

International Taxation

International Taxation

Corporate and Individual

SEVENTH EDITION

Volume 1
Chapters 1–11

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CAROLINA ACADEMIC PRESS
Durham, North Carolina

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ISBN: 978-1-59460-606-9
Library of Congress Control Number: 2012939691

Carolina Academic Press
700 Kent Street
Durham, North Carolina 27701
Telephone (919) 489-7486
Fax (919) 493-5668
www.cap-press.com

Printed in the United States of America

“Remembering that I’ll be dead soon is the most important tool I’ve ever encountered to help me make the big choices in life. Because almost everything—all external expectations, all pride, all fear of embarrassment or failure—these things just fall away in the face of death, leaving only what is truly important. Remembering that you are going to die is the best way I know to avoid the trap of thinking that you have something to lose. You are already naked. There is no reason not to follow your heart.”

Steve Jobs (2005)

To my pyramid of life and to following my heart

Ruth,

Jennifer, Jessalyn, Eric, Matthew

Madison, Reid, Peyton

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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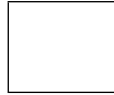
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Preface

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 by the United States of international transactions involving corporations, partnerships, and individuals. 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.¹

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-

¹ 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 particularly important that the practitioner possess a working knowledge of the international tax provisions of the United States.

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.² 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 the United States tax liability,³ and certain foreign source earnings may be exempt from United States taxation.⁴

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.⁵ 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 either eliminates or lowers the domestic tax rate to 30 percent on certain investment income) or by bi-lateral tax treaties.⁶

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*

² IRC § § 1 and 11.

³ IRC § § 164 and 901–908. See discussion at chapter 6.

⁴ IRC § 911. See discussion at chapter 3.

⁵ See discussion at chapters 17–19.

⁶ 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, 2011. Future developments will be covered in forthcoming chapter revisions. Readers are encouraged to make suggestions and comments which will be reflected in future editions.

Acknowledgments

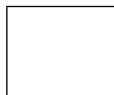
We thank those instrumental in the successful preparation and completion of this work. Their assistance was invaluable and deeply appreciated. Particular thanks is extended to Barry Quirke and Lowell Yoder who are partners at McDermott Will & Emery specializing in international taxation. Through their patience and guidance in teaching courses in Advanced International Taxation and Controlled Foreign Corporations at the Northwestern Tax Program we were introduced to the intersection of geometry and international taxation. As a consequence, we have attempted in the Sixth Edition to incorporate a more modern approach into the text. While our efforts pale by comparison to what they displayed in the classroom, we are building upon their foundation and, like fine wine, hope to improve with age. We can never thank them enough for permitting us to observe first-hand their introduction to life as an international tax lawyer.

Additional thanks is due Olugbenga Ishmael and Gabriella Olteanu who served as our research assistants in the course of the revision. Their assistance, rendered under less than ideal circumstances, improved the quality of the finished work.

The editorial staff at CCH, a Wolters Kluwer business was most helpful and professional. We especially thank Linda Barnich and Jennifer Schencker for their patience, diligence, and exacting attention to detail and their willingness to participate in a “triple loop” of the work.

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Chicago, Illinois

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Introduction

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 Brazil, 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 A, 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 C, a Swiss resident, invests in an interest bearing bank account in the United States or W 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 must be 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.⁷ A foreign corporation is any corporation which is not a United States corporation.⁸

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, 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

⁷ IRC § 7701(a)(4); Reg § 301.7701-5.

⁸ 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.⁹ 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.¹⁰

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 as well as 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 on a 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.¹¹

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.¹² Foreign individuals and corporations are subject to such tax only on income

⁹ 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*, CtCls, 74-1 USTC ¶ 9254, 492 F2d 798 (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).

¹⁰ 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.

¹¹ 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 chapters 5 and 13.

¹² 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.

effectively connected to the conduct of a trade or business in the United States and certain other specified income derived from United States sources.¹³ 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.¹⁴ 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).¹⁵

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.¹⁶ Thus, from a policy standpoint, the United States generally regards the country of income source as having the primary right to tax such income.¹⁷

¹³ IRC §§ 1, 11(d), 871, 881, 882, 1441, and 1442. 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.

¹⁴ IRC §§ 901–908. See discussion at chapter 6.

¹⁵ IRC § 904. This limitation is applied separately to passive and active types of foreign income. IRC § 904(d).

¹⁶ IRC § 906. See discussion at chapter 18.

¹⁷ 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

Certain Special Regimes

Because domestic 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. Entities subject to special tax rules for their United States owners are the Controlled Foreign Corporation and the Passive Foreign Investment Company.¹⁸

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.

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 the borders of the United States to foreign entities.¹⁹ Similarly, § 482 affords the Service a powerful tool to re-allocate income, deductions, and credits between related parties if those parties fail to deal with each other at arm's length.²⁰ These provisions are broad and fairly unforgiving checks on the

(Footnote Continued)

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 frequently address the availability of the foreign tax credit.

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

¹⁹ See discussion at chapters 9 and 20.

²⁰ See discussion at chapters 10 and 21.

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 2011-1²¹ 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.²² 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*.

²¹ 2011-1 CB 1.

²² See Rev. Proc. 2011-7, 2011-1 CB 233.

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, they are 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.

The World Becomes Geometric

As the number of commercial transactions involving international tax transactions has increased exponentially over the last decade, their depiction diagrammatically is replete with geometric symbols. Much of this is attributable to the check-the-box Regulations and the rise of hybrid entities, i.e., those which are treated for tax purposes by one jurisdiction as a separate entity (a corporation) and by the other jurisdiction as a conduit entity (a partnership, a branch, or a division).²³

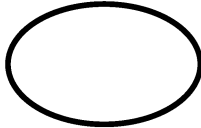

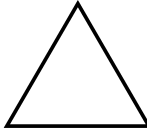
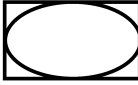
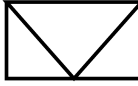
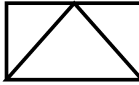
In the offices of international tax practitioners, typically on blackboards, whiteboards, computers, or power point presentations, the world of geometry comes alive as proposed structures are scrutinized, amended, rejected, or embraced. Thus, a mathematical language has arisen in which geometric symbols represent entities to be employed in the proposed transaction and their characterization for United States tax purposes.

As presented below, various geometric shapes, ranging from the oval to the triangle to the rectangle, represent the tax states of various enterprises. While the legend presented below is that which will be utilized in this treatise, it is imperative, particularly when working with foreign lawyers, that all are using the symbols consistently. For example, some European practitioners employ the oval to represent a permanent

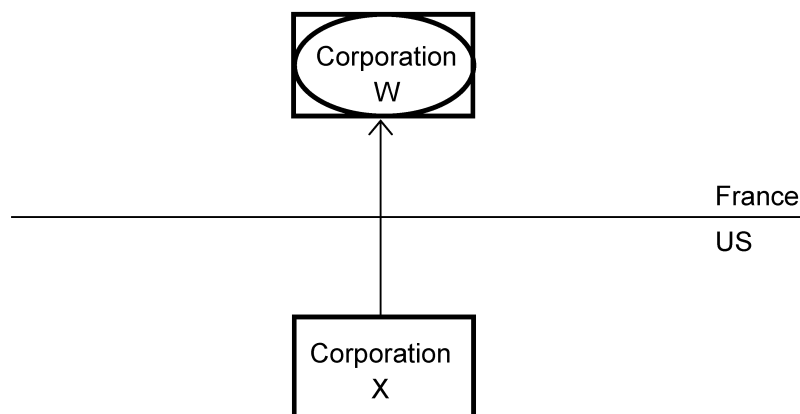
²³ See discussion at chapters 1 and 12.

establishment. From the perspective of a United States tax practitioner, the oval typically represents a branch or a division. While such can constitute a permanent establishment depending upon the governing facts and circumstances, not all constitute a permanent establishment. Thus, the cautious practitioner should start with some basic ground rules to which all parties agree regarding the meaning of the various geometric symbols which appear in the structure being considered.

The legend being employed in this treatise is as follows. It should be noted that these symbols appear nowhere in the Code or Regulations.

A, B, or C	Individual
	Branch
	Corporation
	Partnership
	Foreign corporation, but a disregarded entity (branch) for United States tax purposes
	Foreign corporation, but a partnership for United States tax purposes.
	Foreign partnership, but a corporation for United States tax purposes.

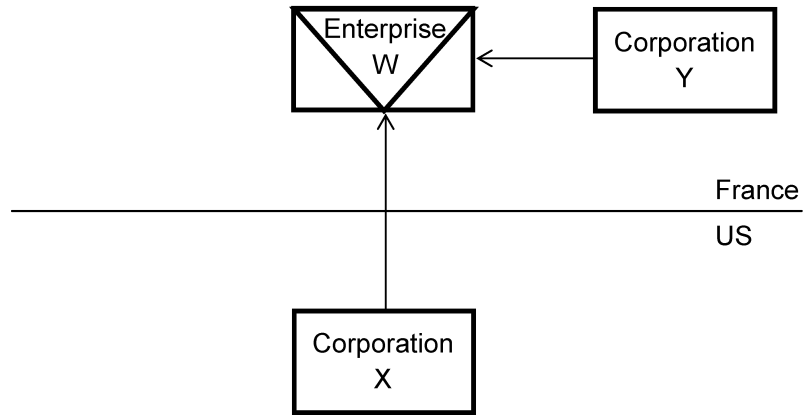
Typically, such symbols will not appear alone but will be accompanied by others. As a consequence, it is important to indicate the relevant jurisdictions involved. For example, if a domestic Corporation A formed a French subsidiary enterprise, Corporation W, which elected/defaulted to disregarded entity status, the diagrammatic presentation would appear as follows:



While not universally followed, it is frequently helpful to list the relevant jurisdictions on the separate sides of the delineation line between countries. Additionally, there is a growing preference in depicting hybrid partnership entities to point the triangle in the direction of the jurisdiction in which it is treated as a partnership.

For example, in the above-described transaction, if Corporation X had joined another French enterprise, Corporation Y, in forming Enterprise W and for United States tax purposes had elected to treat Enterprise W as a partnership, the transaction would appear as follows:

Introduction



By scrutinizing the diagram, the reader would conclude that Corporation X and Corporation Y formed an enterprise treated as a corporation for tax purposes by France but as a partnership by the United States.