

# International Taxation



# International Taxation

## Corporate and Individual

SIXTH EDITION

Volume 1  
Chapters 1–11

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Wobble  
by Matthew Postlewaite

The single word rolls off my tongue like a river  
The two syllables quickly bounding from my mouth  
Pronouncing it by itself can show all of its emotions.

Nothing is perfect,  
When you put wobble into the world  
A twitching hand, a buckling knee, a nervous and twittering  
Butterfly in your stomach.

But wobble doesn't always seem to be such a fiend  
It may not be charming,  
But it leaves a smile on your face  
It's playful,  
It's humorous,  
It's colorful  
Who doesn't love a little kid falling?  
Who doesn't like Cartman, the funny character on South Park?  
Who doesn't like cuddly penguins?  
I do  
I love wobble.

To Matthew

For the never-ending joy which  
you have given me.  
I love you!

PFP



To the many pioneering women whose hard work and perseverance paved the way for my own, especially Verna Hoffer, Magdalen Shaffer Potts, Betty Hoffer, and Alice M. Batchelder. You were, are, and always will be heroes.

SRH







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# *Preface*

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## **Approach and Purpose**

The authors intend to meet two important goals. The primary goal is to provide the novice reader with a comprehensible explanation of the taxation of international transactions involving corporations, partnerships, and individuals from the perspective of the United States. A secondary goal is to offer the experienced user a volume of timely, thorough, and practical reference material.

The area of international taxation is most complex, and the more difficult provisions within that area have been similarly described:

In keeping with the high level of complexity one has come to expect as a matter of course in the foreign tax area, the . . . provisions quickly reach, and rarely leave, a plateau of statutory intricacy seldom rivaled in other sections of the Code, thus, the provisions easily qualify as a “four star” example of Byzantine architecture in a statute not noted for its economy of line.<sup>1</sup>

While the quotation described the technically onerous DISC provisions, given the extensive and rapid developments occurring over the past decades, this comment aptly describes the entire field of interna-

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<sup>1</sup> Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.14 (4th ed. 1979).

tional taxation. As markets continue to globalize, international tax considerations multiply proportionately, if not exponentially. Moreover, Treasury is concentrating an ever-increasing level of resources and attention on international taxation issues and cross-border transactions. In light of these developments, it is increasingly important that the practitioner possess a working knowledge of the international tax provisions.

Due to the volume of material in this area (and the authors' desire to retain a passing familiarity with family and friends), the treatise attempts to refer the reader to other research sources through the use of footnote references. The authors have attempted to review the major cases, rulings, and relevant articles in the area and to provide footnote citations for those sources. Such an approach is designed to assist in the research of a complex problem without detracting from the desired readability of the general text.

To preserve the benefits of this work, revisions will be published regularly, integrating recent cases, Rulings, and Regulations (final and proposed) as well as any legislative changes. Consequently, the treatise will grow in depth and scope with the passage of time.

## Coverage

The treatise discusses in detail the international tax consequences, from a United States perspective, of transactions carried out by individuals, partnerships, and corporations, as well as those occurring between partnerships and corporations and their owners. The tax treatment of trusts and estates and their beneficiaries is not addressed.

The text focuses on two situations: (1) the United States taxation of United States individuals, partners, and corporations with respect to income arising from without the United States, i.e., "outbound transactions," and (2) the United States taxation of their foreign counterparts on both their United States and foreign source income, i.e., "inbound transactions."

Generally speaking, domestic individuals (i.e., citizens and residents), partners, and corporations are subject to United States taxation on all income, whatever its source. Thus, the United States tax rates are applied regardless of whether the income is derived in one of the 50

states, in the District of Columbia, or in any foreign country.<sup>2</sup> However, any taxes which the domestic individual, partner, or corporation pays to a foreign jurisdiction may qualify for either a deduction or a credit against United States tax liability,<sup>3</sup> and certain foreign source earnings may be exempt from United States taxation.<sup>4</sup>

In contrast to the tax treatment of domestic individuals, partners, and corporations, a foreign individual, partner, or corporation is not, by virtue of any *in personam* nexus, subject to tax by the United States. Foreign individuals, partners, and corporations are subject to United States taxation only if they derive income from within the United States (i.e., United States source income) or if they derive income which is “effectively connected” with a United States business.<sup>5</sup> Complete United States taxation of this income, however, is mitigated by Code provisions intended to encourage foreign investment in the United States (such as § 871, which lowers the domestic tax rate to 30 percent on certain investment income) or by bi-lateral tax treaties.<sup>6</sup>

## Legislative Changes

The tax acts of the last decades generated a number of changes in the international tax area. This text generally focuses on current law, touching only briefly on prior law where it is deemed significant.

## Abbreviations and Terms

In this text, *section* or § refers to sections of the United States Internal Revenue Code; *Regulations* or *Reg.*, *Proposed Regulations* or *Prop. Reg.*, *Temporary Regulations* or *Temp. Reg.* refer to Treasury Department Regulations; *Revenue Ruling* or *Rev. Rul.* refers to Rulings published by the Internal Revenue Service; *Private Letter Ruling* or *Priv. Let. Rul.* refers to Private Letter Rulings issued by the Service; *Technical Advice Memorandum* or *Tech. Adv. Memo.* refers to Technical Advice Memoranda issued by the Service; and *Revenue Procedure* or *Rev. Proc.* refers to Revenue Procedures published by the Service. A *domestic*

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<sup>2</sup> IRC §§ 1 and 11.

<sup>3</sup> IRC §§ 164 and 901–908. See discussion at chapter 6.

<sup>4</sup> IRC § 911. See discussion at chapter 3.

<sup>5</sup> See discussion at chapters 17–20.

<sup>6</sup> See discussion at chapters 13–15.

*person* or *United States person* refers generically to United States corporations, partners, citizens, and residents. A *foreign person* refers to a non-resident individual, partner, or a foreign corporation.

## **Relevant Dates and Reader Input**

This work is current through September 1, 2010. Future developments will be covered in forthcoming revisions. Readers are encouraged to make suggestions and comments which will be reflected in supplements and future editions.

## **Acknowledgments**

We thank those instrumental in the successful preparation and completion of the Sixth Edition of *International Taxation: Corporate and Individual*. Their assistance was invaluable and deeply appreciated.

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# *Introduction*

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## **Overview**

In today's globalizing climate, even a mid-sized United States business must necessarily consider selling its goods or services outside of the United States; similarly, a mid-sized foreign business will view the United States as a potentially lucrative market. With the recent developments in the international arena, namely the democratization of Eastern Europe, the increasing strength of the European Union, and the rise of China and India as major commercial centers, the pace of globalization will only accelerate.

In this treatise, the United States tax rules applicable to “outbound” (i.e., Volume 1) and “inbound” (i.e., Volume 2) transactions and investments are discussed. An outbound transaction is defined by either the investment or the conduct of business by a United States person abroad, e.g., if M, a United States citizen, invests in an interest bearing bank account in Switzerland or Z Corporation, incorporated in Delaware, sells shoes in Argentina. Conversely, an inbound transaction is defined by either the investment or the conduct of business by a foreign person within the United States, e.g., if D, a Swiss resident, invests in an interest bearing bank account in the United States or Q Corporation, incorporated in Buenos Aires, sells Argentine wine in the United States. Since either type of transaction may be impacted by the income tax treaties

which the United States has entered with foreign jurisdictions, those treaties and their technical explanations are considered as well.

## Some Fundamental Questions

In deciding how to tax cross-border transactions, every country must answer a series of fundamental policy and pragmatic questions in devising its system of international taxation. Among these questions are:

1. How should “domestic” individuals, partners, and corporations be distinguished from other individuals, partners, and corporations?
2. Is it proper to tax domestic individuals, partners, and corporations on all of their income earned throughout the world or should taxation be limited to income derived within their home countries, a so-called “territorial basis” of taxation?
3. If domestic individuals, partners, and corporations are taxed by their home countries on a worldwide basis, how should foreign taxes imposed on such taxpayers’ overseas operations be taken into account? Should an exemption be provided for such overseas income or should a deduction or credit be granted for the foreign taxes imposed on that income?
4. How are individuals, partners, and corporations other than domestic individuals, partners, and corporations to be taxed?
5. What are the likely international economic and political ramifications of any given system of taxation?

In addressing these questions with respect to corporate entities, the United States has chosen to draw a distinction between domestic corporations and foreign corporations. A “domestic corporation” (sometimes referred to as a “United States corporation”) is any corporation which is created or organized in the United States.<sup>7</sup> A “foreign corporation” is any corporation which is not a United States corporation.<sup>8</sup>

From a policy standpoint, the propriety of this “situs of formation” demarcation may be questioned. It might be preferable, for example, to view a Delaware corporation which conducts all of its activities in France and which is managed and controlled there as a foreign corporation rather than as a United States corporation. On the other hand, the advantage of the situs of formation test is that, as compared to other tests which could be adopted, it is comparatively simple and objective in application, at least in the case of a corporation created under the

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<sup>7</sup> IRC § 7701(a)(4); Reg § 301.7701-5.

<sup>8</sup> IRC § 7701(a)(5); Reg § 301.7701-5. See discussion at chapter 1.



general corporation law of one of the 50 states or that of a foreign country.<sup>9</sup> Thus, even though the situs of formation test generally focuses merely on where a corporation's charter is filed, rather than upon theoretically more meaningful economic and operational criteria, the test is probably justified on grounds of administrative convenience.<sup>10</sup>

A similar objective approach exists as regards the classification of individuals and domestic partners, with a distinction drawn between citizens and residents of the United States and non-residents and domestic corporations and foreign corporations. Historically, with regard to individuals, the classification issue turned on the relevant facts and circumstances with an emphasis on ascertaining whether the individual's economic and personal ties rested more closely in the United States or a foreign jurisdiction. Congress, however, adopted more objective tests with an almost exclusive focus on time spent in the United States rather than social or economic nexus. As in the corporate context, for better or for worse, this time-line approach appears premised on administrative ease and certainty.<sup>11</sup>

## **Taxation of Domestic and Foreign Individuals and Corporations**

Domestic individuals and corporations are subject to United States tax on all of their income, wherever in the world it is derived.<sup>12</sup> Foreign

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<sup>9</sup> More complicated questions may arise in less formal situations in determining where an entity has been "created or organized" for §§ 7701(a)(4) and 7701(a)(5) purposes. See *Compagnie Financiere de Suez et de L'Union Parisienne v United States*, 492 F.2d 798 (Ct. Cl. 1974) (entity was Egyptian, rather than French; hence not entitled to benefits of French tax treaty with United States); Priv. Let. Rul. 8305138 (contractual arrangement under Luxembourg law created entity taxable as corporation under § 7701).

<sup>10</sup> The threshold issue of whether a particular entity constitutes a "corporation" for tax purposes for many enterprises is governed by the "check-the-box" Regulations. See generally Willis and Postlewaite, *Partnership Taxation*, chapters 1, 3, and 21 (Warren, Gorham and Lamont, 7th ed. 2011). See also discussion at chapters 11 and 22.

<sup>11</sup> IRC § 7701(b). See discussion at chapter 1. See also Reg. § 301.7701-3(h). In the tax treaty context, the determination is typically one of facts and circumstances deciding whether the claimant is a "resident" as defined by treaty. See discussion at chapter 13.

<sup>12</sup> IRC §§ 1 and 11(a); Reg §§ 1.1-1(c) and 1.11-1(a). A noteworthy exception for United States individuals, discussed at chapter 3, is the § 911 exclusion for foreign sourced earned income.

individuals and corporations are subject to such tax only on income effectively connected to the conduct of a trade or business in the United States and certain other specified income derived from United States sources.<sup>13</sup> If resident in a treaty country, foreign residents are subject to tax only on income attributable to a permanent establishment in the United States and certain other income addressed by the governing treaty.

## Foreign Tax Credit

In this era of cross-border transactions, United States persons are potentially subject to double taxation—by the United States on worldwide income and by the country in which the income is derived. The foreign tax credit mitigates this exposure. If a domestic individual or corporation derives income from sources outside of the United States and incurs a foreign income tax (or certain other types of foreign taxes) on that income, the United States allows that taxpayer to claim a tax credit for those foreign taxes paid. The credit generally is available to the extent that the foreign tax does not exceed the amount of United States tax which would have been imposed on that income had the credit not been available.<sup>14</sup> Thus, if a United States taxpayer derives 20 percent of its taxable income from foreign sources, its foreign tax credit may generally equal no more than 20 percent of its tentative United States tax liability (computed before applying the foreign tax credit).<sup>15</sup>

Except to a very limited extent, a foreign tax credit is not available for United States tax purposes for foreign taxes paid by a foreign individual or corporation on income which is subject to United States tax.<sup>16</sup> Thus, from a policy standpoint, the United States generally regards

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<sup>13</sup> IRC §§ 1, 11(d), 871, 881, 882, 1441, and 1442. See discussion at chapter 19. Under § 897(a), gain or loss which is derived by a foreign individual or corporation from the disposition of a “United States real property interest” is deemed to be derived from the conduct of a United States trade or business. See discussion at chapter 19. Some foreign source income may also be subject to United States tax. See discussion at chapter 18.

<sup>14</sup> IRC §§ 901–908. See discussion at chapter 6.

<sup>15</sup> IRC § 904. This limitation is applied separately to different types of foreign income. IRC § 904(d).

<sup>16</sup> IRC § 906. See discussion at chapter 18.

the country of income source as having the primary right to tax income.<sup>17</sup>

## Certain Special Regimes

Because United States corporations are subject to United States tax on all of their worldwide income while foreign corporations are generally not subject to such tax on income derived outside of the United States, the United States has enacted certain provisions applicable to foreign corporations owned by United States corporations, partners, or individuals. Such entities subject to special tax rules are the Controlled Foreign Corporation and the Passive Foreign Investment Company.<sup>18</sup>

Generally, these special taxing regimes are designed to prevent the deferral of United States tax by the formation or use of foreign corporations by United States Shareholders. For example, assume that a United States corporation, X, establishes a foreign corporation, Y, to which X contributes \$100. Y then deposits that \$100 in a London bank account. Y itself will not be subject to United States tax on its interest income. However, under the Controlled Foreign Corporation rules, interest earned on the \$100 deposit (net of expenses) generally must be reported by X as ordinary income on its tax return for its United States taxable year in which Y's taxable year ends.

Two general overlays to international transactions must also be considered. A special anti-abuse regime is set forth under §367 which triggers the inherent gain in property transferred outside of United States borders to foreign entities.<sup>19</sup> Similarly, §482 affords the Service a powerful tool to reallocate income, deductions, and credits between related parties if those parties fail to deal with each other at arm's

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<sup>17</sup> Under a relevant tax treaty, the country of income source may agree not to tax the income of corporations, partners, or individuals resident in the other signatory country in certain situations or may agree that it will tax such income only if certain conditions are present. The United States, for example, generally agrees not to tax the business profits of a foreign individual or corporation resident in a signatory country unless that taxpayer maintains a "permanent establishment" within the United States and such business profits are attributable to that permanent establishment. Tax treaties are discussed at chapters 5 and 13–15. Additionally, tax treaties typically address the availability of the foreign tax credit.

<sup>18</sup> IRC §§951–964 (Controlled Foreign Corporations), §§1291–1297 (Passive Foreign Investment Companies). See discussion at chapter 7 (Controlled Foreign Corporations) and chapter 8 (Passive Foreign Investment Companies).

<sup>19</sup> See discussion at chapters 9 and 20.

length.<sup>20</sup> These provisions are broad and fairly unforgiving checks on the generosity of the United States as regards cross-border transactions in which potentially taxable income is being shifted outside of its reach.

## No Ruling Position of Service

Given the complex system described above, if possible, tax advisers would prefer to issue professional opinions and/or structure business transactions when they can be *certain* of the tax consequences. Provided certain specified procedures are followed and information submitted, the Service will issue a Private Letter Ruling to a taxpayer stipulating to the tax consequences of the proposed transaction. The Private Letter Ruling will bind both the taxpayer and the Service provided the facts as submitted in the request are consistent with those of the transaction as *actually* structured. Revenue Procedure 2010-1<sup>21</sup> provides a detailed listing of the procedural and factual requirements for such a request.

Additionally, the Internal Revenue Service annually issues a Revenue Procedure which provides an updated list of issues under the jurisdiction of the associate chief counsel (international) on which the Service will *not* issue guidance through the issuance either of an advance letter ruling or a determination letter.<sup>22</sup> The purpose of “no Ruling” Revenue Procedures is to alert taxpayers and their advisers of those topics which are off limits for discussion. However, the topics listed in the Revenue Procedure also alert the practicing bar of controversial issues on which the Service is unwilling to announce its position publicly as well as those in which the Service is prone to challenge taxpayer actions. Thus, a survey of these topics can be most informative from either standpoint.

The Revenue Procedure is divided into five sections. The first section describes its general purpose and alerts taxpayers to significant changes from the prior year’s “no Ruling” Revenue Procedure. In many ways, the new sections are most revealing, since they suggest the latest “hot button topics” in the international area.

Section 3 of the procedure identifies questions, problems, and general areas on which the Service will not rule *under any circumstances*.

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<sup>20</sup> See discussion at chapters 10 and 21.

<sup>21</sup> 2010-1 CB 1.

<sup>22</sup> See Rev. Proc. 2010-7, 2010-1 CB 231.

Section 4 lists areas in which letter rulings will not *ordinarily* be issued. However, the Revenue Procedure notes that exceptions will be made where unique and compelling reasons justify the issuance of a letter ruling. Even if a taxpayer and/or the taxpayer's adviser concludes that their situation is unique, he or she is put on notice that the matter should be discussed with the Service prior to submission of an official request.

As indicated by the many issues on which the Service will not (or generally will not) rule, taxpayers and their advisers considering such transactions or structures generally will not enjoy the option of receiving the guidance and the "blessing" of the Service. Additionally, taxpayers acting in these areas should be prepared for greater scrutiny of such a transaction by the Service than would normally occur.