otherwise apply, the IRS may invalidate any or all elections made during the taxable year under § 1.988-3(b)(1) if the taxpayer fails to verify each election as provided in this § 1.988-3(b)(4).

As aforementioned the burden of identification can become cumbersome. The IRC regulations provide for independent verification. A taxpayer will receive independent verification of the election if:[6]

(a) the taxpayer establishes a separate account(s) with an unrelated broker(s) or dealer(s) through which all transactions to be independently verified are conducted and reported;
(b) only transactions entered into on or after the date the taxpayer establishes such account may be recorded in the account;
(c) transactions subject to the election are entered into such account on the date such transactions are entered into;
(d) the broker or dealer provides the taxpayer a statement detailing the transactions conducted through such account and includes on such statement the following:

Each transaction identified in this account is subject to the election set forth in section 988(a)(1)(B).

16.5 The 60/40 Exception for Qualified Investment Funds

The term "qualified fund" means any partnership if:

(a) at all times during the taxable year (and during each preceding taxable year to which an election under Section 988(c)(1)(E)(iii)(V) applied) such partnership has at least 20 partners and no single partner owns more than 20 %t of the interests in the capital or profits of the partnership;
(b) the principal activity of such partnership for such taxable year (and each such preceding taxable year) consists of buying and selling options, futures, or forwards with respect to commodities;
(c) at least 90 % of the gross income of the partnership for the taxable year (and each such preceding year) consists of income or gains under IRC Section 7704(d)(1) or gain from the sale or disposition of capital assets held for the production of interest or dividends;
(d) no more than a de minimis amount of the gross income of the partnership for the taxable year (and each such preceding taxable year) was derived from buying and selling commodities; and
(e) an election under section 988 (c)(1)(E)(iii)(V) applies to the taxable year.

A qualifying fund election for any taxable year shall be made on or before the first day of such taxable year.

16.6 Hedging Transactions

Hedge transactions include is a spot contract, futures contract, forward contract, option contract, notional principal contract, currency swap contract, similar financial instrument, or series or combination thereof, that when integrated with a qualifying debt instrument permits the calculation of a yield to maturity (under principles of Section 1272) in the currency in which the synthetic debt instrument is denominated.

A qualifying debt instrument and a hedge are an integrated economic transaction if all of the following requirements are satisfied:[7]

(i) all payments to be made or received under the qualifying debt instrument (or amounts determined by reference to a nonfunctional currency) are fully hedged on the date the taxpayer identifies the transaction as a qualified hedging transaction such that a yield to maturity (under principles of Section 1272) in the currency in which the synthetic debt instrument is denominated can be calculated. Any contingent payment features of the qualifying debt instrument must be fully offset by the hedge such that the synthetic debt instrument is not classified as a contingent payment debt instrument.
(ii) The hedge is identified on or before the date the acquisition of the financial instrument (or instruments) constituting the hedge is settled or closed.
(iii) None of the parties to the hedge are related. The term "related" means the relationships defined in Section 267(b) or Section 707(b).
(iv) In the case of a qualified business unit with a residence, as defined in Section 988(a)(3)(B), outside of the United States, both the qualifying debt instrument and the hedge are properly reflected on the books of such qualified business unit throughout the term of the qualified hedging transaction.
(v) Both the qualifying debt instrument and the hedge are entered into by the same individual, partnership, trust, estate, or corporation. With respect to a corporation, the same corporation must enter into both the qualifying debt instrument and the hedge whether or not such corporation is a member of an affiliated group of corporations that files a consolidated return.
(vi) With respect to a foreign person engaged in a US trade or business that enters into a qualifying debt instrument or hedge through such trade or business, all items of income and expense associated with the qualifying debt instrument and the hedge (other than interest expense

that is subject to § 1.882-5), would have been effectively connected with such US trade or business throughout the term of the qualified hedging transaction had this paragraph (a) not applied.

However, if the qualified hedging transaction results in a synthetic nonfunctional currency denominated debt instrument, such instrument shall be subject to the rules of § 1.988-2(b). But a qualified hedging transaction that creates a synthetic asset or liability denominated in, or determined by reference to, a currency other than the US dollar if the rate that approximates the federal short-term rate in such currency is at least 20 percentage points higher than the federal short-term rate (determined under section 1274(d)) on the date the taxpayer identifies the transaction as a qualified hedging transaction.[8]

Various reasons lead to hedging transactions, including:

(I) Matching source, timing, and character of hedging gain/loss with loss or gain on hedged transaction;
(II) Matching book and tax income to minimize compliance burdens;

(i) Avoiding straddle rules;
(ii) Avoiding tax shelter reporting obligations that may result from "loss" transactions or transactions with significant book/tax differences.

By and large, there are two types of hedges: (i) integrated hedges, and "normal business" hedges (Section 1221 hedges).

(i) Integrated hedges: Section 988(d) and Section 1275(d)

Integration hedge creates a synthetic instrument with a single set of cash flows. It separates existence of hedging and the hedged items are disregarded. Thus, this eliminates virtually all whipsaw potential. Integrated hedge treatment can apply with respect to hedges of debt instruments (either payable or receivable), hedges of "executory contracts" (e.g., certain contracts to buy/sell goods).

16.6.1 Special Rules for Legging in and Legging Out of Integrated Treatment

Legging into integrated treatment means that a hedge is entered into after the date the qualifying debt instrument is entered into or acquired, and

the aforementioned hedging conditions are satisfied on the date the hedge is entered into ("leg-in date"). If a taxpayer legs into integrated treatment, the following rules shall apply:

(a) Exchange gain or loss shall be realized with respect to the qualifying debt instrument determined solely by reference to changes in exchange rates between (1) the date the instrument was acquired by the holder, or the date the obligor assumed the obligation to make payments under the instrument; and(2) the leg-in date.
(b) The recognition of such gain or loss will be deferred until the date the qualifying debt instrument matures or is otherwise disposed of.
(c) The source and character of such gain or loss shall be determined on the leg-in date as if the qualifying debt instrument was actually sold or otherwise terminated by the taxpayer.

If a transaction constitutes a qualified hedging transaction, the qualifying debt instrument and the hedge are integrated and treated as a single transaction with respect to the taxpayer that has entered into the qualified hedging transaction during the period that the transaction qualifies as a qualified hedging transaction. Neither the qualifying debt instrument nor the hedge that makes up the qualified hedging transaction shall be subject to Section 263(g), 1092 or 1256 for the period such transactions are integrated. However, the qualified hedging transaction may be subject to Section 263(g) or 1092 if such transaction is part of a straddle. However, a special rule is provided for income or expense of foreign persons effectively connected with a US trade or business: interest income of a foreign person resulting from a qualified hedging transaction entered into by such foreign person that satisfies the requirements of Treasury Regulation 1.988(a)(5)(vii) will be treated as effectively connected with a US trade or business. The interest expense of a foreign person resulting from a qualified hedging transaction entered into by such foreign person that satisfies the requirements of paragraph (a)(5)(vii) of this section shall be allocated and apportioned under § 1.882-5 of the regulations. Conversely, if a foreign person enters into a qualified hedging transaction that gives rise to US source interest income not effectively connected with a US trade or business of such foreign person, for purposes of Sections 871(a), 881, 1441, 1442 and 6049, Treasury Regulation 1.988(5)(a) will not apply and such sections of the IRC will be applied separately to the qualifying debt instrument and the hedge.

The effect of integrating and treating a transaction as a single transaction is to create a synthetic debt instrument for income tax purposes, which is subject to the original issue discount provisions of Sections 1272 through 1288 and 163(e), the terms of which are determined as follows:

– Qualifying debt instruments

Where the qualifying debt instrument is a borrowing, the denomination of the synthetic debt instrument is the same as the currency paid under the terms of the hedge to acquire the currency used to make payments under the qualifying debt instrument. Where the qualifying debt instrument is a lending, the denomination of the synthetic debt instrument is the same as the currency received under the terms of the hedge in exchange for amounts received under the qualifying debt instrument. For example, if the hedge is a forward contract to acquire British pounds for dollars, and the qualifying debt instrument is a borrowing denominated in British pounds, the synthetic debt instrument is considered a borrowing in dollars. The term of the synthetic debt instrument shall be the period beginning on the identification date and ending on the date the qualifying debt instrument matures or such earlier date that the qualifying debt instrument or hedge is disposed of or otherwise terminated. Unless otherwise clearly indicated by the payment interval under the hedge, the accrual period shall be a six-month period which ends on the dates determined under Section 1272(a)(5). The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument translated into the currency in which the synthetic debt instrument is denominated at the spot rate on the identification date. Where the qualifying debt instrument is a borrowing, the stated redemption price at maturity shall be determined under Section 1273(a)(2) on the identification date by reference to the amounts to be paid under the hedge to acquire the currency necessary to make interest and principal payments on the qualifying debt instrument. Where the qualifying debt instrument is a lending, the stated redemption price at maturity shall be determined under Section 1273(a)(2) on the identification date by reference to the amounts to be received under the hedge in exchange for the interest and principal payments received pursuant to the terms of the qualifying debt instrument. Interest income from a synthetic debt instrument described in paragraph (a)(9)(ii) of this section shall be sourced by reference to the source of income under Sections 861 (a)(1) and 862(a)(1) of the qualifying debt instrument. The character for purposes of Section 904 of interest income from a synthetic

debt instrument shall be determined by reference to the character of the interest income from qualifying debt instrument. Interest expense from a synthetic debt instrument described in paragraph (a)(9)(ii) of this section shall be allocated and apportioned under §§1.861-8T through 1.861-12T or the successor sections thereof or under § 1.882-5.

– Executory contracts

An executory contract is an agreement entered into before the accrual date to pay nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the purchase of property used in the ordinary course of the taxpayer's business, or the acquisition of a service (or services), in the future, or to receive nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the sale of property used or held for sale in the ordinary course of the taxpayer's business, or the performance of a service (or services), in the future. An executory contract does not include a Section 988 transaction. For example, a forward contract to purchase nonfunctional currency is not an executory contract. If a taxpayer enters into a hedged executory contract, amounts paid or received under the hedge by the taxpayer are treated as paid or received by the taxpayer under the executory contract, or any subsequent account payable or receivable, or that portion to which the hedge relates. Also, the taxpayer recognizes no exchange gain or loss on the hedge. If an executory contract, on the accrual date, becomes an account payable or receivable, the taxpayer recognizes no exchange gain or loss on such payable or receivable for the period covered by the hedge.

16.6.2 Normal Business Hedge

IRC Section 1221 hedge defines normal business hedge as: (i) a transaction entered into in normal course of taxpayer's trade or business; (ii) a transaction entered into for the principal purpose of managing risk with respect to ordinary property or ordinary obligation (e.g., taxpayer's own borrowing); (iii) a transaction properly identified as hedge for tax purposes; (iv) a transaction entered into with respect to taxpayer's risk or (subject to exception) risk of consolidated group member.

Although hedging and hedged items are regarded as separate transactions, gain/loss on hedging transaction is ordinary; and the timing of

hedging gain/loss matches timing of hedged transaction income/loss. However, straddle rules do not apply.

16.6.3 Special Rules for Qualified Funds

The interest of a general partner in the partnership shall not be treated as failing to meet the 20 % ownership requirement of paragraph (a)(8)(i)(A) of this section for any taxable year of the partnership if, for the taxable year of the partner in which such partnership's taxable year ends, such partner (and each corporation filing a consolidated return with such partner) had no ordinary income or loss from a Section 988 transaction (other than income from the partnership) which is exchange gain or loss (as the case may be).[9]

16.6.4 Virtual Currency or Cryptocurrencies

Virtual currency (or cryptocurrency) is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency – i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance – but it does not have legal tender status in any jurisdiction.

Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" virtual currency. Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, US dollars, euros, and other real or virtual currencies. A cryptocurrency is a medium of exchange using cryptography to secure transactions and to control the creation of new units of cryptocurrency. In May of 2014, the Internal Revenue Service issued a statement regarding how it will treat transactions in cryptocurrencies. Notice 2014-21 provides that virtual currency is treated as property for US federal tax purposes. General tax principles that apply to property transactions apply to transactions using virtual currency. Thus, the sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability.

Under currently applicable law, virtual currency is not treated as currency that could generate foreign currency gain or loss for US federal tax purposes. A taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency, measured in US dollars, as of the date that the virtual currency was received. The basis of virtual currency that a taxpayer receives as payment for goods or services is the fair market value of the virtual currency in US dollars as of the date of receipt.

For US tax purposes, transactions using virtual currency must be reported in US dollars. Therefore, taxpayers will be required to determine the fair market value of virtual currency in US dollars as of the date of payment or receipt. If a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into US dollars (or into another real currency which in turn can be converted into US dollars) at the exchange rate, in a reasonable manner that is consistently applied.

In general, the character of the gain or loss on sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer. For example, stocks, bonds, and other investment property are generally capital assets. A taxpayer generally realizes ordinary gain or loss on the sale or exchange of virtual currency that is not a capital asset in the hands of the taxpayer. Inventory and other property held mainly for sale to customers in a trade or business are examples of property that is not a capital asset.

When a taxpayer successfully "mines" virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income. If a taxpayer's "mining" of virtual currency constitutes a trade or business, and the "mining" activity is not undertaken by the taxpayer as an employee, the net earnings from self-employment (generally, gross income derived from carrying on a trade or business less allowable deductions) resulting from those activities constitute self-employment income and are subject to self-employment tax. The fair market value of virtual currency received for services performed as an independent contractor, measured in US dollars as of the date of receipt, constitutes self-employment income and is subject to self-employment tax. Moreover, the fair market value of virtual currency paid as wages is subject to federal

income tax withholding, Federal Insurance Contributions Act (FICA) tax, and Federal Unemployment Tax Act (FUTA) tax and must be reported on Form W-2, Wage and Tax Statement.

A person who in the course of a trade or business makes a payment of $600 or more in a taxable year to an independent contractor for the performance of services is required to report that payment to the IRS and to the payee on Form 1099-MISC, Miscellaneous Income. Payments of virtual currency required to be reported on Form 1099-MISC should be reported using the fair market value of the virtual currency in US dollars as of the date of payment. The payment recipient may have income even if the recipient does not receive a Form 1099-MISC.

Finally, taxpayers may be subject to penalties for failure to comply with this notice. For example, underpayments attributable to virtual currency transactions may be subject to penalties, such as accuracy-related penalties under Section 6662. In addition, failure to timely or correctly report virtual currency transactions when required to do so may be subject to information reporting penalties under Sections 6721 and 6722. However, penalty relief may be available to taxpayers and persons required to file an information return who are able to establish that the underpayment or failure to properly file information returns is due to reasonable cause.

16.7 Reporting of Foreign Exchange Currency

Investors trading foreign securities contracts in foreign exchanges must still report gains or losses from that contract on Form 6781, even if those contracts would generally not be treated as a Section 1256 contract.

Form 6781 has separate sections for straddles and Section 1256 contracts, meaning that investors have to identify the specific type of investment used.

Notes

1. Treasury Regulation 1-989(a).
2. Treasury Regulation 1.989(a)-1(e).
3. The term “notional principal contract” means a contract (e.g., a swap, cap, floor or collar) that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. For this

purpose, a "notional principal contract" shall only include an instrument where the underlying property to which the instrument ultimately relates is money (e.g., functional currency), nonfunctional currency, or property the value of which is determined by reference to an interest rate. Thus, the term "notional principal contract" includes a currency swap as defined in § 1.988-2(e)(2)(ii), but does not include a swap referenced to a commodity or equity index.
4. IRC Treasury Regulation 1.988-3(b)(3).
5. A contract that is a part of a straddle as defined in section 1092 may not be independently verified and shall be subject to the rules of paragraph (b)(2) of this section.
6. Treasury Regulation 1.988-3(b)(5).
7. Treasury Regulation § 1.988-5.
8. Treasury Regulation § 1.988-59a)(2).
9. Qualified fund: any partnership if:

   - At all times during the taxable year (and during each preceding taxable year to which an election under Section 988(c)(1)(E)(iii)(V) applied) such partnership has at least 20 partners and no single partner owns more than 20 % of the interests in the capital or profits of the partnership;
   - The principa1 activity of such partnership for such taxable year (and each such preceding taxable year) consists of buying and selling options, futures, or forwards with respect to commodities;
   - At least 90 %of the gross income of the partnership for the taxable year (and each such preceding year) consists of income or gains described in subparagraph (A), (B), or (G) of Section 7704(d)(1) or gain from the sale or disposition of capital assets held for the production of interest or dividends;
   - No more than a de minimis amount of the gross income of the partnership for the taxable year (and each such preceding taxable year) was derived from buying and selling commodities; and
   - An election under section 988 (c)(1)(E)(iii)(V) as provided in paragraph (a)(8)(iv) of this section applies to the taxable year.

CHAPTER 17

Domestic International Sales Corporation

17.1 Introduction

The US Revenue Act of 1971, § 501, created the domestic international sales corporation (DISC), a new tax entity whose business is exporting and whose profits are not subject to federal income tax. The 1971 Act provided tax reduction incentives to stimulate US exports of goods and services. A corporation that made a formal election to be designated as a DISC received a tax deferral for a portion of its income that was derived from exports. The qualification requirements obliged DISCs to have (i) 95 % of gross receipts as qualified export receipts, (ii) 95 % of all assets as qualified export assets, and (iii) only one class of stock. Under the DISC regime, the profits of a DISC were not taxable to the DISC, but were taxed to the shareholders of the DISC when distributed or deemed distributed. Thus, each year, a DISC was deemed to have distributed a portion of its income and the recipient shareholders were required to pay their taxes. However, the tax could generally be deferred on the remaining portion of the DISC's taxable income until such time as the profits are distributed, the shareholder sells his or her stock, or the corporation loses its qualification as a DISC corporation. The DICS regime was replaced after successful challenges by the European Union.

In 1984, the US Internal Revenue Code (IRC) authorized the establishment of foreign sales corporations (FSCs), namely corporate entities in foreign jurisdictions through which US manufacturing companies could

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channel exports. Some 15 % of the revenue concerned was exempted from corporation tax, meaning (at 35 % tax) that companies kept 5.25 % more of their revenue. FSCs are exempt from US tax on a portion of their export income. The exempt income is generally at least 15 % of the combined taxable income (CTI) earned by the FSC and its related supplier from qualified exports.

An FSC is a corporation that meets all the following tests:

- It must be a corporation created or organized under the laws of a qualifying foreign country or a US possession. A qualifying foreign country is a foreign country that meets the exchange of information requirements of the law. A US possession is defined in the law to include Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the US Virgin Islands, but not Puerto Rico.
- It must have no more than 25 shareholders at any time during the tax year.
- It must not have preferred stock outstanding at any time during the tax year.
- During the tax year, it must maintain an office in a qualifying foreign country or a US possession and maintain a set of permanent books of account at that office. Also, it must maintain at a location in the United States the books and records required to sufficiently establish the amount of gross income, deductions, credits, or other matters required to be reported on its tax return.
- At all times during the tax year, it must have at least one director who is not a resident of the United States.
- It must not be a member, at any time during the tax year, of a controlled group of which a DISC is a member.
- The FSC tax year must conform to the tax year of the principal shareholder who, at the beginning of the FSC's tax year, has the highest %age of voting power.
- It must have elected to be a FSC or a small FSC by filing Form 8279, Election To Be Treated as a FSC or as a Small FSC, at any time during the 90-day period immediately preceding the beginning of the taxable year or during the first 90 days of its taxable year if the FSC is a new corporation.

In 1997, the European Union (EU) challenged the legality of the FSC regime before the World Trade Organization (WTO). A WTO panel eventually agreed with the EU and struck down the FSC regime. In 2000,

the US Congress replaced the FSC with a new export-related regime call the Extraterritorial Income Exclusion Act (ETI), which lawmakers believed would bring the USA into compliance with the WTO ruling.

Once again, the EU challenged the ETI regime and, in January 2002, a WTO Appellate body ruled that the ETI constituted a prohibited export subsidy. In August 2002, the WTO ruled that if the USA did not come into compliance with the Appellate decision, then the EU could impose more than $4 billion worth of sanctions against US products.

- Extra-Territorial Income Exclusion Act

The EU did not accept the ETI Act of 2000 legislation as conforming with WTO rules, and in late 2002, after a long series of hearings and appeals, the WTO ruled definitively against the ETI rules. The EU then prepared a list of US products on which it intended to apply sanctions in the form of countervailing duties and obtained the WTO's permission for such action, which it put into effect in early 2004 in the absence of any substantial change in the ETI regime.

Both the FSC and ETI regimes were finally abolished by the American Jobs Creation Act 2004. With the repeal of the ETI, the Internal Revenue Service (IRC) began to see the re-emergence of the domestic international sales corporation (DISC) in the form of an interest charge DISC (IC-DISC).

An IC-DISC cannot be a manufacturer, but usually, is a subsidiary or affiliate of a US manufacturer or exporter (the DISC's "related supplier").

The pricing rules and regulations under IRC Section 482 are not applicable to transactions between related parties. Thus, DISC profits are not dependent on the economic contribution of the DISC, and a DISC need have no substance.

The most recent data available from the IRS "Statistics of Income" reflect that 1,917 DISC returns were filed for the 2008 tax year, up from 876 and 1,209 for the 2005 and 2006 years, respectively. From those 2008 DISC returns, approximately 86 % of all DISC shareholders were individuals or pass-through entities. In addition to US manufacturers (directly exporting or using a US distributor to export), architectural and engineering service providers, distributors of US-made products, and software, film, and agricultural products qualify for the DISC incentive. And, after the American Taxpayer Relief Act of 2012 made the qualified dividend tax rate permanent at 20 %, DISCs are especially advantageous for individual shareholders and/or pass-through entity shareholders.

17.2 Qualifications for IC-DISC Status

An IC-DISC must be a domestic corporation incorporated under the laws of any state or the District of Colombia. There are no restrictions on who can be a DISC shareholder: individuals, C corporations, S corporations, partnerships and limited liability companies can be DISC shareholders. Although the DISC must be formed as a corporation, it cannot be an S corporation, insurance company, regulated investment company or a financial institution, among other prohibited types of business. The DISC also cannot be formed as a limited liability company or other non-corporate entity that elects or "checks-the-box" to be taxed as a C corporation. A newly formed (or existing) corporation must formally elect to be taxed as a DISC by timely filing Form 4876-A,Election to be treated as an Interest Charge DISC", with the IRS. All shareholders must consent to the election. The IRS strictly enforces DISC election timing requirements. The election is to be made within 90 days from the beginning of tax year or inception of entity. Once an election is made, it will, unless revoked by the corporation, continue in effect for subsequent years in which the corporation qualifies as a DISC. The election is still in effect even if the corporation fails, in intervening years, to meet the tests for qualification. However, if the corporation fails to qualify for five consecutive years, the DISC election will terminate.[1] However, certain qualifications must be met for a US domestic corporation to qualify as an IC-DISC and functionally convert income taxed at an ordinary income rate to qualified dividend income taxed at a substantially lower rate.

17.2.1 Capital and Stock Requirements

An IC-DISC must be capitalized with at least $2,500 (of "valid consideration") at par or actual stated value. An IC-DISC can only have one class of stock.

In the case of a corporation which elects to be treated as a DISC for its first taxable year, the requirements are satisfied if the corporation has no more than one class of stock at any time during the year and if the par value (or, in the case of stock without par value, the stated value) of the corporation's outstanding stock is at least $2,500 on the last day of the period within which the election must be made and on each succeeding day of the year. This election however can cover two types of companies, one that was an already existing corporation and one that was newly formed for this one purpose.[2]

For purposes of the $2,500 capitalization requirement the following rules apply:

- The stated value of shares is the aggregate amount of the consideration paid for such shares which is not allotted to paid in surplus, or other surplus.
- The law of the state of incorporation of the DISC determines what consideration may be used to capitalize the DISC.
- A corporation will not be a qualified DISC unless at least $2,500 of valid consideration was used for this purpose.
- If a corporation has a realized or unrealized loss during a taxable year which results in the impairment of all or part of the capital required under this condition, that impairment does not result in disqualification under this condition, provided that the corporation does not take any legal or formal action under State law to reduce capital for that year below the amount required under this condition.
- The DISC may attempt to treat certain debt as stock. As a general rule, debt of a DISC payable to any person, whether or not that person is a shareholder or a member of a controlled group of which the DISC is a member, is treated as debt for all purposes of the IRC, provided that the debt: (i) would qualify as debt for purposes of the IRC if the DISC were a corporation which did not qualify as a DISC; (ii) qualifies under safe harbour rule;[3] or (iii) are trade accounts payable.[4]

17.2.2 The Qualified Export Receipt (QER) Test

At least, 95 % of the DISC's receipts must be "qualified export receipts". These include, among others:

- Gross receipts from the sale, lease, or license of "export property," and gross receipts from services related thereto;
- Dividends from a related foreign export corporation;
- Interest on any obligation that is a qualified export asset;
- Gross receipts from engineering or architectural services for construction projects outside the US; and
- Gross receipts for the performance of managerial services in furtherance of the production of other qualified export receipts.

"Export property" is property manufactured, produced, grown, or extracted in the USA by a party other than the DISC, held primarily for sale, lease, or rental in the ordinary course of business by or to a DISC, for direct use, consumption or disposition outside the USA, and for which 50 % or less of the fair market value is attributable to articles imported into the US manufacture or production does not include assembly or packaging. The property must be finished goods and cannot require further manufacture or production outside the USA.

Intangible property—such as patents, trademarks, most copyrights, models, designs, formulas, goodwill and franchises—does not qualify as export property. A copyrighted article that is not accompanied by a right to reproduce it is export property. A license of computer software, however, should qualify as export property. Most oil and gas products do not qualify as export property.

A DISC's "qualified export assets" are the assets that may remain on a DISC's balance sheet at year end and include accounts receivable, export property and assets (e.g., inventory), working capital and (temporary) US bank deposits. Another important type of qualified export asset is the "producer's loan." A producer's loan enables the DISC to loan its retained earnings to its related supplier to fund manufacturing. The loan must have a maturity date of five years or less and satisfy other requirements, including an arm's length interest rate and terms.

17.2.3 The Qualified Export Asset (QEA) Test

For a corporation to qualify as a DISC, at the close of its taxable year at least 95 % of the sum of the adjusted bases of all its assets must be qualified export assets. An asset that qualifies as more than one type of qualified export asset may be taken into account only once in determining the sum of the adjusted bases of all qualified export assets.

Accounts receivable and other evidences of indebtedness derived from transactions that generated QER between the DISC and the party with which it conducts business qualify as export asset. However, if the DISC acts as a commission agent for a principal in a transaction that produces QER then the trade receivables will be the accounts receivable of the principal. The determination of the amount of money, bank deposits, and other similar temporary investments reasonably necessary to meet the requirements of the DISC for working capital will depend upon the nature

and volume of the activities of the DISC existing at the end of the DISC's taxable year for which the determination is made.

In situation where the qualified export assets are below the 95 % threshold but not substantially the 95 % amount, it is still possible to examine the underlying transactions to find additional qualifying gross receipts or additional DISC income in an amount which would raise it up to the 95 %. This could be achieved by a redetermination of the DISC income before the filing of the DISC's return. Under Treasury Regulation § 1.994-1(e)(5), the resulting additional receivable generally would be a qualified export asset at the end of the prior taxable year if paid within 90 days of the redetermination.

17.3 Structuring an IC-DISC

Several structuring possibilities exist for IC-DISC. However, for each structure careful consideration must be given to avoid multiple layers of taxation. That is, privately held corporations as well as publicly held corporations can use the IC-DISC for their international sales transactions. Further, unlike other tax planning strategies susceptible of being challenged in courts by the IRS for lack of economic substance, the IRS recognizes that IC DISCs are not required to have economic substance (e.g., have its own employees and operations) generally because of the desire to incentivize the export of US-manufactured goods.

(i) A C corporation structuring an IC-DISC

When a C corporation is willing to take advantage of the IC-DISC regime, effective tax planning would require that the IC-DISC be directly owned by the shareholders of the C corp. rather than by the C corp. itself. In so doing, double taxation would be avoided and the C corp. would receive dividends at 23.8 % capital gains rate. IRC Section 861(a)(1)(D) qualifies IC-DISC dividends attributable to qualified export receipts as foreign source income to US shareholders. In situations where a C corporation has many owners, it is advisable to insert a trust between the owners of the C corporation and the IC DISC. The IC-DISC would then be owned by a trust, whose beneficiaries are the owners of a C corporation. Under such a structure, the trust would be able to distribute the dividends to the beneficiaries without having to worry about constantly changing

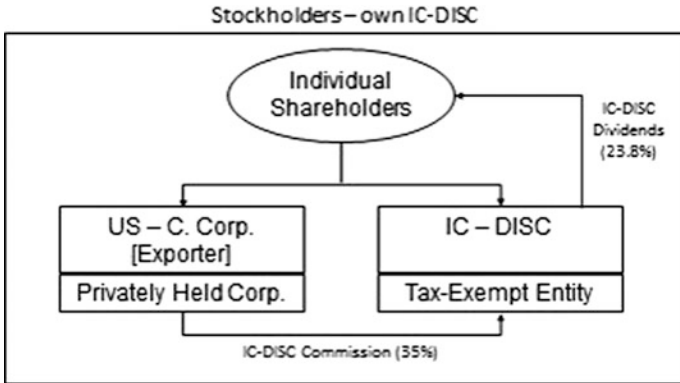

Fig. 17.1 Stockholder-Own IC-DISC (C corporation structure)

the ownership of the IC-DISC to replicate the ownership of the C corporation's shares (Fig. 17.1).

(ii) Structuring an IC IDSC with pass-through entities

Another way to structure an IC DISC is with pass-through entities (i.e., LLP, LLC, or S Corp. IC-DISC) can be included in the structure as a brother-sister entity of a pass-through entity that exports its manufactured products.

In most situations ownership should be held by an individual or flow-through entity for the greatest tax benefit. If the exporting entity is one of these pass-through entities, the IC-DISC can even be formed as a subsidiary. That is, if the exporting company is an S corporation or other pass-through entity that wholly owns the IC-DISC, the S corporation exports the goods and pays the IC-DISC a commission based on those export sales that is deductible for income tax purposes and not taxed to the IC-DISC. The IC-DISC can distribute back to the S corporation that same amount, which passes through to the S corporation's shareholders and is taxed to them at the dividend rate, not the ordinary income tax rate that it otherwise would have been without the IC-DISC. Thus, the S corporation shareholders would have paid less tax on these commissions equal to the difference in the applicable ordinary income tax and dividend tax rates (Fig. 17.2).

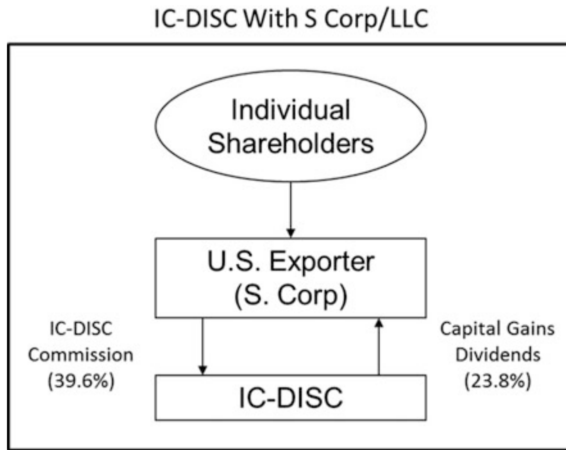

Fig. 17.2 IC-DISC with S corp./ LLC

(iii) Structuring an IC DISC with a publicly held corporation

A publicly held corporation can also take advantage of the IC DISC regime:

An IC-DISC may defer from taxation 16/17 of first $10 million of gross receipts, and the balance is deemed distributed to its shareholders. Very often, publicly held corporations with large volume of export generate large export receivables through their operations. These receivables can be factored (at discount) to the IC-DISC, and the discount income qualifies as qualified export receipts (Fig. 17.3).[5]

(iv) Structuring an IC-DISC with foreign individuals, partnerships/ trusts

Under US applicable tax laws, foreign persons are generally subject to US federal income tax either (i) if they carry on a trade or business in the United States, or ((ii) if they earn income that is effectively connected to US trade or business. In addition, the income of a foreign person which is not effectively connected with a US trade or business is subject to US federal income tax if it is considered to be from sources within the United States and is of certain classes of income known as "fixed or determinable, annual

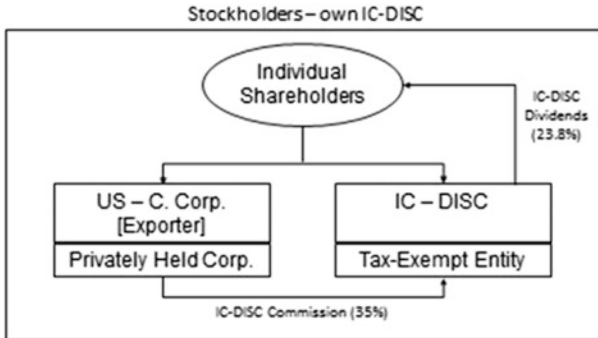

Fig. 17.3 IC-DISC (with publicly held corporation)

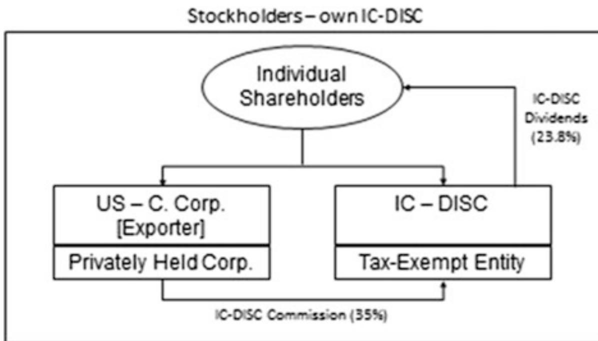

Fig. 17.4 IC-DISC (with foreign individual/ partnership/ trust)

or periodical" (FDAP) income. FDAP income includes, for example, interest, dividends, rents, and royalties. Through an IC-DISC, both the interests and dividends qualify as FDAP (Fig. 17.4).

17.4 IC-DISC Shareholders Taxation

The shareholders of a DISC, or a former DISC, are subject to taxation on the earnings and profits of the DISC by way of distributions from the DISC in accordance with the provisions of Chap. 1 of the IRC enerally applicable to shareholders. There are three divisions of earnings and profits of a DISC, or former DISC from which distributions to shareholders may be made: (i) accumulated DISC income, (ii) previously taxed income, and (iii) other earnings and profits. Accumulated DISC income is the earnings

and profits of the DISC which have not been deemed distributed and which may be deferred from taxation so long as they are not actually distributed with respect to its stock. However, deferral of taxation on "accumulated DISC income" may be terminated, in whole or in part, in the event of: (i) certain foreign investment attributable to producer's loans;[6] (ii) revocation of the election to be treated as a DISC or other disqualification;[7] and (iii) certain dispositions of DISC stock in which gain is realized.[8]

Under IRC § 995(b)(1) and Prop. Treasury Regulation § 1.995-2A, each shareholder of a DISC is treated as having received a distribution (i.e., a deemed distribution) taxable as a dividend with respect to the shareholder's stock on the last day of each taxable year of the DISC an amount equal to the shareholder's pro rata share of the sum of the following items

Whether or not, and to what extent, those distributions are taxable to the shareholder will vary according to which division of earnings and profits (E&P) the distribution is considered to have come from.

- In the case of a shareholder which is a C corporation, the received or deemed received dividend is the sum of: (i) an amount equal to 1/17 of the excess, if any, of the taxable income of the DISC for the taxable year, before reduction for any distributions during the year, over the sum of the amounts deemed distributed and (ii) an amount equal to 16/17 of the excess of the taxable income of the DISC for the taxable year, before reduction for any distributions during the year, over the sum of the amounts deemed distributed, multiplied by the international boycott factor determined under IRC § 999(c)(1), or (iii in lieu of the amount determined in (ii) above, 16/17 of such excess as is described in IRC § 999(c)(2).

- Distributions upon disqualification

IRC § 995(b)(2) provides the consequences to a shareholder when a DISC election is revoked or the DISC failed one or more of the requirements to qualify as a DISC. A shareholder of a DISC that either revoked its election to be a DISC or failed to satisfy one or more of the requirements to be a DISC will be deemed to have received in equal instalments in each of the next ten years (or number of immediately preceding consecutive taxable years corporation was a qualified DISC if less) beginning after the year of disqualification an amount equal to the shareholder's pro rata share of the accumulated DISC income. The deemed distributions are taxable as dividends. The pro rata share is determined as of the end of the last taxable year that the DISC was a qualified DISC.

The deemed distributions upon disqualification will be includible on the shareholder's return only as long as the shareholder holds the shares with respect to which the distributions are deemed made. If the shares are transferred than the transferee will include the remaining deemed distributions. In other words, the reporting of the deemed distributions upon disqualification follow the stock not the stock holder at the time of disqualification. However, if the transferee acquired the shares in a transaction in which the transferor's gain is treated in whole or in part as a dividend under Treasury Regulation § 1.996-4(a) then the transferee does not have to include the subsequent instalments as coming from accumulated DISC income. Instead the subsequent instalments will be treated as coming from previously taxed income.

A deemed distribution paid as part of a disqualification continues and is included into income by the shareholder even if the DISC subsequently requalifies and is again treated as a DISC.

17.5 Operations of an IC-DISC

IC-DISC benefits are generally available on sales of property produced in the United States but for ultimate use outside the country. Manufacturers, producers, resellers, and exporters of goods that are produced in the United States with an ultimate destination outside the United States can use an IC-DISC. IRC Section 993(c) defines export property as property:

- That is manufactured, produced, grown, or extracted in the United States;
- That is then held for sale, lease, or rental for direct use, consumption, or disposition outside the United States; and
- The fair market value of which is not more than 50 % attributable to articles imported into the United States.

Exporter in the chain of supply can also use an IC-DISC.

17.6 Tax Benefits of an IC-DISC

An IC-DISC can distribute the commission to its shareholders in the form of qualified dividends under Section 995(b)(1). An IC-DISC reduces its shareholders' income tax liability by converting ordinary

income from sales to foreign unrelated parties into qualified dividend income. The IRS allows exporters a commission deduction (deductible against 35 % income) payable to the IC-DISC. The owners of the IC-DISC will report this income as dividends (taxed at 15 %) at the distribution. The structure allows owners the opportunity to convert regular income taxed at 35 % into dividend income taxed at 15 %. There are special provisions which allow for a one-year deferral of income to individual IC-DISC shareholders on income attributable to $10 million or less of export receipts. That commission income of the IC-DISC is calculated using one of the two following methods, whichever is greater: (i) 4 % of qualified export receipts or (ii) 50 % of combined taxable income from export sales.

Example
An example of the calculation is as follows:
ABC Exporter

Foreign Trading Gross Receipts	$10,000,000
Cost of Goods Sold	$8,000,000
Gross Margin	$2,000,000
Selling, General and Administrative	($1,000,000)
Export Net Income	$1,000,000
Tax Paid without IC-DISC	$350,000

IC-DISC Commission

(a)	4 % of Qualified Gross Receipts	$400,000
(b)	50 % of Export Net Income	$500,000
	IC-DISC Commission (greater of a or b)	$500,000

Tax Savings

Value of the Deduction 35 % of $500,000 =	$175,000
Cost of the Income 15 % of $500,000 =	($75,000)
Tax Savings with IC-DISC	$100,000

17.7 DISCs in Tax Planning

DISCs are a legitimate tax planning vehicle authorized by the IRC. While a DISC must be a C corporation and may be a subsidiary of a C corporation "parent," it is usually structured as a subsidiary of its pass-through entity related supplier or as a brother/sister company owned by its related supplier's (individual) shareholders.

The amount of the commission is deductible by the related supplier as an ordinary and necessary business expense and is not subject to federal corporate income tax upon receipt by the DISC. The export earnings (the commission) of the DISC that are retained by the DISC (up to $10 million annually) are also tax-free until actually or constructively repatriated to the shareholder(s). This retention is the taxable income deferral subject to the interest charge (i.e., the tax deferral.) If the export earnings are distributed to individual shareholders or a shareholder that is a pass-through entity owned by individuals, they are taxed as "qualified dividends" subject to the 20 % qualified dividend rate (plus the 3.8 % investment income Medicare tax, if applicable to the shareholder). Thus, while those export earnings are taxed at a top individual federal income tax rate of 39.6 % (plus the 0.9 % Medicare tax for a top rate of 40.5 %), the export earnings of the DISC when distributed to individual shareholders are taxed at a rate of almost half that top rate. In addition, since the DISC is not a taxable entity, there is no double level of federal income tax. Thus, a DISC could offer significant tax advantages to a small US exporter.

Example

Commission expense calculation: Company A is a manufacturer of widgets in the United States and sells a portion of the widgets produced to Company C based in Mexico for use in Company C's business in Mexico. Company A decides to set up an IC-DISC to take advantage of the tax savings, and, after it sets up the IC-DISC, it has taxable income for the year of $200,000. The IC-DISC has no activity other than the commission received from Company A (Table 17.1).

Of the $1,000,000 of sales, $250,000 comes from qualified export receipts. Of the $ 750,000 of cost of goods sold, $125,000 is directly related to qualified export receipts. SG&A is split equally. The tax-deductible commission to the IC-DISC calculated under the 4 %-of-qualified-export-receipts method would be $10,000 ($250,000 × 4 %). Based on the information outlined above, the tax-deductible commission under the 50 %-of-combined-taxable-income method would be $50,000 (Table 17.2).

Table 17.1 Commission expense calculation

Sales	1,000,000
Cost of goods sold	(750,000)
SG&A expenses not specifically related to domestic or foreign activities	(50,000)
Taxable income	$200,000

Table 17.2 Tax deductible commission calculation

	Domestic	*Foreign*	*Total*
Sales	$750,000	$250,000	$1,000,000
COGS	($625,000)	(125,000)	($750,000)
SG&A	($25,000)	($25,000)	($50,000)
Net income	$100,000	$100,000	$200,000
50 % of the combined taxable income			**$100,000**

Notes

1. IRC § 992(b)(1) and (2).
2. Treasury Regulation § 1.992-1(d).
3. Treasury Regulations § 1.992-1(d)(2)(ii)).
4. Treasury Regulations § 1.992-1(d)(2)(iii)).
5. Neal Block (2014): IC-DISC Strategies-Mastering the Complex Operational Challenges: Anticipating IRS Audit Risks, Calculating Commissions, and Tackling Computational Intricacies, Strafford Presentation, p. 33.
6. Treasury Regulation §§ 1.995-2(a)(5) and 1.995-5.
7. Treasury Regulation § 1.995-3.
8. Treasury Regulation § 1.995-4.

CHAPTER 18

International Outbound Transactions

18.1 Introduction

International outbound transactions come in various forms. Structuring a deal to comply with all legal, regulatory, and tax aspects requires specific skills. While some restructuring transactions are tax-free, others can trigger tax and therefore careful considerations is needed.

18.2 Tax-Free Restructuring

Under Internal Revenue Code (IRC) Section 368, certain mergers and acquisitions (M&A) qualify for tax-free treatment if specific requirements are met. In addition to statutory requirements, courts have elaborated a series of judicially created requirements that must be met as well for a M&A to qualify for tax-free treatment. While the statutory requirements vary according to the "type" of reorganization involved, the judicially-created requirements apply to all M&A types. Continuity of interest (i), continuity of business enterprise (ii), and business purpose (iii) are the three judicially created requirement for an M&A to qualify for the tax-free regime.

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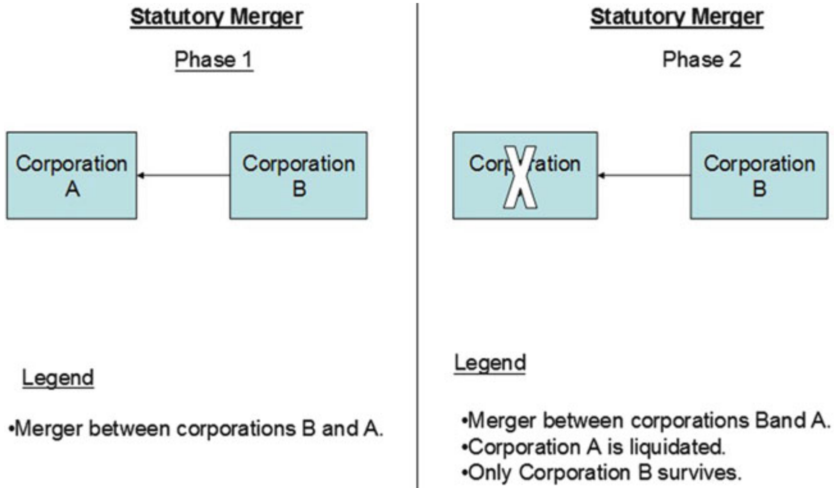

Fig. 18.1 Statutory merger

- In a statutory merger or acquisition, one entity will absorb the other entity after the completion of the process (in step 2) (Fig. 18.1).
- In a pure consolidation, two companies merge into a newly formed company, which survives the two (Fig. 18.2).
- In a regular triangular merger the acquiring corporation will set up a vehicle for the acquisition, which then merges with the acquired corporation. In the final step, the acquired corporation is liquidated.

Under IRC Section 368(a)(2)(D), a forward triangular qualifies as a M&A (or reorganization) only if substantially all of the assets of the target company are acquired by the set up vehicle of acquisition in consideration of the acquiring company's stock. That is, no stock of the newly created subsidiary can be used as merger consideration (Fig. 18.3).

- In a reverse triangular, the acquired corporation set up a vehicle to be merged with the acquiring entity. In the final step, the acquiring entity is liquidated.
- A reverse triangular qualifies as a tax free, under IRC Section 368(a)(2)(E) if two conditions are met: (i) the target company shareholders must exchange at least 80 % of their stock for the voting stock of the Acquiring company; and (ii) after the transaction, the target

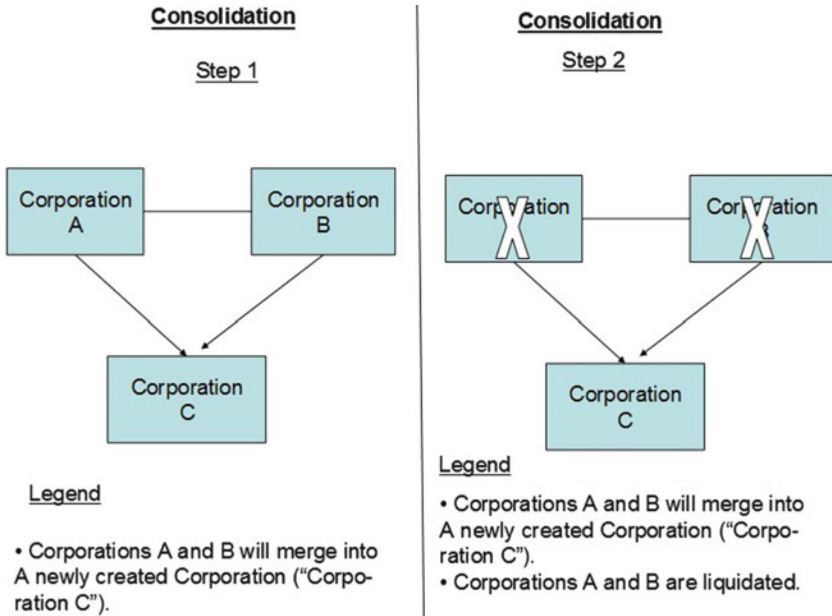

Fig. 18.2 Consolidation

company must own 'substantially' all of the assets of the newly created vehicle in addition to its own assets (Fig. 18.4).[1]

18.2.1 Analysis of the Different Tax-Free Regimes

Once all these judicial doctrines are satisfied, the tax-free treatment transaction must qualify and fit in within a specific type or classification under IRC Section 368. The IRC has classified M&A as type "A," type "B," type "C," type "D," type "E," type "F," and type "G" reorganizations. This section discusses only A, B, C, and D types.

- Type "A" Reorganization

IRC Section 368(a)(1)(A) defines the type "A" reorganization as a statutory merger or consolidation. To qualify as a tax-free type "A," the transaction must be carefully structured to fit in all the statutory requirements: (i) at least 50 % of the consideration must be in the

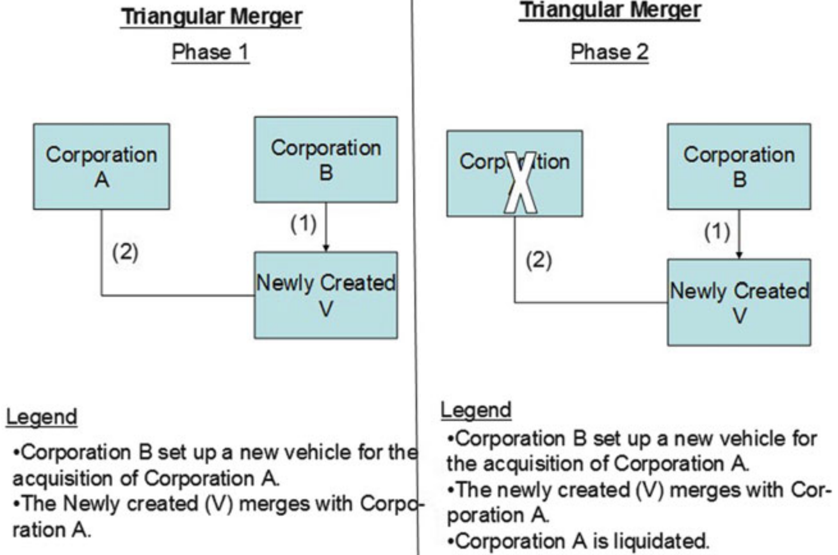

Fig. 18.3 Triangular merger

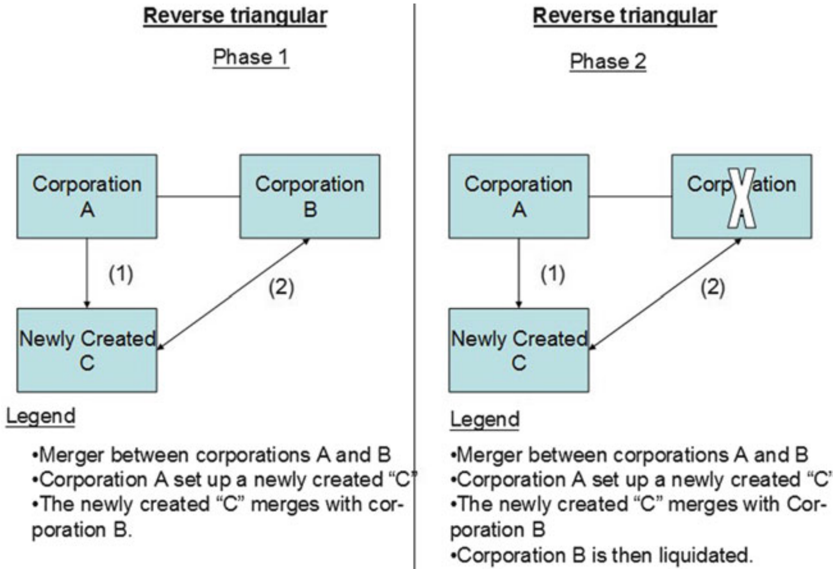

Fig. 18.4 Reverse triangular

form of stock of the acquiring company (voting or non-voting stock, common or preferred stock, even other securities); (ii) the acquiring company be in control of the target (acquired) company just after the transaction. However, the concept of control, under IRC Section 368(a)(1)(A) is subject to the continuity of business purpose and the continuity of proprietary interest.[2]

As opposed to types "B," "C," and "D," type "A" allows the acquiring company to use and pay a significant amount of cash, notes or other taxable consideration to the shareholders of the target company.

Tax considerations under type "A" M&A are as follows:

1. Shareholders of the target company do not recognize gains, except for considerations which do not qualify as security (boots). However, no loss should be recognized on the exchange of the target stock, unless the target's shareholders have received no stock or security but only boot.
2. Shares that are exchanged for non-equity consideration are subject to capital gains tax. In such cases, the taxable amount is the lesser of the amount of boot or the total gain on the transaction.
3. The target corporation shareholders take carryover bases in the acquiring corporation stock under IRC §358.
4. The acquiring company basis in the assets acquired will be equal to the target company basis in those assets, increased by the amount of gain (if any) recognized by the target company as a result of the transaction.
5. The acquiring corporation does not recognize gain or loss and takes a carryover basis in the target corporations' assets under IRC § 362.

- Type "B" Reorganization

IRC Section 368(a)(1)(B) defines a type "B" M&A as the acquisition by one company, in exchange solely for all or portion of its voting stock … of the stock another company (target), if immediately following the transaction, the acquiring company has the control of the target company." The acquiring company must buy at least 80 % of the target, and the shareholders of the target should have no option for cash.[3]

The observance of the threshold (80 %) constitutes a mandatory requirement under type "B" reorganization. However, under the Roosvelt Hotel Co. case,[4] payments by the acquiring corporation of expenses arising in a reorganization such as legal fees, investment

banking fees, costs of stock registration under the securities laws, etc., have been held not to represent additional consideration.[5] Also, cash payment to the target corporation shareholders in lieu of fractional shares would not violate the solely for voting requirement.[6]

A transaction would still qualify as a type "B" when the acquiring company purchases the stock of the target in several transactions over a period of time not exceeding 12 months if the transactions are held to be part of pre-determined plan. Likewise, the target company may redeem up to 50 % of its stock prior to the merger without destroying the tax-free features of the transaction, provided the cash for the redemption did not come from the acquiring corporation.[7]

Tax considerations under type "B" M&A are as follows:

Shareholders of the target company do not recognize gain or loss on the exchange of their target stock for acquiring corporation voting stock under IRC § 354. Instead, each takes a substituted basis in his acquiring corporation exchanged stock. Any gain on appreciation in value of the target company stock is deferred until later sale or taxable disposition.

The target corporation stockholders take a carryover basis in the acquiring corporation voting stock under IRC § 358. The receipt of a carryover basis preserves the unrecognized gain for later recognition in a taxable sale or other taxable disposition.

The acquiring corporation generally does not recognize gain or loss under IRC § 1032.

The acquiring company basis in the assets acquired will be equal to the target company basis in those assets, and the acquiring is not allowed to elect to step up the basis under IRC Section 338.

- Type "C" Reorganization

IRC Section 368(a)(1)(C) defines a type "C" M&As as "the acquisition by one corporation, in exchange solely for all or a part of its voting stock….of substantially all of the properties of another corporation…, but in determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the other…shall be disregarded."

Three statutory requirements should be met: (i) the acquiring corporation must purchase at least 80 % of the fair market value of the target's assets; (ii) the target corporation should distribute the consideration received and liquidate; and (ii) immediately after the transfer, the transferor or its stockholders or both must be in control

of the transferee (target) corporation or retain the ownership of at least 80 % of the voting stock and at least 80 % of the total of all classes of stock of the corporation.[8]

Unlike type "B" reorganization, in type "C" a small amount of boots is permitted, so long as the amount does not exceed 20 % of the fair market value of the target's assets.

Tax considerations under type "C" M&As are as follows:

Shareholders of the target company do not recognize gain or loss on the distribution of the acquiring corporation stock following the liquidation of the target. Instead, each takes a substituted basis in his acquiring corporation received stock. Any gain on appreciation in value of the target company stock is deferred until later sale or taxable disposition.

The target corporation shareholders that received boot in the liquidation are taxed on the receipt of that boot as either capital gain or a dividend, under IRC § 356. The taxable amount is the lesser of the amount of the boot or the total gain on the transaction.

The acquiring company does not recognize any gain or loss, and the basis in the assets acquired will be equal to the target company basis in those assets prior to the exchange.

The target (or acquired) corporation tax attributes will be carried over to the acquiring corporation tax attributes, subject to certain limitations under IRC Section 383.

- Type "D" Reorganization

Type "D" reorganization covers two different sets: the acquisitive type "D" and the divisive type "D". Divisive type 'D' includes spin-offs,[9] split-ups,[10] and split-offs.[11]

To benefit for a tax-free spin-off under IRC Section 355(b), both the controlling and the distribute corporations must have been engaged in active conduct of trade or business prior to the distribution. A corporation is considered engaged in an active conduct of trade or business, when it is not itself (directly or indirectly) under control of any distributee.[12]

Treasury Regulation 1. 355-3(b)(3(iii) provides an exception to the five-year mandatory requirement in the case of a corporation engaged in one business purchasing creating, or acquiring another business, in the same line of business. The facts that a trade or business underwent change during the five-year period shall be disre-

garded if the changes are not of such a character as to constitute the acquisition of a new or different business.[13]

IRC Section 368(a)(1)(D) requires the target corporation or its shareholders be in control of or possess at least 50 % of vote or value of the acquiring corporation. But, contrary to type "C," Section 368(a)(1)(D) has not expressed limitation on the consideration that may be used.[14] If the requirements of an acquisitive type "D" reorganization are met, the parties generally defer current federal taxation on gains (on their stock or assets).

Type "D" reorganization, particularly a spin-off, should be carefully structured since the IRS has enacted Section 355(e) to challenge pre-arranged series of transactions that used to qualify for tax-free spin-off. IRC Section 355(e) provides:

> Stock or securities in a controlled corporation will not be considered qualifying property for purposes of Section 355(C)(2) or Section 361(C)(2) if the intended distribution under Section 355 is part of a plan (or series of related transactions) in which one or more persons acquire directly or indirectly stock representing a 50 % or greater interest in the distributing or any controlled corporation, within the four-year period beginning two years before the spin-off distribution.[15]

18.3 Taxable Mergers & Acquisitions

In taxable acquisitions, the acquiring company's tax basis in the stock or assets acquired is equal to the amount paid. The selling company recognizes immediately the entire gain (or loss), which is subject to tax.

Taxable mergers occur in two main forms: (i) taxable purchase or sale of stock, and (ii) taxable sale or purchase of assets.

18.3.1 Taxable Purchase of Stock

In a taxable purchase of stock transaction, one corporation purchases stock of the target corporation directly through the target's shareholders, in consideration of cash, notes or other.

The tax considerations of the transaction are as follows:

1. The target's corporation shareholders recognize gain or loss on the sale, measured by the difference between the basis of the stock and its purchase price.
2. The target corporation itself does not recognize any gain or loss, and its tax attributes remain unchanged.

3. The acquirer corporation takes a new basis in the stock purchased equal to the purchase price.

Under Revenue Ruling 90-95,[16] a liquidation or merger of the target corporation subsequent to a taxable purchase of 80 % or more will render the transaction tax-free.

18.3.2 Taxable Sale/Purchase of Assets

In a taxable purchase of assets transaction, one corporation (transferor) transfers substantially all of its assets to another (transferee) in consideration of the payment of cash, notes, or others. After the transfer, the transferee becomes the new owner and assumed liabilities. The transferor may or may not remain into existence.

The tax considerations are as follows:

1. The transferor corporation recognizes gain or loss on the sale (or transfer) of its assets. The gain or loss may be capital or ordinary depending on the nature of the assets transferred.
2. The transferor corporation shareholders do not recognize gain or loss unless the Transferor is liquidated.
3. If the assets transferred have been amortized (or depreciated) in the United States, a recapture of depreciation will be subject to tax as ordinary income, under IRC Sections 1245 and 1250.
4. The transferor corporation tax attributes do not carry over to the transferee, which takes the assets at their purchase price as basis.

18.3.3 After Tax-Free Advisory Considerations

Advising corporation after a taxable or tax-free M&A is of even significance than advisory in the midst of any M&A. That is because some tax or corporate aspects of the transaction unfold sometime after the deal has been closed.

Section 381 of the United States IRC stipulates that major benefits, privileges, elective rights, and obligations of the transferor in a tax-free reorganization can, after some limitations, be carried over to the acquiring corporation.

The successor corporation steps in the tax shoes of its predecessor.[17]

However, only obligations not reflected in the amount of the consideration on the date of the transfer have to be taken into account.

Therefore, a mere promise to pay, speculative liabilities, such as workforce contingent would not be taken into account. Two main items are of the importance: (i) the contingent liabilities, and (ii) the net operating losses, subsequent to a restructuring.

(i) Contingent liabilities

Liabilities or obligations are considered reflected in the amount of the consideration transferred, if on the transfer date, the parties were aware of their existence and adjusted the amount to the extent of them.[18]

Revenue Ruling 58-374 has held that no gain or loss will be recognized if the income involved is a mere adjustment of the stock price or property value related to a tax-free reorganization. However, the issue is somewhat tricky, when the liabilities paid later are higher than the initial estimation.

In the Illinois case,[19] the Tax Court considered the overpayment as part of the acquisition price and subsequently required its capitalization.

Furthermore, the IRS is reluctant to allow the deductibility required, when the taxpayer, in determining the basis of the liability has departed from general principles of tax law, under IRC Section 1.338-5(b)(2)(ii).

Under IRC Section 357(b), liabilities are considered as a distribution of money or boots, if after IRS scrutiny, it appears that the principal purpose of the taxpayer was to avoid federal income tax on the exchange; or was not a bona fide business purpose.

The classification of the income related to contingent liability is to be determined by the nature and the basis of the liability involved. Payment of contingent liabilities in connection with a tax-free reorganization is treated as capital (profit or loss) if it constitutes an addition to the basis of the asset conveyed. In contrast, such payment will be treated as ordinary income, when it is a mere recovering, through litigation or settlement of an ordinary income owed to the predecessor.

In the Hort case,[20] where the contention between the taxpayer and the Commissioner of Internal Revenue focused on the consideration received for cancellation of a lease, the High Court held:

> The cancellation of the lease is nothing more than a relinquishment of the right for future rental payment.

The formulation of the principle by the Supreme Court requires some precisions. Indeed, the Supreme Court has stated:

> When the origin of the claim is an action to recover a capital asset, the proceeds to the recovery could then be capital in nature. But, when… the origin of the claim is a right to recover an item of ordinary income, then the proceeds of the recovery necessarily represent ordinary income in the hands of the recipient.

It is worth noting that for the recovery of a capital asset, the Supreme Court used "could," which excludes all automaticity of the capital nature of the proceeds, whereas, for the proceeds of an item of ordinary income, the Supreme Court established this automaticity by the use of the adverb "necessarily."[21]

This is not merely a semantic matter but obliges the investment banks and/or the counsels to conduct a thorough analysis of the transaction in order to cope with the issue rather than jumping into a hazardous conclusion departing from the current jurisprudence trend.

(ii) The net operating loss or NOL

A tax-free reorganization could be followed by unduly harsh tax consequences for the ongoing business after the restructuring. Therefore, the IRC has supplied privileges—carryover and carryback—to set off lean years against lush years in a single business. Subsequent to a tax-free reorganization, the NOL may be used as a "net operating carryback" to the two years and, if not exhausted by that carryback, the remainder may be used as a "net operating carryover" to the three succeeding years. The NOL is the most sought after attribute because it can be used to directly reduce the taxable income. Therefore, it management or use must fit with the statutes. Otherwise, the entire carryover can be disallowed, or limited.

- Disallowance of the entire carryover

The change in corporate identity and/or ownership can strip the corporate for the use of the privilege. In the New Colonia case,[22] where the continuity of ownership between the two corporations were broken, and neither corporation had any control over the other at the time the privilege was sought, the Supreme Court has held:

> The taxpayer was sustained the loss is the one to whom the deduction be allowed.…the privilege is not transferable to or usable by another.

Likewise, under the Libson Shops case,[23] the privilege was denied to a taxpayer who had made a sovereign management decision to file separate income tax returns rather than a consolidated one after the merger.

- Limitations on NOL carryovers and carrybacks

The NOLs carryovers are limited if there is a substantial change in the controlling interest in the loss corporation. That occurs often, if within the three years, more than 50 % of stocks changed hands, or where the losses are created by interest deductions allocable to corporate equity-reducing transactions.

Likewise, carrybacks are limited after the NOL corporation acquires the stock of another corporation, or makes an extraordinary distribution. When generated by interest deductions as a result of a major stock acquisition, the NOL can be unusable.[24]

The limited amount equals the product of the value of the corporation loss on the date of the ownership change, multiplied by a statutory rate of return published monthly by the Treasury bill yield.

18.4 International Outbound Transactions

Section 367 was enacted to prevent use of the non-recognition provisions in sub-chapter C to avoid taxation on the transfer of property by and to controlled foreign corporations in transactions which would otherwise be covered by those non-recognition provisions. It does so by providing, in the situations that it covers, that the entity will not be considered to be a corporation for the purposes of IRC §§ 332, 351, 354, 356, and 361. Since the provisions of these sections are available only to corporations, the non-recognition provisions would not apply. IRC § 367 has two broad purposes:

- To prevent the tax free removal of appreciated stock, assets, or other property from US tax jurisdiction; and
- To preserve the ability to impose US income tax currently, or at a later time, on the accumulated E&P of certain foreign corporations.

The scope of IRC Section 367 is broad as it applies to outbound, inbound, and foreign-to-foreign transfers.

18.4.1 Section 367(a): Outbound Transfer

Section 367(a) provides general rules governing the taxation of outbound transfers of property by US persons to foreign corporate transferees in transactions that would qualify as non-recognition transactions if the transferee had been a US corporation. IRC Section 367(a) is intended to prevent US persons from avoiding tax by transferring appreciated property to a foreign corporation in a tax-free organization or reorganization, and then selling the appreciated property outside the tax jurisdiction of the United States.

Section 367(a)(1) provides that:

> if, in connection with any exchange described in Sections 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation will not, for purposes of determining the extent to which gain would be recognized on such transfer, be considered to be a corporation.

IRC Section 367(a) generally treats a transfer of property (including stock) by a US person to a foreign corporation (an "outbound transfer") in connection with an exchange described in Sections 351, 354,356 or 361 as a taxable exchange unless the transfer qualifies for an exception to this general rule.

- Exception for certain stock or securities

The general rule under Section 367(a)(1) will not apply to the transfer of stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization. A transfer of stock or securities of a foreign corporation by a US person to a foreign corporation is not subject to Section 367(a)(1) if either (i) the US transferor owns less than 5 % of stock of the transferee or (ii) the US transferor owns 5 % or more but agrees to enter into a five year gain recognition agreement (GRA).

Treasury Regulation §1.367(a)-3(c) provides that no gain is recognized if:

1. the US transferors receive less than 50 % of the ownership of the transferee post-transaction. For purposes of this test, it is presumed that transferors are US persons. Ownership statements from foreigners must be obtained to show that the 50 % US ownership threshold is not exceeded.

2. The transferee is engaged in active conduct of a trade or business outside the US for 36 months prior to the transfer (and no sale anticipated).
3. The US transferor owns less than 5 % or if a 5 % or greater US transferor, has a gain recognition agreement to avoid gain recognition.

By entering into a GRA, the US transferor consents to include in income the gain realized but not recognized if certain events ("triggering events") occur before the close of the fifth full tax year following the year of the transfer. Events that might trigger gain recognition includes, among others, dispositions—directly or indirectly—of stock of the transferee. Yet the regulations provide detailed exceptions for certain disposition that may avoid creating a gain recognition event if further reporting is complied with. A taxpayer that makes an outbound transfer that is subject to IRC Section 367(a) may be required to report the transfer under IRC Section 6038B. Failure to report may subject the taxpayer to penalties and an extended statute of limitations under IRC Section 6501(c)(8).

- Transfers of certain property used in the active conduct of a trade or business

The transfer of property by a US person to a foreign corporate transferee qualifies for non-recognition treatment if such assets are used by the transferee in an active trade or business outside the United States. Therefore, to determine whether property is subject to the exception provided by this section, four factual determinations must be made: (i) what is the trade or business of the transferee; (ii) do the activities of the transferee constitute the active conduct of that trade or business; (iii) is the trade or business conducted outside of the United States; and (iv) is the transferred property used or held for use in the trade or business?

  – Whether the activities of a foreign corporation constitute a trade or business is determined under all the facts and circumstances. In general, a trade or business is a specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit. To constitute a trade or business, a group of activities must ordinarily include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit. In this regard, one or more of such

activities may be carried on by independent contractors under the direct control of the foreign corporation.[25]

- Whether a trade or business is actively conducted is determined under all the facts and circumstances. In general, a corporation actively conducts a trade or business only if the officers and employees of the corporation carry out substantial managerial and operational activities. A corporation may be engaged in the active conduct of a trade or business even though incidental activities of the trade or business are carried out on behalf of the corporation by independent contractors.[26]
- Whether a foreign corporation conducts a trade or business outside of the United States is determined under all the facts and circumstances. Generally, the primary managerial and operational activities of the trade or business must be conducted outside the United States and immediately after the transfer the transferred assets must be located outside the United States.[27] Thus, the exception provided by this section would not apply to the transfer of the assets of a domestic business to a foreign corporation if the domestic business continued to operate in the United States after the transfer. Moreover, the transferred assets would be located in the United States. However, it is not necessary that every item of property transferred be used outside of the United States. As long as the primary managerial and operational activities of the trade or business are conducted outside of the United States and substantially all of the transferred assets are located outside the United States, incidental items of transferred property located in the United States may be considered to have been transferred for use in the active conduct of a trade or business outside of the United States.
- Whether the property is used or held for use in a trade or business is determined under all the facts and circumstances. In general, property is used or held for use in a foreign corporation's trade or business if it is (i) held for the principal purpose of promoting the present conduct of the trade or business; (ii) acquired and held in the ordinary course of the trade or business; or (iii) otherwise held in a direct relationship to the trade or business.[28]

Property is considered held in a direct relationship to a trade or business if it is held to meet the present needs of that trade or business and not

its anticipated future needs. Thus, property will not be considered to be held in a direct relationship to a trade or business if it is held for the purpose of providing for future diversification into a new trade or business, future expansion of trade or business activities, future plant replacement, or future business contingencies.

The active trade or business exception does not apply to transfers of certain types of property, however, even if that property is used in the active business of the transferee foreign corporation. Property generally ineligible to be transferred tax-free ("tainted assets") to a foreign corporation includes:

- inventory and certain property created by the efforts;
- installment obligations, accounts receivable, and similar property;
- foreign currency or other property denominated in foreign currency;
- Intangible property within the meaning of Code Section 936(h)(3)(B);
- certain property leased by the transferor;
- recapture of US depreciated property;
- property expected to be sold;
- branch loss recapture of §367(a)(3)(C).

Moreover, if the assets deemed transferred are US depreciated assets, then the US person will have to include in its gross income for the tax year in which the transfer occurs ordinary income equal to the gain realized that would have been includable in its gross income as ordinary income under IRC §§ 617(d)(1), 1245(a), 1250(a), 1252(a), or 1254(a) if at the time of the transfer the US person had sold the property at its fair market value.[29]

- Transfer of partnership interests

A transfer by a United States person of an interest in a partnership to a foreign corporation in an exchange described in paragraph (1) will, for purposes of this subsection, be treated as a transfer to such corporation of such person's pro rata share of the assets of the partnership.

- Branch loss recapture rule

Another exception to the active trade or business exception applies to the transfer of a foreign branch with losses previously deducted pursuant

to IRC § 367(a)(3)(C). The active trade or business exception is not available to the gain realized on the deemed transfer of assets of a foreign branch to the extent that cumulative losses incurred by the foreign branch and deducted by the US person before the transfer exceed gains of the foreign branch in subsequent years. The transferor (US person) must recognize gain equal to the lesser of the gain on the transfer of the previously deducted branch losses. The gain has the same character as the branch losses, whilst the gain is deemed foreign source income. Moreover, IRC § 904(f)(3) also overrides the active trade or business exception. Under IRC § 904(f)(3), if the US person is deemed to transfer certain assets that could potentially generate foreign-source taxable income, the disposition may trigger recapture of overall foreign loss accounts.

- Transfer of intangibles

If a US person transfers intangible property to a foreign corporation in an exchange described in IRC Section 351 or 361, the US person is treated as transferring the intangible in exchange for contingent payments (for a period of no more than 20 years) that must be commensurate with the income attributable to the intangible. Section 367(d) provides special rules for the taxation of outbound transfers of intangible property by a US person to a foreign corporation in an exchange that otherwise would qualify as a non-recognition transaction under §351 or 361. However, the regulations provide exception to the rules of §367(d) for foreign goodwill and going concern value, as well as for certain other items (copyrights, artistic compositions, or letters or memoranda) to which specific rules apply. IRC Section 936(h) (3)(B) defines intangible property by providing a list of 27 items, including patents, designs, copyrights, trademarks, franchises, contracts, systems, programs, and customer lists, and ends with "and any similar item which has substantial value independent of the services of any individual".

A taxpayer that is subject to IRC Section 367(d) with respect to a transfer of intangible property must report the transfer in accordance with IRC Section 6038B, or be subject to penalties and an extended statute of limitations under IRC Section 6501(c)(8).

Sham sales or sham licensing arrangements are subject to §367(d) (Treasury Regulation §1.367(d)-1T(g)(4)(ii) states that a sale or license of intellectual property may be disregarded and treated as a transfer subject to §367(d) if the terms do not have economic substance). Contribution of intangibles (exception for foreign-based goodwill) is treated as a sale of

intangible property in exchange for deemed annual payments per super-royalty provision of §367(d)(2)(A). The annual payment is ordinary in character from sources without the United States (§367(d)(2)(C)) and §904(d) look-through rules apply. The amount of annual payments are commensurate with income over useful life (but no longer than 20 years). Disposition of transferred intangible by foreign subsidiary accelerates transferor's gain recognition. §367(d)(2)(A)(ii)(II).

Under IRC § 367(d), the multinational corporation (MNC) deemed to transfer the intangible property to the "new" foreign corporation is treated as having sold such property in exchange for annual payments that are contingent on the productivity, use, or disposition of the property over the useful life of the property. Such amounts must be commensurate with the income attributable to the intangible asset and included as ordinary income by the MNC.

- Liquidation of US Corp. into a foreign parent corporation

§367(e)(2) denies non-recognition of gain to a US corporation making a liquidating distribution to a foreign parent corporation. Exceptions are: (1) when distributed assets are used in a US trade or business; or (2) if a US real property interest.

- Liquidation of a foreign corporation into a parent corporation

As a general rule there is no gain recognition of a "foreign-to-foreign" liquidation.[30] However, gain recognition is required if US trade or business assets are transferred, unless the ten-year gain recognition rule is applicable.

- Outbound spinoffs

If US corporation distributes stock or securities of a US or foreign subsidiary to a foreign person in a §355(a) transaction the distributing corporation recognizes gain under §367(e)(1). However, exceptions do exist if: (i) after distribution both distributing and distributed controlled corps are US real property holding corps; (ii) 80 % or more of stock of the US corporation is to distributees holding 5 % or less of the distributing corporation's stock (i.e., publicly held); (iii) distributing corp. agrees to file an amended return if foreign distributee of US stock disposes of that stock.

18.4.2 Section 367(b): Inbound Transactions

IRC Section 367(b) covers inbound transactions where assets of foreign taxpayers are transferred to a US person.

In the case of any IRC Sections 332, 351, 355, or 361 transfer, to the extent that 367(a) does not apply, a foreign corporation is considered to be a corporation, but 367(b) may modify the taxation of the exchange to protect tax attributes. Treasury Regulation §1.367(b)-4 backstops the application of Section 1248 when a US shareholder or foreign corporation transfers stock or assets in a subchapter C non-recognition transaction.

– Monitoring the earnings and profits of a controlled foreign corporation

IRC Section 367(b) provides that in the case of any exchange described in IRC Sections 332, 351, 354, 355, 356 or 361 in connection with which there is no transfer of property described in IRC Section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of federal income taxes. If a transaction described in IRC Sections 332, 351, 354, 355, 356 or 361 affects the potential US taxation of the earnings and profits of a controlled foreign corporation, consider whether the regulations and other authorities under IRC Section 367(b) apply to require current taxation. In addition to preserving Section 1248 amounts, Section 367(b) applies in situations in which the foreign corporation involved in the liquidation / reorganization is not a CFC. Finally, there are proposed regulations under Section 367(b) addressing the carryover of earnings and profits and taxes.

18.4.3 Section 367(c): Foreign-to-Foreign Rules

If a domestic corporation distributes the stock of a foreign corporation to a foreign person in a distribution described in IRC Section 355, the distribution is taxable under IRC Section 367(e)(1).

If, immediately before the exchange, the exchanging shareholder is either (i) a §1248 shareholder with respect to the foreign acquired corporation, or (ii) a foreign corporation, and a US person is a §1248 shareholder of such foreign corporation and of the foreign acquired corporation; then if either of the following conditions is satisfied, the exchanging shareholder must include in income as a deemed dividend the Section 1248 amount attributable to the stock that it exchanges.

18.4.4 Section 367(e): Distribution of Stock of Foreign Corporation

If a domestic corporation distributes the stock of a foreign corporation to a foreign person in a distribution described in IRC Section 355, the distribution is taxable under IRC section 367(e)(1). If a domestic corporation distributes the stock of a domestic corporation to a foreign person in a distribution described in IRC Section 355, the distribution is non-taxable.

If a US corporation is liquidated into a foreign parent corporation under IRC Section 332, IRC Section 367(e)(2) provides in effect that, except as provided by regulations, the US corporation is treated as if it sold its assets in a taxable transaction (IRC Section 337(a) and (b)(1) will not apply).

Notes

1. In Revenue Ruling 2001-25, 2001-22 I.R.B. 1291, the IRS has ruled that the 'substantially' all test was satisfied even when the target company has sold half of its assets prior to the merger, since the proceed of those assets were retained by the target company.
2. Dr. Felix I. Lessambo, BNA-Tax Planning International- Mergers & Acquisitions, November 2003, p. 13.
3. The mere existence of a cash option disqualifies the transaction, even when at least 80 % of voting stock is actually used.
4. *Roosvelt Hotel Co., v. Commissioner, T.C 399* (1949).
5. Felix I. Lessambo, BNA-Tax Planning International- Mergers & Acquisitions, November 2003, p. 14.
6. Revenue Ruling 66-365, 1966-2 C.B. 116.
7. Revenue Ruling 55-440, 1955-2 C.B. 226, and Revenue Ruling 68-285, 1968-1 C.B. 147.
8. Felix I. Lessambo, BNA-Tax Planning International- Mergers & Acquisitions, November 2003, p. 15.
9. Spin-off is a transfer of the assets of the parent corporation (typically the assets of a division or line of business) to a newly formed corporation and dividend of the stock of the newly created corporation to the parent corporation' shareholders.
10. Split-up is a transfer of the assets of the parent corporation to two or more newly formed corporations and dividend of the stock of the newly created corporations to the parent corporation's shareholders.

The parent corporation liquidates and the stockholders hold shares in the two or more newly formed companies.

11. Split-off is an exchange offer in which the stockholders of the parent corporation exchange their stock in the parent for stock in a new entity.
12. Felix I. Lessambo, BNA-Tax Planning International- Mergers & Acquisitions: Tax-free Spin-off and the Active Conduct of Business, May 2004, p. 8.
13. Rev. Ruling 98-27, 1998-1 C.B. 1159; Rev. Ruling 2003-18, 2003-7 IRB. 467; and Rev. Ruling 2003-38, 2003-17 IRB 811.
14. Felix I. Lessambo, BNA-Tax Planning International- Mergers & Acquisitions, November 2003, p. 15.
15. Felix I. Lessambo, BNA-Tax Planning International- Mergers & Acquisitions: Tax-Free Spin-Off Within a Pre-arranged Series of Transactions, April 2004, p. 12.
16. Revenue Ruling 90-95, 1990-2 C.B. 67.
17. Senate report N0. 1622, Eighty-third Congress, p. 52.
18. Felix I. Lessambo, BNA-Tax Planning International- Mergers & Acquisitions, January 2004, p. 11.
19. Illinois Tool Works & Subs. v. Commissioner, 117 T.C., N0 4, July 31, 2001.
20. *Hort v. Commissioner of internal Revenue*, US. S.Ct. 313 US 28 (1941).
21. Felix I. Lessambo, BNA-Tax Planning International- Mergers & Acquisitions, January 2004, p. 12.
22. New Colonial Ice Co. v. Helvering, S.Ct. 292 US 435 (1934).
23. Libson Shops, Inc. v. Koehler, S.Ct. 353 US. 382 (1957).
24. Felix I. Lessambo, BNA-Tax Planning International- Mergers & Acquisitions, January 2004, p. 13.
25. § 1.367(a)-2T (b)(2).
26. § 1.367(a)-2T(b)(3).
27. § 1.367(a)-2T(b)(4).
28. § 1.367(a)-2T(b)(5).
29. § 1.367(a)-4T(b)(1).
30. IRC Section 332.

CHAPTER 19

Cross-Border Tax Arbitrage

19.1 Introduction

The diversity of tax regimes all around the world offer possibilities for sharp tax practitioners to engage in sophisticated tax planning, which is often referred to as tax arbitrage. The aim of tax arbitrage consists of taking advantage of differences among national tax codes and/or regulations in order to mitigate or eliminate, if possible, the amount of taxes due to sovereign tax jurisdictions. These mismatch arrangements (or hybrid mismatch arrangements) significantly reduce overall tax for taxpayers. Although there are no comprehensive data on the collective tax revenue loss caused by hybrid mismatch arrangements, anecdotal evidence shows that the amounts at stake in a single transaction or series of transactions are substantial.[1]

The hybrid mismatch arrangements generally use one or more of the following underlying elements:[2]

1. Hybrid entities: entities that are treated as transparent for tax purposes in one country and as non-transparent in another country.
2. Dual residence entities: entities that are resident in two different countries for tax purposes.
3. Hybrid instruments: instruments which are treated differently for tax purposes in the countries involved, most prominently as debt in one country and as equity in another country.

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4. Hybrid transfers: arrangements that are treated as transfer of ownership of an asset for one country's tax purposes but not for tax purposes of another country, which generally sees a collateralized loan.

Hybrid mismatch arrangements generally aim at achieving one of the following effects:[3]

1. Double deduction schemes: arrangements where a deduction related to the same contractual obligation is claimed for income tax purposes in two different countries.
2. Deduction/no inclusion schemes: arrangements that create a deduction in one country, typically a deduction for interest expenses, but avoid a corresponding inclusion in the taxable income in another country.
3. Foreign tax credit generators: arrangements that generate foreign tax credits that arguably would otherwise not be available, at least not to the same extent, or not without more corresponding taxable foreign income.

19.2 Common Schemes

The following are the most commonly used cross-border tax arbitrage schemes.

19.2.1 Dual No Tax Residence

Arbitrage between corporate residence definitions in Ireland appears to be the perfect condition for the USA to create a company that is not a tax resident in any country. Both countries define corporate tax residence in terms of a single factor: place of incorporation for the USA, and central management and control for Ireland. A company incorporated in Ireland with central management and control in the USA is therefore not a resident of either country. It follows that under the source principle, the Irish company would be subject to tax in Ireland only on its income sourced in the country (if any). The important implication of the non- resident status of Apple Sales International (ASI) in Ireland is that its foreign source income is tax free in the Ireland.[4]

19.2.2 Original Issue Discount

The opportunity for cross-border tax arbitrage with original issue discount (OID) bonds occurred where US issuers of OID bonds paired

with buyers in a country that did not require current accrual of the holder's interest income. Japan, in particular, was a market into which US issuers sought to sell their bonds. The basic tax picture was rather attractive. The US issuer received current annual interest expense deductions, while under Japanese law the Japanese holder paid no tax on the foreign bond interest until the interest income was actually received (for example, at the end of the bond period). US income tax also was not imposed on the holder, presumably because the bonds in question qualified for the portfolio interest exemption. (In any event there would be no US withholding tax on the OID until the US issuer made payments to the holder). Thus, the parties benefited by pairing current US deductions with deferred income recognition in Japan. Had the borrowing been entirely domestic, with either the US issuer selling to US purchasers or Japanese investors buying from Japanese issuers, this timing benefit might not have been available.

19.2.3 Hybrid Financing Instrument

A hybrid financing instrument is a finance instrument which is considered debt in one country, where the payment on the instrument is tax deductible, while in another country, the same instrument is treated as equity and the proceeds often constitute a tax-exempt dividend.

In the Internal Revenue Code (IRC), the distinction between debt and equity is a gray area, where the lawmakers have never been able to provide clear-cut set of rules or guidance. Therefore, taxpayers often find opportunities for tax arbitrage. The motivation of a taxpayer to categorize or label an instrument as debt or equity varies and often depends on the tax advantages aimed. Debt is more tax efficient than equity as it results in a single layer of tax whereas dividends—profits distributed by a corporation–are subject to two levels of tax.

Further, taxpayers may also structure cross-border transactions using a hybrid finance instrument (i.e., CPEC or Convertible Preferred Equity Certificates), which is treated as equity for financial accounting and reporting purposes, in one country, while it is treated as debt for tax purposes in another tax jurisdiction.

Though the courts have provided some factors to distinguish a debt from an equity instrument, savvy taxpayers still use several financial products which deliberately include the features of both and rendering the determination quite impossible.[5] The ability to use hybrid instruments to engage in foreign tax credit planning was significantly curtailed with

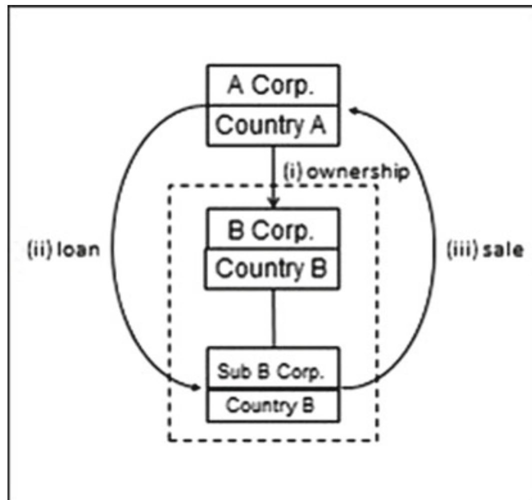

Fig. 19.1 Hybrid financing instrument

the enactment of IRC Section 909.[6] Prior to enactment of Section 909, hybrid instruments treated as debt for foreign tax purposes and as equity for US tax purposes were used to help facilitate certain "foreign tax credit splitter" transactions where creditable foreign taxes were separated from the underlying foreign earnings and profits (E&P) (Fig. 19.1).

19.2.4 *Feline PRIDES*

Feline PRIDES are two instruments packaged together into a single investment unit sold by an issuer to raise capital. For federal tax purposes, the issuer seeks to effectively issue stock (without doing so currently) while generating current interest deductions. In Revenue Ruling 2003–97, the Internal Revenue Service (IRS) ruled that interest accruing on a feline PRIDES-like instrument was deductible for tax purposes. The instrument consists of a three-year forward contract to purchase the issuer's common stock and a five-year note paying interest. The forward contract obligates the holder to purchase, and the issuer to sell, an amount of the issuer's common stock in three years. The amount of common stock to be purchased is determined by reference to the market price of the stock on the settlement date three years in the future. The note obligates the issuer to pay a sum certain in five years. The five-year note serves as collateral for the holder's obligation under the forward contract. The issuer of the single purchase-contract/note unit allocates the aggregate amount paid between the forward and the note as if the

instruments were in fact separately issued. The amount allocated to the note is the stated principal amount of the note.

19.2.5 Repurchase Agreements (REPO)

A repurchase agreement is an agreement involving the sale of securities by one party to another with a promise to repurchase the securities at a specified price and on a specified date in the future. Whether a transaction is termed as a repo or reverse repo depends on which party initiated the transaction. Many commercial banks use their idle funds to enter into repo transactions. The basic structure often involves a company in country A ("A Co") typically seeking financing from a company in country B (B Co). A Co establishes a special purpose vehicle (SPV), contributes equity in exchange for (preferred) shares in SPV and enters into a repo over the preferred shares with B Co. According to the repo, A Co sells the SPV preferred shares to B Co and receives cash in exchange, and at the same time the parties agree that A Co will purchase back the shares at a later point in time at an agreed price. Between sale and repurchase, SPV earns income (e.g. receives interest on bonds) that is taxable in country A, and pays corporate income tax to country A. SPV further pays out dividends to B Co, typically at a fixed rate. Under the repo agreement used in the arrangement, B Co is entitled to keep the dividends, which economically serve as B Co's remuneration in the transaction.[7]

Tax Analysis:

- For country B tax purposes, the repo is treated as a sale and a repurchase. B Co is thus treated as the owner of the SPV shares and the recipient of the dividends during the time of the repo. Country B has an indirect foreign tax credit regime that allows B Co to claim a foreign tax credit for the corporate income tax paid by SPV in country A.
- On the other hand, for country A tax purposes, the transaction is treated as a loan by B Co to A Co that is secured through the SPV shares. A Co is thus regarded as still being the owner of the SPV shares and as recipient of the dividends during the time of the repo. Country A applies an exemption for dividends received by B Co, or an indirect foreign tax credit regime that allows A Co to claim a tax credit for the corporate income tax paid by SPV, in any case a method that allows A Co to receive the dividends effectively tax-free. A Co further claims a deduction for the interest expenses

on the deemed loan received from B Co, equal to the dividend payments.
- The effect of this scheme is a net deduction in country A, coupled with
- taxation in country B, but offset by an indirect foreign tax credit for the taxes the SPV paid on the distributed profits.

19.2.6 Lease-Back Transaction

In its simplest form, a sale-leaseback is a transaction in which the owner of property sells the property and simultaneously leases it back from the purchaser. The purposes of a sale-leaseback are typically related to financing, accounting and/or tax. The transaction provides several benefits for both the seller and the buyer from financial, accounting, and tax viewpoints:

- an increase in financing cash flow while retaining the use of the property;
- increase in current ratio on the company's balance sheet;
- deductibility of the rental payments or expenses;
- deductible loss or offsetting gain on the sale of the property, if any.

However, careful planning of the transaction is crucial as the IRS can strip all the aforementioned benefits. That is, if not properly structured, the IRS may attempt to disallow deductions for such things as depreciation, rental payments, interest and investment tax credit by the parties to a putative sale-leaseback arrangement, on the grounds that the arrangement actually constituted a financing device or exchange of like-kind property. Judicial interpretation of tax laws and accounting rules may impact how the sale-leaseback transaction affects a company's financial statements.

Whether a sale-leaseback is mere paper shuffling, a sham not entitled to tax recognition, or a genuine transaction so that the buyer-lessor may deduct depreciation and take tax credits, depends on the circumstances. In the Frank Lyon Co case,[8] the Supreme Court upheld, against the Commissioner's challenge, that tax deductions were taken by the paper owner in a sale-leaseback transaction. The relevant facts of that case can be summarized as follows:

- A bank wanted to build a new building, but could not proceed as it wished because of regulatory limitations. After obtaining a commitment from a third party to loan 95 % of the expected costs of the building, the bank arranged with one of its board members, Mr. Lyon, for him to be the owner.

- Mr. Lyon paid 5 % of the purchase price with his own money, and borrowed 95% from the third party lender the bank had located. The bank constructed the building, sold it to Mr. Lyon's company, and leased it back. Mr. Lyon's company was to have no maintenance or other ordinary landlord duties.
- The bank's lease payment to Mr. Lyon's company was equal to his mortgage payment to the third party lender. The bank retained an option to buy the building from Mr. Lyon's company for what he had in it, that is, the balance on his mortgage to the third party lender, his 5 % down, plus 6 % interest compounded on his 5 % down. With such an option, the bank was positioned to take advantage of any appreciation in the value of the building, so Mr. Lyon could not expect to profit from his ownership beyond the agreed upon interest.
- The Commissioner took the position that the sale and leaseback was a sham, a financing device dressed up as ownership, so Mr. Lyon's company was not the owner for tax purposes and was not entitled to the depreciation deductions and other tax benefits of ownership.
- The Supreme Court held for the taxpayer, Mr. Lyon's company, finding that (i) the investor, and not the bank, was personally liable on the loan to the third party lender, (ii) the investor's personal liability was significant because he had a "real and substantial risk" such that, "should anything go awry" in the plan to have the bank's rent always cover the obligation on the note, the investor's capital and assets were exposed.

In some instances, the courts have held that a sale-leaseback transaction is a financing device rather than a sale or a lease, especially if the tenant retains sufficient characteristics of ownership over the property. Moreover, the IRS will review a sale-leaseback transaction to ensure that there is a legitimate business purpose for the transaction other than tax consequences.

This was the case in *Casebeer v. Commissioner*,[9] where a computer leasing company sold computers to investors and leased them back. The computers were already leased out to end users. The investors gave recourse and nonrecourse notes to the computer leasing company, and assumed nonrecourse debt owed by the company to the banks which financed the original purchase. The investors were to pay the leasing company on the nonrecourse notes the same amount which the leasing company was supposed to pay the investors to rent the computers from them. The Ninth Circuit affirmed the Tax Court's determination that these sale-leasebacks were shams. After careful examination of the record the Circuit found

that the selling and leasing back the computers, the investors had nothing at risk and nothing to gain except tax benefits. The computer company retained all the benefits and risks of ownership.

19.2.7 Entity Classification

Though with a relatively short history, the check-the-box regime represents a fascinating example of the significant influence of politics on the US tax system. The regime was introduced in 1997. It allows taxpayers to elect the classification of an eligible entity as either a corporation or a pass-through entity. The regime was intended to relieve both taxpayers and the IRS from the need to expend considerable resources in determining the proper classification of … entities, when classification was effectively elective for well-advised taxpayers.

One year after the introduction of the regime, the Treasury and the IRS recognized that the flexibility allowed by the regime was excessive, creating significant tax avoidance opportunities to circumvent the controlled foreign companies (CFC) regime by using hybrid entities. In essence, the CFC regime is effectively "gutted" by the check-the-box regime. By simply "checking the box" for all the subsidiaries (including ASI and Apple Operations International (AOI) those companies are deemed to have disappeared and become part of AOI for US tax purposes.[10]

Proponents of the check-the-box regime have put forward two basic arguments. First, the regime helps to reduce the foreign income tax of a US multinational enterprise (MNE) and thus eventually will increase the profits repatriated to the USA. Secondly, many MNEs operate on a regional basis—a typical example is the European Union (EU). The proponents argue that the check-the-box regime allows MNEs to "operate from a tax perspective in a manner that reflects these business realities." However, both arguments are problematic. With respect to the first argument, avoiding foreign income tax implies a lower effective foreign tax rate, which in turn encourages MNEs further to shift profits overseas.

Furthermore, empirical evidence shows that most US MNEs keep their foreign profits permanently overseas. The second argument does not sit comfortably with the MNEs' insistence that international tax rules should respect the legal contracts between group members, even though the "economic reality" is that the group as a whole operates as one single enterprise. In any case, a tax rule that facilitates tax avoidance is not a good rule. Matching tax law with business reality is no excuse for double non-taxation.

Nevertheless, the proponents of the check-the-box regime not only successfully blocked the introduction of the specific anti-avoidance measures to deal with the hybrid entity issue in 1998, but even managed to convince Congress to enact the "CFC look-through rule" in 2006. This rule specifically excludes from the CFC regime certain payments of passive income between two CFCs. In other words, the look-through rule effectively enacted the effect of the check-the-box regime—which was introduced through Treasury regulations that can be revoked or revised at any time—with respect to passive income.[11]

Compared with a fundamental reform of the international tax regime that requires international consensus, it is a relatively task to fine-tune US tax law to deal with Apple's double non-taxation issue. The key pressure areas are apparent and the solutions obvious, as listed below:[12]

1. Check-the-box regime: this regime, together with the statutory look through rule in the CFC regime, is a structural flaw in the US tax system. It effectively disables to a large extent the CFC regime and facilitates tax avoidance structures using hybrid entities. Many commentators have proposed an outright repeal of the regime. The US Senate Committee that conducted the Apple hearing recommended reforming the regime so that it does not "undermine the intent" of the CFC regime.
2. CFC regime: even without the check-the-box regime, the CFC regime contains problematic provisions that facilitate the creation of double non-taxation. Exceptions within the regime—such as the manufacturing exception—should be tightened to enable the CFC regime to effectively prevent profit shifting to low tax countries.
3. Transfer pricing rules with respect to intangibles: it appears that the US has recently strengthened the transfer pricing rules for cost sharing arrangements, although it remains to be determined whether this will be effective in preventing similar abuse, as in Apple's case, in the future.

19.2.8 Dual Resident Company

A dual resident company is an entity that is considered to be a resident of two tax jurisdictions. Dual resident corporations are prevented from using a single economic loss once to offset income that was subject to US tax, but not foreign tax, and a second time to offset income subject to foreign tax, but not US tax. In 1988, the application of the legislation was extended

to cover “separate units” of US resident corporations (“domestic corporations”), in view of situations where, for example, a domestic corporation’s foreign branch or permanent establishment was allowed, under foreign law, to consolidate with the corporation’s foreign affiliate. In general, a dual consolidated loss is the net operating loss of a dual resident corporation, or the net loss attributable to a “separate unit” of a domestic corporation. A dual resident corporation is generally defined as a domestic corporation subject to the income tax of a foreign country on its worldwide income or on a residence basis. A separate unit is generally defined as a foreign branch (including permanent establishments) or an interest in an entity that is not taxable as a corporation for US tax purposes but is subject to an income tax of a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis. Subject to certain exceptions, the “domestic use” of a dual consolidated loss is not permitted. A domestic use occurs when a dual consolidated loss is made available to offset, directly or indirectly, the income of a “domestic affiliate,” which includes a member of a consolidated group. The primary exception to the domestic use limitation is where the taxpayer makes a “domestic use election.” This election generally permits the domestic use of a dual consolidated loss if the taxpayer agrees, for a five-year certification period, not to use any portion of the dual consolidated loss to offset the income of a foreign corporation, or income attributable to certain interests in hybrid entities (a “foreign use”).[13]

19.2.9 Double Dipping

Alternative techniques for reducing source and residence taxation that have been used in recent times seek to double up on favorable tax rules in both source and residence countries (generally referred to as double-dipping). A variety of methods are used. One method is to exploit differences in the tax law treatments of the same transaction in the source and residence countries. A common example has been the financial lease of equipment. Some countries recharacterize finance leases for tax purposes as purchases and loans, while other countries treat them in the same way as operating leases (i.e., the lessee is treated as paying rent and the lessor as being the owner of the equipment). The result is that two countries can end up treating two separate taxpayers (one country the lessor and the other country

the lessee) as the owner of equipment and entitled to depreciation and interest deductions. Given that rent in economic terms is equivalent to depreciation and interest, the difference in treatment should not produce a substantial tax variance, but many countries have tax incentives for investment in capital equipment in the form of accelerated depreciation, investment credits, or allowances. Where two different taxpayers are treated as the owner of the equipment in different countries and each is entitled to these incentives in one of the countries, the taxpayers effectively double up on the incentives in a way not intended by either country.

It is not clear, however, which country is being disadvantaged in tax terms and which might therefore be expected to take remedial action. One of the affected countries could enact a rule that investment incentives will not be available under its law when similar incentives are being obtained in respect of the equipment under the law of another country, but the rule will lead to circularity if both countries adopt it. Alternatively, a country may limit investment incentives to equipment used in the country, which will work in most cases, although not for mobile equipment like airplanes. Another solution is for each country to do away with or reduce the investment incentives, as in fact happened in many industrial countries during the 1980s (for more general policy reasons having little to do with the problems of international tax avoidance). Where a developing or transition country adopts this kind of investment incentive, a rule limiting the benefit of the incentive to equipment used in the country is probably the easiest way to ensure that it does not suffer unduly from double-dipping of this form.

Another form of double-dipping that has been much exploited involves dual-residence companies. Some countries permit grouping of the income and losses of commonly owned resident companies (often achieved by permitting the transfer of tax losses to related companies). If the same company is resident in two such countries and has borrowed to finance group operations (whether in those countries or elsewhere), it may be able to deduct the interest in each country. If it has little or no current income, a loss will arise from the interest deductions that may be able to offset the income of two related companies, one in each country where the loss company is resident. Again, it is not clear which country is the loser from this transaction. Nevertheless, a number of countries have enacted rules that prevent the losses of dual-residence companies arising from financing transactions being used to offset the income of any other related company

in the country; that is, the losses can be used only to offset future income of the dual residence company If a developing or transition country does not permit the transfer of losses within a group of companies, it is unlikely to suffer from this particular double-dipping problem. It follows that care should be exercised in permitting transfer or consolidation of losses for tax purposes among commonly owned resident companies.

The deduction of the same expense in two countries is not of itself a cause for concern. Where a resident of a foreign tax credit country has a branch in another country, it will typically get deductions for the same expenses in the source and residence countries. These deductions will generally be offset, however, against the same income that each country is taxing, with the residence country giving double tax relief. The double-dipping problem usually involves the offsetting of the same deductions against different income of different taxpayers. As there are probably as many ways for taxpayers to exploit differences in tax systems of different countries as there are differences, and as the outcome is often ambiguous in terms of whether tax avoidance is involved and which country is suffering an unfair reduction in tax, it is likely that double-dipping will continue to be a difficult international tax problem without a clear solution.

19.3 The OECD Approach to Tax Arbitrage

Individual country approach to combating tax arbitrage has shown little effects. Therefore, the Organisation for Economic Co-operation and Development (OECD) was asked by the G-20 countries to provide some leadership on the issue. The OECD published its conclusions in 2014. Action 2 focuses on the neutralization of hybrid mismatch arrangements. A hybrid mismatch arrangement is an arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement.[14] Hybrid mismatch arrangements have been divided into two distinct categories based on their underlying mechanics: (i) the use of hybrid entities, where the same entity is treated differently under the laws of two or more jurisdictions; and (ii) the use of hybrid instruments, where there is a conflict in the treatment of the same instrument under the laws of two or more jurisdictions.[15] The category of hybrid instruments is a subdivided into hybrid transfers, and hybrid financial instruments.

Notes

1. OECD (2012): Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, p. 5.
2. OECD (2012): Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, p. 7.
3. Ibid.
4. Antony Ting (2014) iTax – Apple's International Tax Structure and the Double Non-Tax Issue, British Tax review, No.1, p. 46.
5. Meredith R. Conway (2011): Stealth Inequity: Using Corporate Integration to Ease Unfairness in the Tax Code, William & Mary Policy Review, Vol. 2:1, pp. 27–8.
6. Pub. L. No. 111-226, sec. 211.
7. Ibid.
8. *Frank Lyon Co. v. United States, 435 US 561 (1978).*
9. *Casebeer v. Commissioner, 909 F.2d 1360 [66 AFTR 2d 90-5361]* (9th Cir. 1990).
10. Antony Ting (2014) iTax – Apple's International Tax Structure and the Double Non-Tax Issue, British Tax review, No.1, p. 52.
11. Ibid., p. 53.
12. Ibid., p. 58.
13. OECD (2012): Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, p. 16.
14. OECD/G20 Base Erosion and Profit Shifting Project Neutralizing the Effects of Hybrid Mismatch Arrangements ACTION 2: 2014 Deliverable, p. 29.
15. OECD/G20 Base Erosion and Profit Shifting Project Neutralizing the Effects of Hybrid Mismatch Arrangements ACTION 2: 2014 Deliverable, p. 30.

CHAPTER 20

Base Erosion and Profit Shifting

20.1 Introduction

The erosion of the corporate tax base caused by the shifting of profits into tax havens is not only a US tax problem or limited to US multinational corporations (MNCs) as 74 % of the Fortune Global 500 companies are non-US-headquartered companies. While BEPS opportunities impair the ability of many countries to achieve their tax policy goals, effectively undermining their sovereignty,[1] a recent Congressional Research Service study in the USA reported that BEPS activities are estimated to reduce US corporate tax revenue by $10–60 billion annually.[2]

In July 2013, and on September 16, 2014, the Organisation for Economic Co-operation and Development (OECD), released action plans to better assist governments in their efforts to combat base erosion and profit shifting (BEPS) within the international tax system. The US Treasury Department and Internal Revenue Service (IRS) have actively joined the ongoing OECD effort to develop better international principles for taxing multinational corporations, including by requiring MNCs to disclose their business operations and tax payments on a country-by-country basis, stop improper transfers of profits to tax havens, and stop avoiding taxation in the countries in which they have a substantial business presence.[3]

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F.I. Lessambo, *International Aspects of the US Taxation System*,
DOI 10.1057/978-1-349-94935-9_20

20.2 The Overall Schemes

US corporations are creating opportunities to erode their taxable basis through aggressive transfer pricing gimmicks, allocation of debts among affiliated entities, abusive anti-deferral techniques, improper allocation of income, transactions deprived of any business purposes, and other improper income shifting. US MNEs engage in both "real income shifting"[4] and "artificial income shifting,"[5] by choosing the country in which to locate manufacturing facilities, research and development activities, service centers, or the country in which to incur debt payable to unrelated parties. Further, they engage in artificial income shifting through intercompany transfer pricing for sales of goods, intercompany charges for services provided, intercompany royalties for the use of intellectual property, intercompany rentals for the use of tangible property, and/or interest charged on intercompany debt.[6]

20.2.1 The Caterpillar Swiss Tax Strategy

The Caterpillar case study shows that offshore profit shifting is not reserved for high tech companies transferring intellectual property to tax havens, but is also the province of traditional manufacturers using financially engineered transactions to transfer billions of dollars of profits offshore to a tax haven affiliate.[7] The Caterpillar case study focuses on how this US industrial manufacturer used tax planning techniques to direct billions of dollars in profits to a related affiliate in a tax haven.[8]

After executing its Swiss tax strategy, over a 13-year period beginning in 2000, Caterpillar allocated more than $8 billion in non-US parts profits to its Swiss affiliate, CSARL, and has deferred paying $2.4 billion in US taxes on those profits. Caterpillar was also engaged in a tax motivated "virtual inventory system," created contradictory valuation methods for intangibles, and other profit shifting schemes to avoid paying its fair share of corporate income tax in the United States.[9] In 2013, Caterpillar's revenues were about $55.7 billion, and from 2012 to 2013 exceeded $120 billion. As of the end of 2013, Caterpillar had total assets of $85 billion, of which $17 billion, or 20 %, were indefinitely reinvested earnings held offshore.[10]

Caterpillar US were engaged in several restructuring programs from the late 1980s to the 2000s. The US parent company was reorganized as Caterpillar Inc. in the State of Delaware and has currently 30 business

segments organized into seven types. From 2008 through 2012, Caterpillar exported more than $82 billion in products from the United States. In 2011, exports from the USA made up $19.4 billion or about one-third of its $60 billion in consolidated sales. While most sales now occur outside the United States, most of Caterpillar's machines and parts are still built in the United States. In 2012, about 70 % of finished Caterpillar replacement parts sold offshore were manufactured in the United States.[11]

Although its major operations have always been in the United States, Caterpillar has also had a small continuous presence in Geneva, Switzerland, for four decades through COSA (Caterpillar Overseas), which was one of the Caterpillar several offshore marketing companies.

In 1999, Caterpillar's external auditor (PwC) and tax consultant approached the management of Caterpillar and offered to assist the company reduce its overall tax exposure. As part of the PwC "skilled tax strategies," COSA was liquidated to give birth to CSARL (Caterpillar SARL). PwC designed a Swiss tax strategy to direct the lion's share of Caterpillar's non-US purchased finished replacement parts (PFRP) profits away from the United States to Switzerland, where Caterpillar had negotiated an effective tax rate of 4 %–6 % lower even than the Swiss federal statutory rate of 8.5 %.[12]

PwC proposed deferring or avoiding that tax by "removing Caterpillar Inc. from the chain of title passage for purchased finished parts (from US or foreign sources) sold to foreign marketers," and replacing the US parent with a new Swiss entity as the direct purchaser of the third party manufactured replacement parts.[13]

Prior to the creation of CSARL in 1999, Caterpillar Inc., the US parent corporation, bought the PFRPs needed for Caterpillar machines directly from the third-party suppliers that manufactured the parts for the company.[14] Moreover, Caterpillar was the initial buyer of its third-party manufactured replacement parts, and if the replacement parts were to be sold in Europe, Africa, or the Middle

East (EAME region), Caterpillar typically sold the parts to its affiliated marketing company, Caterpillar Overseas S.A. (COSA), which was incorporated in Switzerland. COSA, in turn, sold the parts to Caterpillar's independent foreign dealers in the EAME region. Caterpillar's standard practice was to compensate the internal Business Divisions involved with the sales of its non-US parts. Its practice was to assign a routine profit to the divisions that performed routine business services and the residual profits—sometimes called "entrepreneurial" profits—to the divisions that contributed directly to the creation of those residual profits.

As part of the devised tax strategy, CSARL was formed and assigned the role of “global purchaser” of caterpillar’s finished parts in various licensing agreements. According to PwC, that designation resulted in two key changes: (i) Caterpillar Inc., the US parent corporation, was removed from the non-US parts supply chain, and replaced with CSARL, which became the nominal “global purchaser” of PFRP parts,[15] and (ii) that CSARL entered into “tolling agreements” with Caterpillar’s two main European manufacturing operations in France and Belgium.[16]

CSARL as a nominal global purchaser, entered into several licencing and servicing agreement with related entities and paid minimal royalties to Caterpillar US, the parent company. Further, the “tax strategy” included the construction of a virtual parts inventory, and invoices alteration. All these tax gimmicks were poorly conceived and executed without considering the basic tax concepts such as business purposes, and economic substance doctrines, the assignment of income, the arm’s length principle, the clear ownership of inventories, the definition of intangibles.

The data showed that the parts profits reported by CSARL over that eight-year period totaled about $8 billion, while the royalty payments paid by CSARL to Caterpillar totaled about $1 billion. The data further showed that CSARL retained 84 %–91 % of the parts profits each year, leading to an overall eight-year average of 86 %. This data confirmed that, overall, Caterpillar obtained 15 % or less of the non-US parts profits, while CSARL obtained 85 % or more.[17] As of the end of 2013, Caterpillar’s offshore cash assets totaled $17 billion, giving the company the 33rd largest offshore amount of 1,000 corporations reviewed by the US Senate Committee.[18]

The US Senate Subcommittee’s investigation looked at Caterpillar’s offshore tax strategy and its relation to the company’s non-US parts business, the profit sharing between the US and CSARL, as well as the role played by PwC as both external auditor and tax consultant.

- Lack of Economic Substance

The economic substance doctrine was a well-established part of tax law long before it was codified as IRC Section 7701(o) in 2010. As developed by the courts, in order for a transaction to be respected for tax purposes, it must satisfy either or both prongs of the economic substance test, which are (a) the subjective prong, i.e., that the taxpayer or its agents believe that the transaction has a valid non-tax business purpose, and (b) the objective prong, i.e., that the transaction has a reasonable possibility of generating a profit regardless of the tax consequences.[19]

Caterpillar US developed its argument in two ways: (i) its outside tax expert asserted the existence of economic substance, (ii) assuming that the Subcommittee found it hard to recognize any economic substance, its in-house tax experts sustained that the key analysis was not whether the CSARL transaction lacked economic substance, but whether the licensing transactions were executed in conformance with US transfer pricing laws and regulations, under the arm's length standard. They asserted that the company complied with all US transfer pricing requirements.

New York University School of Law Professor John Steines, who was hired by Caterpillar to analyze the economic substance issue and who concluded the CSARL transaction, did not offend that doctrine:

> Legislative history of the codification of the economic substance doctrine makes clear that the decision to remove Caterpillar from the outbound PFRP supply chain did not violate the economic substance doctrine. And case law interpreting the substance-over- form and economic substance doctrines reveals that they are primarily reserved for highly engineered transactions, frequently unrelated to the taxpayer's core business and involving tax-indifferent parties with no stake in the outcome other than a fixed return, that Congress would not have countenanced as consistent with the purpose of the statutes it enacted—in other words, transactions that most impartial tax professionals would concede are tax shelters.
>
> Caterpillar's restructuring is of an entirely different realm—a sensible business decision to remove a redundant middleman between supplier and customer, fully within the text and spirit of subpart F, notwithstanding that it deferred some US tax. The inventory accommodation and flash title features of Caterpillar's inventory control system are pragmatic business solutions to normal business problems and do not approach what would raise a problem under the case law digested above.
>
> In my professional judgment, it is extremely unlikely that a court adjudicating with fidelity to the law presented in this report would find that the restructuring or the countless ensuing outbound PFRP transactions offend the doctrines of substance over form or economic substance.[20]

The US Subcommittee received, on the other side, the expert opinion from another tax professor from Michigan Law School, Reuven Avi-Yonah, whose conclusion departed from his NYU Colleague. Professor Reuven Avi-Yonah concluded:

> in my opinion the IRS would have had a good case to challenge Caterpillar's original restructuring on economic substance grounds.[21]

It should be noted that Caterpillar US's outside expert's report did not view CSARL's six Swiss partners, each assigned a separate profit stream that included a stream for worked parts, PFRPs, and various machines; its licensing agreements with 37 Caterpillar affiliates; its service agreement with Caterpillar to run the non-US parts business; or its use of flash titling or a virtual inventory system, as an example of a "highly engineered transaction." Instead, the report viewed it as reflecting a "sensible business decision to remove a redundant middleman between supplier and customer … notwithstanding that it deferred some US tax." The report failed to explain, however, why the decision to remove Caterpillar Inc. from the supply chain made business sense from a non-tax perspective, in particular since Caterpillar Inc., the "redundant middleman," continued to play the central role in the company's physical supply chain and parts business, from designing parts and forecasting parts demand, to overseeing the company's third party parts suppliers, to tracking, storing, and delivering the parts, to providing the leadership needed to run such a complex, far-flung business—all functions that CSARL did not have the personnel, infrastructure, or expertise to perform.

- Transfer pricing out the arm's length principle

For a transfer between related parties of valuable assets, such as licensing rights, to be valid under the tax code, the transfer must meet an arm's-length standard, including compensating the transferring party as though the transfer were a sale to an unrelated third party.

Caterpillar US explained its transfer pricing policies and practice as follows:

The fact that a company may have structured its transaction flows one way for some period of time does not prevent the company from structuring its transactions flows in a different way later. Of course there must be compensation for any property transferred and services performed in connection with a restructuring, as there was in Caterpillar's case, but changing a supply chain structure is not, in and of itself, a taxable event.[22]

The data showed that subsequent to the tax scheme with the CSARL transaction, Caterpillar gave a significant portion of the profits from its non-US finished replacement parts business to CSARL in exchange for a licensing fee. While Caterpillar contended that the aggregated royalty rate was the more appropriate rate to consider, since that rate contained in the final license agreement which covered both parts and machines, it is notable that the Swiss tax strategy that led to the licensing agreement

targeted only the company's non-US parts profits, without mentioning machines. In any event, both profit splits have resulted in lopsided profits allocations in favor of CSARL over Caterpillar. Additional facts also supported the non-arm's length character of transaction these several licensing and servicing agreements:

(i) Caterpillar continued to perform key functions supporting the non-US sales of Caterpillar branded parts, including much of the parts design, parts forecasting, inventory management, parts ordering, supplier oversight, quality control, parts pricing, and parts storage and delivery. It did so for cost plus a 5 % mark-up, which produced only limited income for the US parent.[23]

(ii) It defies logic that Caterpillar would have entered into a licensing transaction with an unrelated party in which it gave away 69 %, 85 %, or more of its business profits on an annual basis in exchange for a 31 %, 15 %, or smaller share of the profits, while continuing to perform core functions to support those profits and continuing to bear the ultimate economic risk. Caterpillar only engaged in the CSARL transaction, because the profits sent to Switzerland went to CSARL, a related party, and enjoyed a low Swiss tax rate of 4 %. In addition, CSARL's profits were included in Caterpillar's consolidated financial statements, so that CSARL's financial success contributed directly to Caterpillar's positive results.

(iii) CSARL paid nothing to Caterpillar Inc. to compensate the company for the decades Caterpillar spent developing its parts business before turning it over to CSARL, including developing a third party supplier base, designing a large selection of proprietary parts, and creating a world class logistics system to store and deliver those parts anywhere in the world within 24 hours. Nor did CSARL compensate Caterpillar Inc. for the right to the future profit streams associated with the non-US parts business—billions of dollars in parts "annuities" that would last as long as Caterpillar's durable machines. In fact, CSARL made no "buy-in" or other payment or provided any super royalty to compensate Caterpillar Inc. for the business it had built or for the future profits that would be generated. Instead, CSARL paid Caterpillar Inc. only an annual royalty equal to 15 % or less of the profits produced by the non-US parts business each year plus a service fee for performing key parts functions on a cost plus 5% basis. It is hard to understand how Caterpillar would ever have entered into such an arrangement with an unrelated party.

- Violation of the Assignment of Income Doctrine

The Assignment of Income Doctrine is a judicial doctrine that prohibits an inequitable distribution of profits. Under *Lucas v. Earl*, a taxpayer cannot separate the "fruit," or income, from the "tree on which it grew." Yet in this transaction, Caterpillar acted to separate the "fruit," the sale of its high-profit-margin parts, from the "tree," the sales of its low-profit-margin machines on which the parts profits depend, and did so without seeking any compensation for producing the machines on which future parts rely to have value. As a result of the tax strategy, the profits for Caterpillar's parts business were split off from the profits of the machine business, without CSARL's offering any compensation for Caterpillar's development of the underlying business.[24] By executing the CSARL transaction, the company transferred its parts annuity to a foreign affiliate without receiving any compensation for the forfeited income stream or for the development and of the underlying business, thus separating the parts fruit from the machine tree. The Assignment of Income Doctrine may require those parts profits to be reassigned to Caterpillar Inc., which continues to design, manufacture, and sell the original machines.

- Reckless disregard to the accounting and tax rules as to inventories

The virtual inventory system, which splits ownership of groups of parts between Caterpillar Inc. and CSARL without assigning ownership of any particular part to either company, uses a retroactive after-the-sale method of assigning parts ownership. This inventory system could be viewed as establishing CSARL partnership activity on US soil which would trigger US taxation of its US parts profits. In addition, on paper, CSARL routinely acquires replacement parts from third party suppliers for instantaneous pass-through resale to Caterpillar Inc. in the United States.[25] Caterpillar disputed the characterization asserting that:

> CSARL sells 40 to 50 % of its total PFRP purchases immediately to Caterpillar Inc. using what is referred to as a "flash title." A flash title simply means that CSARL makes the initial purchase of the part and automatically and instantaneously transfers the ownership title to Caterpillar Inc. CSARL's purchases the flash-titled parts using Caterpillar's internal forecasts of the quantities of parts that will be sold to US customers. When CSARL flash-titles parts to Caterpillar Inc., it does so at cost and without charging any fee, which suggests the sales are little more than paper transactions between related parties, as opposed to arm's-length transactions.

The Subcommittee found inter alia:

(i) Under the US tax code, while foreign entities like CSARL are allowed to hold goods awaiting export in US warehouses without creating a taxable presence in the United States, if those goods are commingled, co-owned, or co-managed as a joint enterprise, they may create a taxable US presence for the foreign company.
(ii) When a common pool of inventory is jointly managed for the mutual benefit of two entities, the courts have long held that a de facto US partnership may exist. The inventory profits of each partner, including those attributed to CSARL, would then become subject to US taxation

- Unsustainable intangible existence, and valuations

PwC's claim that COSA had previously unrecognized, valuable marketing intangibles is contradicted by other documents showing that Caterpillar was well aware of and had long acknowledged the valuable work of its marketing companies. For example, three years earlier, in 1996, PwC had cited the role of Caterpillar's marketing companies in helping to distribute its prime products and parts to the Caterpillar network of dealers. Its 1996 transfer pricing documentation, which is required to be maintained by law to defend transfer pricing positions, stated:

> Parts distribution is one of Caterpillar's most important competitive advantages in the marketplace. Caterpillar's guarantee to deliver parts anywhere in the world on very short notice enables it to sell more machines, since customers know that they will not be idled by long missing parts. The parts distribution function at Caterpillar is very closely associated with the marketing functions because of its strategic importance in sales and aftermarket services.[26]

Still another set of documents that contradict the claims about the value of the marketing intangibles held by CSARL date from 2001, when CSARL acquired a related US marketing company responsible for Caterpillar's marketing efforts in Latin America, the Caribbean, and Canada, and treated its intangible assets as having little economic value.[27]

Both Caterpillar US and PwC characterized the "strategy" as a mere alignment of the company's tax structure with sales practices.[28]

It is worth noting that prior to 1999, Caterpillar reported 85 % or more of the profits from the sale of its replacement parts to non-US customers as taxable US income, while attributing 15 % or less of the profits to its Swiss affiliate and other marketing companies. At that time, even the portion of the profits attributed to its market companies was included on Caterpillar's US tax return as taxable income under Subpart F. The implementation of the tax strategy paid from PwC lead to the following:

> Over the next thirteen years, from 2000 to 2012, Caterpillar shifted US taxable income of more than $8 billion offshore to Switzerland and deferred or avoided paying US taxes totaling about $2.4 billion.[29]

Ironically, PwC was still providing external auditing services, tax consulting services and approved its own tax shelter strategy as compliant with the US tax laws and regulations in effect. From 1998 to 2004, Caterpillar paid PwC over $80 million in tax consulting fees, including over $55 million related to the development and implementation of the Swiss tax strategy involving CSARL. From 2000 to 2012, Caterpillar also paid PwC another $200 million in auditing fees.[30]

The Subcommittee finding are much clear and showed that Caterpillar Swiss tax strategy has so far enabled Caterpillar to defer paying US taxes totaling $2.4 billion.

20.2.2 Deutsche Bank and Barclays: The Basket Option Contracts

Deutsche Bank, Barclays, and 12 hedge funds—mainly George Weiss and Renaissance Technologies (RenTec)— initiated, participated in and implemented fraudulent tax shelters using basket option contracts as a derivative. The two banks disguised their illegal trading activities under the guise of a derivative, and particularly an option. For all practical purposes, the COLT and MAPS accounts functioned like prime brokerage accounts actively traded by RenTec, rather than as proprietary accounts used by the banks to hedge the options. Both banks recognized this fact and in internal communications frequently characterized the option accounts as "prime brokerage" accounts.

Opening the COLT and MAPS accounts in the name of the banks and styling them as carrying out option agreements, rather than prime brokerage accounts intended to transact trading, were actions taken to achieve objectives related to lower taxes, increased leverage, and loss protection.[31]

In its initial approval documentation for the COLT basket option structure in 2002, Barclays described COLT as providing:

> an after tax benefit to these investors [RenTec] through the conversion of their return from the fund from short term capital gains (taxed at 39.6 %) to long term capital gains (taxed at 20 %). This would be achieved by substituting the Fund's direct execution of its trading strategy with the cash settled call option over a Barclays proprietary account whose performance substantially replicates the Fund's trading strategy.[32]

Likewise, Deutsche Bank described its MAPS structure, in internal document as:

The options reference the value of these PB [Prime Brokerage] accounts, which is equivalent to them referencing the assets directly, and therefore there is no leakage between the value of the assets … and the value of the options. Thus, the net effect is that Barclays is extending senior financing to RenTec.[33]

- Deutsche Bank developed and marketed a less costly structure it named Managed Account Product Structure (MAPS). The MAPS basket option product at Deutsche Bank evolved from a similar product called MAIDS, which was initially designed by National Westminster Bank (NatWest). In 2003, the hedged fund by the name George Weiss was approached by representatives of Deutsche Bank with a new basket option structure that Deutsche Bank had developed. Between 2003 and 2006, George Weiss purchased from Deutsche Bank a total of ten MAPS basket options with terms exceeding one year involving trading assets with an initial total notional value of about $2.8 billion. George Weiss purchased an additional six options in May 2010. Deutsche Bank sold the similar 29 basket options to RenTech (another hedge fund) with a total notional value of about $46 billion and profits totaling about $15.9 billion.

  Altogether, Deutsche Bank sold MAPS basket options to 13 different hedge funds. RenTec was the largest MAPS client, and George Weiss was the second largest. Deutsche Bank used the original MAPS structure from approximately 2000 to the end of 2007, writing over 100 options that were used to purchase trading assets with a notional value in excess of $75 billion. In 2008, Deutsche Bank restructured the MAPS option, and its hedge fund clients stopped purchasing new basket option contracts, except for RenTec.

- Barclays, on the other hand, provided similar basket options (COLT) solely to RenTech, from 2002 to 2012. Barclays developed the COLT basket option structure in 2002, at the request of RenTec, and it was used solely by that hedge fund over the next decade. The COLT structure was designed and administered by the bank's Structured Capital Markets (SCM) group until 2013, when Barclays disbanded that group for involvement with overly aggressive tax strategies.[34] By entering into the basket option arrangement, while RenTec placed its initial premium at risk, Barclays bore the catastrophic risk (also called the "gap risk") associated with the option accounts. According to Barclays and RenTec, that catastrophic risk applied to a situation in which market conditions deteriorated so rapidly that all of the premium paid by RenTec was lost and Barclays was unable to sell the remaining assets from the Palomino accounts quickly enough to cover losses in excess of the premium. Barclays included several features in the basket options structure to ensure that it faced little or no real risk, including provisions giving the bank the right to liquidate the account assets once the losses exhausted the premium amount. Moreover, in more than ten years of operation, in which the COLT options not only experienced millions of trades as detailed below but also operated throughout the worst financial crisis to affect the market in generations, no knockout event ever took place. In fact, the facts indicate that no losses took place in any year with respect to any COLT option.[35]

  Barclays also entered into tax indemnity agreements with RenTec as part of the COLT transactions. In the agreements, RenTec promised to reimburse Barclays for any tax exposure that Barclays might suffer as a result of entering into the COLT transaction, such as being required to pay penalties for failing to withhold taxes in its role as withholding agent for the option accounts. In other words, under the tax indemnification agreement, Barclays would not have to pay any tax penalties levied on it in connection with the COLT options.[36]

MAPS and the COLTs have similar features. Although the option accounts and assets were held in the name of the banks, as investment advisors to the trading accounts, RenTec and George Weiss had the exclusive right and discretion to determine what assets were purchased and sold from each account, subject to basic risk reduction guidelines specified in the investment advisory agreements.[37] In substance, the structures

functioned as prime brokerage accounts with non-recourse financing that enabled the hedge funds to far exceed federal leverage limits on margin accounts, conduct non-stop, direct trades using the banks' trade execution software, and reap the resulting profits from their own trading activity. In the case of RenTec, the basket option contracts were not even administered as distinct, independent legal contracts, but were instead woven into an integrated trading strategy across multiple banks, multiple legal entities, and multiple accounts. This integrated strategy conducted hundreds of thousands of trades each day, yet RenTec used the basket option structure to characterize the resulting profits from the option related trades as long-term gains, saving billions of dollars in taxes over more than a decade.[38] The key questions when analyzing the basket options are: (i) as structured, were these basket options "real derivative, or real options"? and (ii) was there any business purpose to the transactions?

20.2.2.1 Basket Options Are Not Derivatives

Options and other derivatives usually require the participants to make careful calculations about how specified financial assets will perform, but in the case of basket options the hedge funds and banks agreed to allow constant change in the option assets. The agreement to allow such extensive asset changes is evidence that the option accounts were intended to function as trading accounts rather than an option or other derivative.[39] A fundamental feature of a derivative is the presence of an underlying or referenced set of assets that can be identified, analyzed, and used to determine the derivative's price, performance, and ultimate resolution with respect to the participating parties. To evaluate and price a derivative, including an option, the participants typically analyze the referenced assets; if those assets are not fixed or easily identified, and are instead permitted to undergo constant and fundamental change, the required analysis cannot be performed. Products such as basket options that cannot, as a practical matter, produce an identifiable set of referenced assets do not function as true options or even as derivatives.[40]

In a true option account, the option holder does not actively trade the securities that determine the value of the options, nor does the option holder seek or use financing to make more trades. Instead, the option holder passively awaits the financial return on a trading account under the control of the option seller. The accounts set up in connection with the so-called basket option structures, however, were designed and intended from their inception to be under the control of the option holder and to produce

trading profits benefiting the option holder alone.[41] Here, RenTec served as both the controller and the beneficiary of the trading activity in the basket option accounts, and but for mischaracterizing this as option activity RenTec would not have been permitted under law to receive the added leverage it sought. While those accounts were purportedly established to provide a reference account for the basket option as well as a hedge for the banks, and all trading assets were held in the name of the banks, in reality, the accounts functioned in substance as prime brokerage trading accounts used by RenTec to carry out its trading strategy, while claiming lower taxes and higher leverage than it could otherwise justify.[42]

The basket option contracts between RenTec, Deutsche Bank, and Barclays did not set up an arrangement that would produce an identifiable set of referenced assets. The contracts stated that the determinant of what the banks would owe RenTec upon exercise of the option would be the performance of a designated option account. The account, which was to be managed and controlled by RenTec, was permitted to include a broad array of assets, whose selection was at the discretion of RenTec, subject only to some basic guidelines to reduce trading risk. RenTec then used the basket option accounts to implement a proprietary investment strategy that employed as many as 300,000 securities trades at two banks per day, constantly changing the mix of assets in the option accounts. RenTec personnel were continually monitoring and adjusting the factors used by the complex computer model that RenTec developed and employed to execute its strategy. The volume of trades that RenTec conducted in the account was so large and the length of time that the assets were held was generally so short that the entire composition of tens of thousands of assets in the option accounts changed several times a year. In essence, the banks allowed RenTec to write an option on RenTec's own daily trading activity, whatever RenTec might decide that trading activity would be. The contracts did not further identify the referenced assets.[43] Further, by ignoring the option formalities and treating the assets as part of a single, large investment pool, the hedge funds and banks showed the option format was a pretext for enabling the hedge funds to conduct a complex trading strategy while claiming the strategy produced lower taxes and higher leverage than would otherwise be available through a normal prime brokerage account.[44] The fact that RenTec was able to orchestrate the timing of the options to guarantee itself regular access to the gains from short-term trades underscores how completely it controlled the transactions. In addition, RenTec's ability to make routine cash withdrawals from

the basket option accounts to support its business operations is additional evidence that RenTec acted in the role of an owner of the underlying account assets, rather than as an option holder awaiting final resolution of an option under the control of another party.[45]

20.2.2.2 Basket Options Had No Business Purpose

Both Barclays and Deutsche Bank internal document attest that they knew that the economic driver of their basket options was tax avoidance.

> Barclays wrote: "This transaction is designed to provide hedge funds with a tax effective means of undertaking the business and for Barclays it would generate both a structuring fee and additional volume for its prime brokerage business."[46]

Like Barclays, Deutsche Bank senior executives understood that tax avoidance was a key motivator for MAPS basket options.[47]

20.2.3 Apple Tax Abusive Structure

Apple's organizational structure allows it to shift billions of US dollars overseas, mainly in Ireland through two wholly owned subsidiary located in Ireland: Apple Operations International (AOI) and Apple Sales International (ASI). Apple Operations International (AOI), created in 1980 has no employees or physical presence, and whose operations are managed and controlled out of the United States. Despite receiving $30 billion in earnings and profits during the period 2011 to 2015 as the key holding company for Apple's extensive offshore corporate structure, AOI has no declared tax residency anywhere in the world and, as a consequence, has not paid corporate income tax to any national government for the past five years.

On another hand, ASI has acquired certain economic rights to Apple's intellectual property. Apple Inc. has used those rights of ASI to shift billions in profits away from the United States to Ireland, where it pays an agreed upon corporate tax rate of 2 %.

Neither AOI or ASI have tax residency in any jurisdiction, despite receiving over a four year period from 2009 to 2012, sales income from Apple affiliates totaling $74 billion.[48]

Apple has $145 billion in cash, cash equivalents and marketable securities, of which $102 billion is "offshore." Apple has used offshore entities,

arrangements, and transactions to transfer its assets and profits offshore and minimize its corporate tax liabilities.[49]

In sum, Apple Inc. has used several tax "gimmicks" such as (i) tax arbitrage with dual non-resident subsidiaries, (ii) the entity classification rules, and circumvented the Subpart F regime. Its tax dodging includes also a peculiar cost sharing agreement with two wholly owned subsidiary participants.

20.2.3.1 The Dual Non-Residence Irish Subsidiaries

The two wholly owned subsidiaries AOI and ASI were incorporated in Ireland in 1980. AOI shares the same mailing address as several other Apple affiliates in Cork, Ireland, and has no physical presence, nor had any employee.[50] Like AOI, ASI is incorporated in Ireland, is not a tax resident in the USA, and does not meet the requirements for tax residency in Ireland. Like AOI, the majority of ASI's directors are Apple Inc. employees residing in California.[51] Both AOI and ASI exploited the same difference between Irish and US tax residency rules Fig. 20.1.

Fig. 20.1 Apple's offshore organizational structure

20.2.3.2 Entity Classification Rules

Entity Classification rules, commonly referred to as "check-the-box" rules, were issued by the US Treasury Department in 1997. Treasury stated at the time that the regulations were designed to simplify tax rules for determining whether an entity is a corporation, a partnership, a sole proprietorship, branch or disregarded entity (DRE) for federal tax purposes.[52] The regulations eliminated a multi-factor test in determining the proper classification of an entity in favor of a simple, elective "check-the-box" regime. Treasury explained that the rules were intended to solve two problems that had developed for the IRS. First, the rise of limited liability companies (LLCs) domestically had placed stress on the multi-factor test, which determined different state and federal tax treatment for them. Second, international entity classification was dependent upon foreign law, making IRS classification difficult and complex. In short, the check-the-box regime was intended to eliminate the complexity and uncertainty inherent in the test, allowing entities to simply select their tax treatment. Through passage of time, CTB regulations presented significant unintended consequences and opened the door to a host of tax avoidance schemes.[53] In an effort to close the perceived abuses, the IRS and Treasury issued Notice 98-11on February 9, 1998. The Notice stated:

> Treasury and the Service have concluded that the use of certain hybrid branch arrangements [described in Examples 1 and 2 of the Notice] is contrary to the policies and rules of subpart F. This notice (98-11) announces that Treasury and the Service will issue regulations to address such arrangements.[54]

Under the IRS check-the-box regulations, a US multinational can elect to have lower-tier foreign subsidiaries "disregarded" by the IRS as separate legal entities and instead treated as part of an upper-tier subsidiary for tax purposes. If that election is made, transactions involving the disregarded entities disappear for tax purposes, because US tax regulations do not recognize payments made within the confines of a single entity.

However, the transactions between those disregarded entities are not recognized by the IRS, because the transactions are viewed as if they were conducted within the confines of the same company. The result is that the IRS sees only AOI and treats AOI as having received sales income directly from the end customers who purchased Apple products; that type of active business income is not taxable under Subpart F (Fig. 20.2).

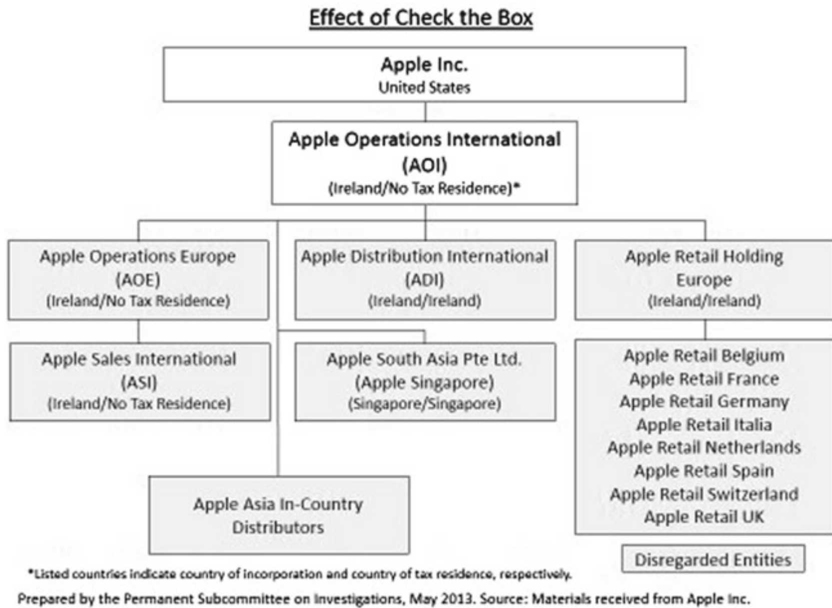


Fig. 20.2 Apple's effect of check-the-box

The issuance of Notice 98-11 and the temporary and proposed regulations provoked controversy among taxpayers and members of Congress. On July 6, 1998, Treasury and the IRS reversed course in Notice 98-35, withdrawing Notice 98-11 and the proposed regulations issued on March 26, 1998.

The repeal opened doors to BEPS far above Congress imagination, reducing the Subpart F regime to almost nothing.

20.2.3.3 The Circumvention of Most Subpart F Rules

Under Subpart F, passive income paid from one separate legal entity to another separate legal entity—even if they were both within the same corporate structure—was immediately taxable. However, with the implementation of the check-the-box regulations, a US multinational could set up a CFC subsidiary in a tax haven and direct it to receive passive income such as interest, dividend, or royalty payments from a lower-tiered related CFC without it being classified as Subpart F income.

The check-the-box rule permitted this development, because it enabled the multinational to choose to have the lower tiered CFC disregarded or

ignored for federal tax purposes. In other words, the lower tiered CFC, although it was legally still a separate entity, would be viewed as part of the higher-tiered CFC and not as a separate entity for tax purposes. Therefore, for tax purposes, any passive income paid by the lower-tiered entity to the higher-tiered CFC subsidiary would not be considered as a payment between two legally separate entities and, thus, would not constitute taxable Subpart F income. The result was that, for tax purposes, the check-the-box regulations enabled multinationals to ignore the facts reported in their books—which is that they received passive income.[55] On March 26, 1998, Treasury and the IRS proposed regulations to close the loophole opened by the check-the-box rule to prevent the unintended impact to Subpart F. Recognizing that neither had the authority to change the tax law, the IRS and Treasury stated in the proposed rule "the administrative provision [check-the-box] was not intended to change substantive law. Particularly in the international area, the ability to more easily achieve fiscal transparency can lead to inappropriate results under certain provisions [of subpart F] of the Code."[56]

Congress's effort did not last longer. In 2006, Congress eliminated related party passive income generally from Subpart F when it enacted Section 954(c)(6), which It provided "look-through" treatment for certain payments between related CFCs, and became known as the CFC look-through rule. It granted an exclusion from Subpart F income for certain dividends, interest, rents and royalties received or accrued by one CFC from a related CFC.[57]

Apple also uses the check-the-box regulations to avoid US taxation of a second type of offshore income. When an offshore subsidiary of a multinational corporation receives dividends, royalties or other fees from a related subsidiary, that income is considered foreign personal holding company (FPHC) income. That passive income, as it is commonly known, is normally subject to immediate taxation under Section 954(c) of Subpart F. However, once again, under check-the-box rules, if a US multinational elects to have lower-tier subsidiaries "disregarded"—i.e., no longer considered as separate entities—and instead treated as part of an upper-tier subsidiary for tax purposes, any passive income paid by the lower-tier subsidiary to the higher-tier parent would essentially disappear. Because those dividends, royalties and fee payments would be treated as occurring within a single entity, the IRS would not treat them as payments between two legally separate entities or as taxable income under Subpart F.

The weakening of Subpart F was further achieved through the "same country exception" and "manufacturing exception."

- The look-through rule

Under IRC Section 954 (c)(6) Subpart F look-through rule, dividends, interest, rents, and royalties received or accrued from a CFC which is a related person shall not be treated as Subpart F income to the extent attributable or properly allocable to income of the related person which is neither Subpart F income nor effectively connected income.

- The same country exception

This exception to Subpart F allows payments made between related parties organized and operating within the same country to escape taxation. This exception was created to address the situation in which related entities are located in the same jurisdiction, are theoretically subject to the same tax rate, and supposedly have less incentive to engage in tax-motivated transactions.

However, in Notice 2007-9, the IRS states that a recipient CFC would have to treat income received from a related person as Subpart F income if the associated expense reduces Subpart F income of the payor CFC or creates or increases a qualified deficit under Section 952(c).

Many of the dividends paid to AOI originate from other Apple affiliates incorporated and operating within Ireland, such as AOE and ASI. Under the same country exception, even if the check-the-box and the look-through rules were abolished, the dividend payments made by AOE and ASI to AOI would escape taxation under Subpart F, since the companies are all organized and operating within Ireland. Ironically, because the rule is drafted in terms of the country under whose laws a company is organized, Apple could take advantage of this exception even though it claims AOI, an Irish organized company, is not tax resident in Ireland or anywhere else in the world. Under the explicit terms of the exception, Apple may be able to avail itself of the exception and eliminate all tax liability for intra-country transfers, despite the fact that, according to Apple, AOI and ASI are not tax resident in the same jurisdiction.[58]

- The manufacturing exception to FBSC income

A common means of outsourcing cheaper labour overseas is contract manufacturing, which involves contracting a third-party for the production of finished goods component parts. These goods or components are

then imported to the home country, or to both countries, for assembly or sale. Alternatively, they may be sold in the host country.

The second loophole is the manufacturing exception to FBCS income. FBCS income is income attributable to related-party sales of personal property made through a CFC if the country of the CFC's incorporation is neither the origin nor the destination of the goods and the CFC itself has not "manufactured" the goods. Under Subpart F, FBCS income is currently taxable. However, under the manufacturing exception, the income from related party purchases and sales will not be characterized as FBCS income if the goods are sold to a related party that transforms or adds substantive value to the goods. In 2008, the regulations governing the manufacturing exception were liberalized to make it very easy for a company to claim such an exception.

Apple told the Subcommittee that it has made no determination about whether the company's supervision of third-party manufacturers qualifies it for the manufacturing exception to FBCS income taxation, since the company relies on the check-the-box rules. However, according to experts consulted by the Subcommittee, the low threshold of the new manufacturing exception rules makes it easy to meet the exception requirements and could be used to avoid taxation.[59]

20.2.3.4 The Cost Sharing Agreement

An international licensing agreement grants the rights to a firm in the host country to either produce or sell a product, or both. This agreement involves the transfer of rights to patents, trademarks, or technology for a specified period of time in return for a fee paid by the licensee. In general, the entity which has developed the R&D maintains the ownership of the intellectual property (IP).

Apple's transfer of the economic rights to its IP to Ireland has no apparent commercial benefit apart from its tax effects.

Apple Inc.'s Irish affiliates have also helped Apple avoid US taxes in another way, through utilization of a cost-sharing agreement and related transfer pricing practices. Three key offshore affiliates in this effort are ASI, its parent AOE, and Apple Distributions International (ADI), each of which holds a second or third tier position in Apple's offshore structure in Ireland. All three companies are incorporated and located in Ireland, and share the same mailing address. Another key second-tier player is Apple South Asia Pte. Ltd., a company incorporated and located in Singapore (Apple Singapore). These offshore affiliates enable

Apple Inc. to keep the lion's share of its worldwide sales revenues out of the United States and instead shift that sales income to Ireland, where Apple enjoys an unusually low tax rate and affiliates allegedly with no tax residency.[60]

In the agreement, Apple Inc. and ASI agree to share in the development of Apple's products and to divide the resulting intellectual property economic rights. To calculate their respective costs, Apple Inc. first pools the costs of Apple's worldwide research and development efforts. Apple Inc. and ASI then each pay a portion of the pooled costs based upon the portion of product sales that occur in their respective regions. For instance, in 2011, roughly 40 % of Apple's worldwide sales took place in the Americas, with the remaining 60 % took place offshore. That same year, Apple's worldwide research and development costs totaled $2.4 billion. Apple Inc. and ASI contributed to these shared expenses based on each entity's percentage of worldwide sales. Apple Inc. paid 40 % or $1.0 billion, while ASI paid the remaining 60 % or $1.4 billion.[61]

The cost-sharing agreement that Apple has signed with ASI and AOE is a key component of Apple's ability to lower its US taxes. Several aspects of the cost-share agreement and Apple's research and development (R&D) and sales practices suggest that the agreement functions primarily as a conduit to shift profits offshore to avoid US taxes. First, the bulk of Apple's R&D efforts, the source of the intangible value of its products, is conducted in the United States, yet under the cost sharing agreement a disproportionate amount of the resulting profits remain outside of the United States. Second, the transfer of intellectual property rights to Ireland via the cost-sharing agreement appears to play no role in the way Apple conducts its commercial operations. Finally, the cost-sharing agreement does not in reality shift any risks or benefits away from Apple, the multinational corporation; it only shifts the location of the tax liability for Apple's profits (Fig. 20.3).[62]

20.2.3.5 The Irish Ruling and the EU State Aid

The Irish tax authorities have granted to Apple International, ASI and Apple Operations Europe (AOE) several rulings concerning profit allocation to branches. On June 12, 2013, the EU Commission requested information on any ruling granted in favor of the aforementioned companies. By letter of March 7, 2014, the Commission informed the Irish

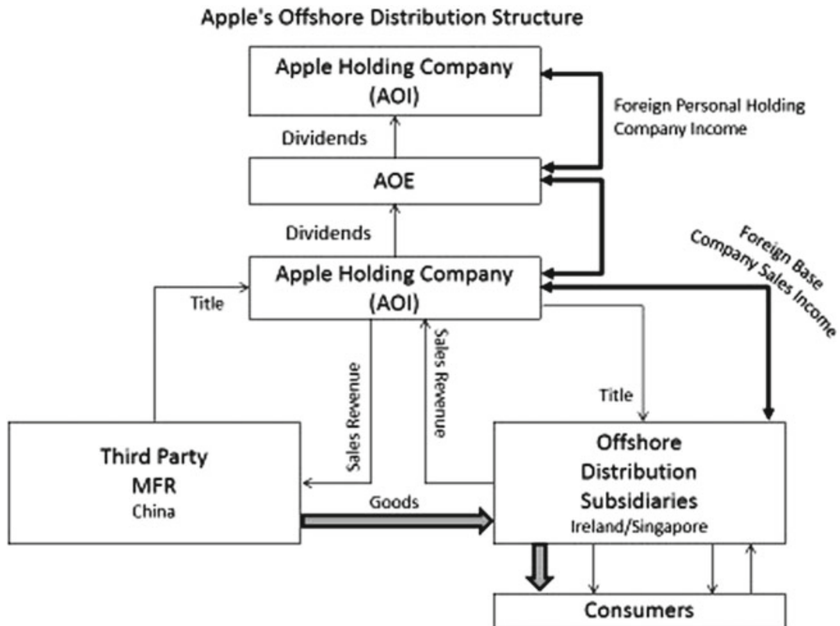


Fig. 20.3 Apple's offshore distribution structure

authorities that it was investigating whether the tax rulings in favor of Apple constitute new aid and invited the Irish authorities to comment on the compatibility of such aid.

Noting that the Commission had already requested, in its request of October 21, 2013, all essential elements underlying the tax rulings, the Commission invited Ireland to provide any additional information related to the transfer pricing arrangements on which the Irish tax authorities provided a positive opinion in the tax rulings of 1991 and 2007.

On November 6, 2014, the EU Commission has decided to initiate the procedure laid down in Article 108(2) of the Treaty on the Functioning of the European Union (TFEU). In order to trigger the procedure under Article 108(2) of the treaty, the Commission needs to establish whether: (i) establish the existence of aid, or in the case of the contested rulings that the contested rulings do not comply with the arm's length principle;

and (ii) determined whether they fall within the exceptions provided by the EU Treaty.

The Existence of Aid

According to Article 107(1) TFEU, any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the provision of certain goods shall be incompatible with the common market, in so far as it affects trade between Member States.

The qualification of a measure as aid within the meaning of Article 107(1) therefore requires the following cumulative conditions to be met.[63]

(i) The measure must be imputable to the State and financed through State resources

As regards the imputability of the measure, the contested rulings were issued by Irish Revenue, which is part of the Irish state. In the present case, those rulings were used by Apple to calculate its corporate income tax basis in Ireland. Irish Revenue has accepted those calculations and on that basis set the tax due.

(ii) It must confer an advantage on its recipient

The contested rulings resulted in a lowering of Apple's tax liability in Ireland, it can also be concluded that those rulings give rise to a loss of State resources. That is because any reduction of tax for Apple results in a loss of tax revenue that otherwise would have been available to Ireland.

(iii) That advantage must be selective

Treating taxpayers on a discretionary basis may mean that the individual application of a general measure takes on the features of a selective measure, particularly, where the exercise of the discretionary power goes beyond the simple management of tax revenue by reference to objective criteria. Rulings should not have the effect of granting the undertakings concerned lower taxation than other undertakings in a similar legal and factual situation.

(iv) The measure must distort or threaten to distort competition and have the potential to affect trade between Member States.

> Apple being a globally active firm, operating in various Member States, any aid in its favour distorts or threatens to distort competition and has the potential to affects intra-Union trade.

The Commission noted several inconsistencies in the application of the transfer pricing method chosen when determining profit allocation to AOE and ASI that do not appear to comply with the arm's length principle. Then, the EU Commission moved on to assess whether the "aid" may follow within the acceptable exception under the Treaty.

The Compatibility of the Aid

State aid measures can be considered compatible with the internal market on the basis of the exceptions listed in Article 107(2) and 107(3) TFEU.

Article 107(2) TFEU, provides an exception concerning aid of a social character granted to individual consumers, aid to make good the damage caused by natural disasters or exceptional occurrences and aid granted to certain areas of the Federal Republic of Germany. Apple does not fall within that category.[64]

Another exception provided for in Article 107(3)(a) TFEU covers aid to promote the economic development of areas where the standard of living is abnormally low or where there is a serious unemployment, and for the regions referred to in Article 349 TFEU, in view of their structural, economic and social situation. Such areas are defined by the Irish regional aid map. Apple does not fall within this category.

Article 107(3)(b) and (d) TFEU, does consider compatible, the aid intended to promote the execution of an important project of common European interest or to remedy to a serious disturbance in the economy of Ireland, or is it intended to promote culture or heritage conservation.

Apple does not fit within this category.[65]

Finally, according to Article 107(3)(c) TFEU, aid granted in order to facilitate the development of certain economic activities or of certain economic areas could be considered compatible where it does not adversely affect trading conditions to an extent contrary to the common interest. The Commission has no elements at this stage to assess whether the tax advantages granted by the contested measure are related to specific investments eligible to receive aid under the State aid rules and guidelines, to job creation or to specific projects.

It should be noted that Article 108(3) of the Treaty on the Functioning of the European Union has suspensory effect, and Article 14 of Council

Regulation (EC) No 659/199935, provides that all unlawful aid may be recovered from the recipient.[66]

On October 21, 2015, the European Commission has decided that Luxembourg and the Netherlands have granted selective tax advantages to Fiat Finance and Trade and Starbucks, respectively. These are illegal under EU state aid rules. Margrethe Vestager, the Commissioner in charge of competition policy, stated:

> Tax rulings that artificially reduce a company's tax burden are not in line with EU state aid rules. They are illegal. I hope that, with today's decisions, this message will be heard by Member State governments and companies alike. All companies, big or small, multinational or not, should pay their fair share of tax.
>
> EU Commission (October 21, 2015)

The tax ruling issued by the Netherlands to Starbucks' coffee roasting company artificially lowered the tax paid by the company. Rulings as comfort letters issued by tax authorities to give a company clarity on how its corporate tax will be calculated or on the use of special tax provisions are perfectly legal. However, rulings without economic reality such as the one granted to Starbucks, by setting prices for goods and services within Starbucks groups (so-called "transfer prices") do not correspond to market conditions. Otherwise, it would give that company an unfair competitive advantage over other companies (typically SMEs) that are taxed on their actual profits because they pay market prices for the goods and services they use. Therefore, the Commission has ordered the Netherlands to recover the unpaid tax from Starbucks, in order to remove the unfair competitive advantage Starbucks group has enjoyed and to restore equal treatment with other companies in similar situations.

The Commission's investigation found that the royalty paid by Starbucks Manufacturing to Alki cannot be justified as it did not adequately reflect market value. In fact, only Starbucks Manufacturing was required to pay for using this know-how-—no other Starbucks group company nor independent roasters to which roasting was outsourced were required to pay a royalty for using the same know-how in essentially the same situation. In the case of Starbucks Manufacturing, however, the existence and level of the royalty means that a large part of its taxable profits were unduly shifted to Alki, which is neither liable to pay corporate tax in the UK or in the Netherlands. Furthermore, the investigation found that Starbucks Manufacturing's tax

base was also unduly reduced by the highly inflated price it paid for green coffee beans to a Swiss company, Starbucks Coffee Trading SARL. In fact, the margin on the beans had more than tripled since 2011. Due to this high key cost factor in coffee roasting, Starbucks Manufacturing's coffee roasting activities alone would not actually generate sufficient profits to pay the royalty for coffee-roasting know-how to Alki. The royalty therefore mainly shifted to Alki profits generated from sales of other products sold to the Starbucks outlets, such as tea, pastries, and cups, which represent most of the turnover of Starbucks Manufacturing. The Commission determined the undue competitive advantage enjoyed by Starbucks, i.e. the difference between what the company paid and what it would have paid without the tax ruling. This amount was €30 million for Starbucks but the precise amounts of tax to be recovered must now be determined by the Dutch tax authorities on the basis of the methodology established in the Commission decisions.

It is almost evident that the Commission would decide, almost verbatim in the pending investigations concerning Apple, Microsoft, and many others multinational groups.

20.2.4 Microsoft's Tax Abusive Structure

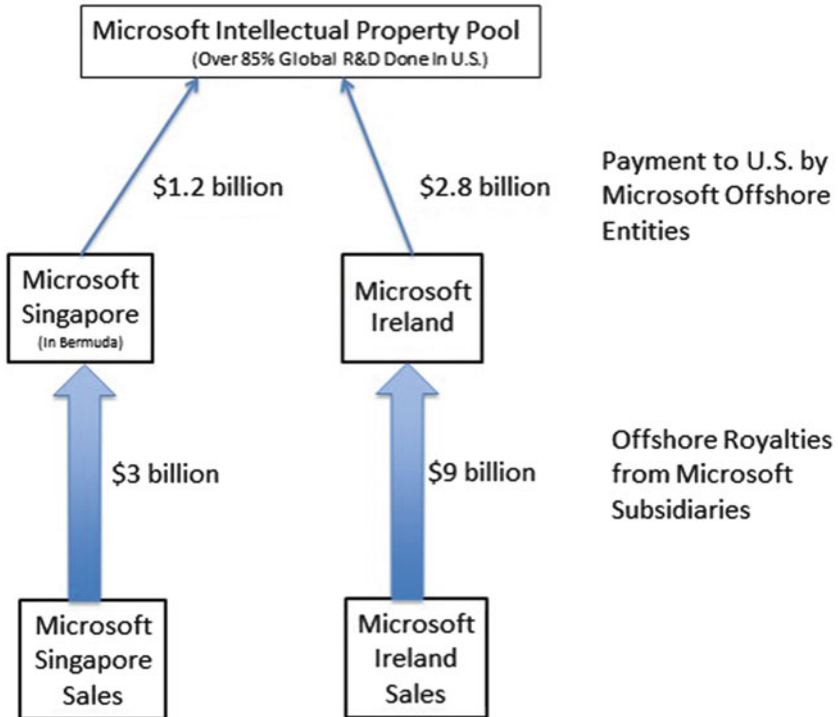
From 2009 to 2011, Microsoft shifted, through aggressive tax planning $21 billion offshore, almost half its US retail sales revenue, saving up to $4.5 billion in taxes on goods sold in the United States.

Microsoft achieved its BEPS through aggressive transfer pricing with several of its subsidiaries overseas.

20.2.4.1 Microsoft Transfer Pricing

Microsoft began establishing a complex web of interrelated foreign entities to facilitate international sales and reduce US and foreign tax. It established three regional operating centers in low tax jurisdictions: Ireland, Singapore, and Puerto Rico. Microsoft Ireland is responsible for retail sales to Europe, the Middle East, and Africa, Singapore is responsible for retail sales in Asia, and Puerto Rico is responsible for retail sales in North and South America, including the United States. In 2011, over $7.8 billion out of a total research budget of $9.1 billion was spent on research and development in the US (Fig. 20.4)

Microsoft received $200 million in US tax credits for conducting this research in the United States. To transfer intellectual property rights from the US group to foreign subsidiaries, Microsoft and the regional operating



Permanent Subcommittee on Investigation, In: Statement of Senator Carl Levin (D-Mich) Before U.S. Senate Permanent Subcommittee on Investigations on Offshore Profit Shifting and the U.S. Tax Code, September 20, 2012

Fig. 20.4 Microsoft IP payments

centers engage in a worldwide cost sharing agreement. The participating entities each pay a portion of the research and development cost based on the entity's portion of global revenues.

Microsoft Corporation has used aggressive transfer pricing transactions to shift its intellectual property, a mobile asset, to subsidiaries in Puerto Rico, Ireland, and Singapore, which are low or no tax jurisdictions, in part to avoid or reduce its US taxes on the profits generated by assets sold by its offshore entities.[67] From 2009 to 2011, by transferring certain IP rights to a Puerto Rican subsidiary, Microsoft was able to shift offshore nearly $21 billion, or almost half of its US retail sales net revenue, saving up to $4.5 billion in taxes on goods sold in the United States, or just over $4 million in US taxes each day.[68]

The hearing featured a case study involving Microsoft's shifting of IP rights for software developed in America, and the earnings that flow from them, to divisions in lower-tax Puerto Rico, Ireland, and Singapore. One witness, Professor Stephen Shay of Harvard Law School, pointed out that in 2011 these three units enjoyed an average effective tax rate of just 4 % and managed to book $15.4 billion of pre-tax profit—55 % of Microsoft's worldwide total. Their 1,914 employees generated an eyebrow-raising $8m of profit each, compared with $312,000 each for the 88,000 working in the rest of Microsoft. Whether or not this apportionment of profits complies with transfer-pricing rules, it is "not consistent with a common sense understanding of where the locus of Microsoft's economic activity… is occurring," said Mr Shay. The claim that fair transfer prices were paid is "just not credible given the bottom-line outcome," he added.

In 2011, the Senate investigators asserted, Microsoft's parent company was paid $4 billion by Ireland and Singapore for rights that the two subsidiaries used to generate three times that amount in royalty payments from other bits of the group. Under one cost-sharing agreement, they said, head office sold Puerto Rico certain rights then repurchased them straight afterwards for a lot more, a money manoeuvre that saved the group $4 billion in tax over three years. A Microsoft man who was grilled at the hearing said the staffers' sums ignored hefty, regular "buy-in" payments that the foreign subsidiaries have to make to the parent.

20.2.4.2 Check-the-Box and the CFC Look-Through Rule
In 2011, Microsoft Corporation excluded an additional $2 billion in US taxes on passive income at its offshore subsidiaries, relying on the "check-the-box" regulations and the CFC "look-through" rule, which have undermined the intent of the tax code's Subpart F to prevent the shifting of passive CFC profits to tax havens to avoid US tax.

20.2.5 Hewlett-Packard

Another case study concerned lightly taxed foreign profits brought back to America by Hewlett-Packard. Since at least 2008, Hewlett Packard Co. has used billions of dollars of intercompany offshore loans to effectively repatriate untaxed foreign profits back to the United States to run their US operations, contrary to the intent of US tax policy.

America doesn't chase its companies for income tax if the income is kept overseas. The moment it returns, it is fair game. (As a result, American firms hold $1.5 trillion overseas, 60 % of their total cash.) However, an exception is made for funds that flow back as short-term loans to other parts of the corporation. HP has taken advantage of this loophole to provide a steady flow of liquidity to its American operations using loans from Belgian and Cayman subsidiaries. In a 30-month period from 2008 to 2010, for instance, these two alternated their lending (of several billion dollars in all) so as to provide the American division with unbroken funding while keeping each loan below the 60-day ceiling allowed under the exception, according to the subcommittee memo.

Characterizing this steady financing as short-term lending is "the ultimate example of form over substance" and undermines a fundamental tenet of American tax policy, huffed Mr. Levin. When an HP executive tried to insist the manoeuvre did not constitute profit repatriation, the senator wielded an internal HP document in which it was discussed—in the repatriation strategy section. The Senate investigators said they suspected other companies were doing the same thing but couldn't say how prevalent the practice was.

Who to blame for all this darting through loopholes? To no one's surprise, Mr. Levin pointed the finger mostly at the companies that engage in "tax alchemy" (Fig. 20.5).

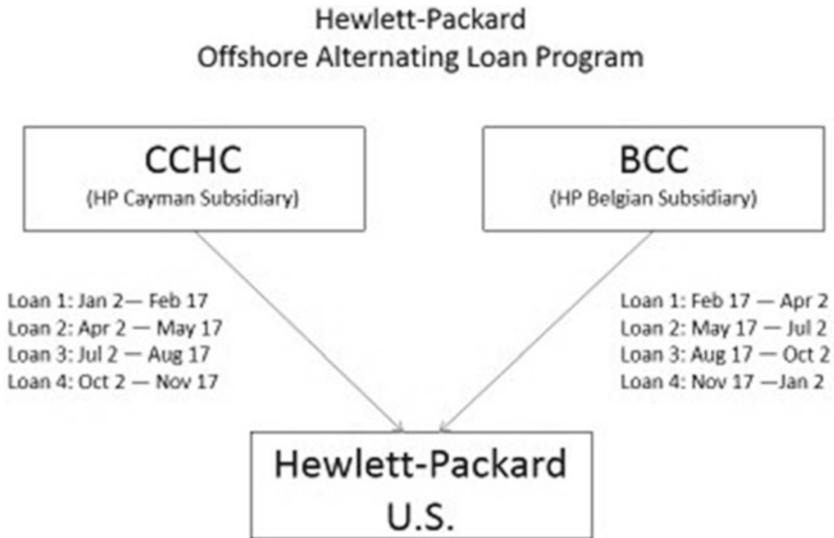


Fig. 20.5 HP offshore alternating loan program

20.3 The OECD

Since 2013, the OECD which has become the driving force in the international field, embarked within an ambitious plan to revise the fundamentals of the international tax rules, align them to developments in the world economy, and ensure that profits are taxed where economic activities are carried out and value is created. The OECD effort aims to (i) introduce coherence in the domestic rules that affect cross-border activities, (ii) reinforce substance requirements in the existing international standards and (iii) improve transparency, as well as certainty for businesses that do not take aggressive positions.

G-20 country leaders and other participants have agreed, inter alia (i) to ensure fair tax competition; (ii) to eliminate or modify preferential

regimes that have the potential to attract paper income rather than substantial business activities; (iii) that the minimum standard in the area of treaty shopping will ensure that treaty benefits are only granted to those entities that are entitled to them; (iv) agreement on a minimum standard to secure progress on dispute resolution has been reached and an effective monitoring mechanism will be established in 2016.

Notes

1. Pascal Saint-Amans (July, 22nd, 2013): Testimony of the Director, Centre for Tax Policy and Administration, Organization for Economic Co-operation and Development (OECD) Before the United States Senate Committee on Finance, p. 6.
2. Pascal Saint-Amans (July, 22nd, 2013): Testimony of the Director, Centre for Tax Policy and Administration, Organization for Economic Co-operation and Development (OECD) Before the United States Senate Committee on Finance, p. 3.
3. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 7.
4. Real income shifting refers to income that is shifted in a manner that results in both explicit and implicit tax consequences.
5. Artificial income shifting refers to income that is shifted to avoid explicit taxes without incurring the implicit taxes generally associated with a reduction in explicit taxes.
6. T. J. Atwood (2013): Are Worldwide Tax Systems Disadvantageous for Residents Firms Compared with Territorial Tax Systems?, Florida Tax Law Review, p. 8.
7. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 95.
8. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 4.
9. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 6.
10. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 18.
11. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 21.
12. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 41.

13. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 43.
14. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 46.
15. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 50.
16. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 51.
17. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 56.
18. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 62.
19. Reuven Avi-Yonah, p. 4.
20. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's Offshore tax strategy, p. 79.
21. Reuven Avi-Yonah, p. 6.
22. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 94.
23. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 81.
24. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 83.
25. Ibid., p. 85.
26. Ibid., p. 89.
27. Ibid., p. 90.
28. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 44.
29. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 41.
30. United States Senate- Permanent Subcommittee on Investigations (April 1, 2014): Caterpillar's offshore tax strategy, p. 46.
31. United States Senate- Permanent Subcommittee on Investigations (2014): Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits, p. 60.
32. Ibid., p. 60.
33. Ibid., p. 61.
34. United States Senate- Permanent Subcommittee on Investigations (2014): Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits, p. 39.

35. Ibid., p. 42.
36. Ibid., p. 43.
37. Ibid., p. 50.
38. Ibid., p. 50.
39. Ibid., p. 64.
40. Ibid., pp. 64–5.
41. Ibid., p. 61.
42. Ibid., p. 62.
43. Ibid., p. 65.
44. Ibid., p. 66.
45. Ibid., p. 71.
46. Ibid., p. 75.
47. Ibid., p. 75.
48. US Senate Committee – Permanent Subcommittee on Investigations-Apple Inc, Memorandum, p. 4.
49. US Senate Committee – Permanent Subcommittee on Investigations-Apple Inc, Memorandum, p. 5.
50. Instead, three individuals serve as AOI's directors and sole officer, while working for other Apple companies. Those individuals currently consist of two Apple Inc. employees, Gene Levoff and Gary Wipfler, who reside in California and serve as directors on numerous other boards of Apple offshore affiliates, and one ADI employee, Cathy Kearney, who resides in Ireland. Mr. Levoff also serves as AOI's sole officer,
51. US Senate Committee – Permanent Subcommittee on Investigations-Apple Inc, Memorandum, p. 24.
52. IRC Sections 301.7701-1 through 301.7701-3 (1997).
53. US Senate Committee – Permanent Subcommittee on Investigations-Apple Inc, Memorandum, p. 13.
54. 1/16/1998, IRS Notice 98-11, at 2.
55. US Senate Committee – Permanent Subcommittee on Investigations-Apple Inc, Memorandum, p. 13.
56. 3/26/1998 "Guidance under Subpart F Relating to Partnerships and Branches," 26 CFR Parts 1 and 301 [TD 8767], at 2.
57. Section 954(c)(6) had earlier passed the Senate and the House as part of the American Jobs Creation Act of 2004, but was then dropped without explanation in conference. When it reemerged one-and-a-half years later in TIPRA it did not attract huge pre-enactment atten-

tion, and when finally enacted, its retroactive effective date surprised some taxpayers.

58. US Senate Committee – Permanent Subcommittee on Investigations-Apple Inc, Memorandum, p. 37.
59. US Senate Committee – Permanent Subcommittee on Investigations-Apple Inc, Memorandum, p. 37.
60. US Senate Committee – Permanent Subcommittee on Investigations-Apple Inc, Memorandum, p. 25.
61. US Senate Committee – Permanent Subcommittee on Investigations-Apple Inc, Memorandum, p. 26.
62. US Senate Committee – Permanent Subcommittee on Investigations-Apple Inc, Memorandum, p. 28.
63. European Commission, C (2014) 3606- Ireland, final, p. 14.
64. European Commission, C (2014) 3606- Ireland, final, p. 19.
65. European Commission, C (2014) 3606- Ireland, final, p. 20.
66. European Commission, C (2014) 3606- Ireland, final, p. 21.
67. United States Senate Permanent Subcommittee on Investigation – Microsoft, (Sept. 20, 2012).
68. United States Senate Permanent Subcommittee on Investigation – Microsoft, (Sept. 20, 2012).

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