International Taxation

Corporate and Individual

NINTH EDITION

Volume 1

Chapters 1–11

Philip Frederick Postlewaite
Professor of Law and
Director of the Graduate Tax Program
Northwestern University

Carolina Academic Press
Durham, North Carolina

ISBN 978-1-61163-625-3
Library of Congress Control Number 2014939598

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

And the seasons they go round and round
And the painted ponies go up and down
We're captive on the carousel of time
We can't return we can only look
Behind from where we came
And go round and round and round
In the circle game
. . .

And they tell him take your time it won't be long now
Till you drag your feet to slow the circles down.

The Circle Game
by Joni Mitchell

Instead of slowing it down,
with the help of family and friends,
I will try to outrun it.

PFP

Contents

Volume 1: Outbound

Preface xxi
Approach and Purpose xxi
Coverage xxii
Legislative Changes xxii
Abbreviations and Terms xxii
Relevant Dates and Reader Input xxiii
Acknowledgments xxiii

Introduction xxv
Overview xxv
Some Fundamental Questions xxv
Taxation of Domestic and Foreign Individuals and Corporations xxvi
Foreign Tax Credit xxvii
Certain Special Regimes xxvii
No Ruling Position of Service xxviii
The World Becomes Geometric xxix

Chapter 1 · Residency 3
§1.01 Overview of Taxing Structure for Domestic Individuals 3
§1.02 Overview of Taxing Structure for Domestic Corporations 4
§1.03 Residency Classification for Foreign Entities 6
§1.04 Citizenship 12
§1.05 Residency Classification of Individuals 12
§1.06 Green Card Test 13
§1.07 Substantial Presence Test 14
§1.08 Thirty-Day De Minimis Rule 15
§1.09 Tax-Home Exception 16
§1.10 Exempt and Other Special Categories of Individuals 17
§1.11 First-Year Residency Election 19
§1.12 Residency Commencement and Termination 20
§1.13 Split Taxable Years 22
§1.14 Residency and Tax Treaties 25
§1.15 Residency Elections of Sections 6013(g) and 6013(h) 25
§1.16 Advantages and Disadvantages of Resident Status 27

Chapter 2 · Source Rules 31
§2.01 Introduction 31
§2.02 Source Rules for Interest 33
§2.03 Exceptions to Interest Source Rule 36
§2.04 Source Rules for Dividends—Generally 38
§2.05 Dividends from United States Corporations 39

§2.06 Dividends from Foreign Corporations 39
§2.07 Source Rules for Personal Services Compensation 40
§2.08 Source Rules for Rents and Royalties 44
§2.09 The Cascading Royalties Problem 46
§2.10 Source Rules for Dispositions of United States Real Property Interests 48
§2.11 Source Rules for Sales of Personal Property 49
§2.12 Sales of Inventory Property 49
§2.13 Sales of Non-Inventory Property 53
§2.14 Underwriting Income, Social Security Benefits, and Income from Guaranty of Debt 58
§2.15 Section 862—Income from Sources Without the United States 58
§2.16 Sources of Income Not Specifically Covered by Sections 861 and 862 59
§2.17 Section 863(b)—Mixed Source Income 59
§2.18 International Communications Income 60
§2.19 Transactions Involving Computer Programs 61
§2.20 Source Rules for Other Income 63

Chapter 3 · The Section 911 Exclusion: Taxation of United States Citizens Working Abroad 65
§3.01 Taxation of Americans Abroad—Introduction 65
§3.02 Eligibility for the Section 911 Exclusion 67
§3.03 Tax Home Standard 69
§3.04 Bona Fide Residence Test 71
§3.05 Physical Presence Test 77
§3.06 The Foreign Source Earned Income Limitation: Section 911(b) Generally 79
§3.07 Deferred Payments 81
§3.08 Amounts Received from a Sole Proprietorship or Partnership 81
§3.09 Other Amounts 82
§3.10 Limitation on the Amount of the Exclusion 83
§3.11 Employer-Provided Housing Exclusion 84
§3.12 Self-Provided Housing 87
§3.13 Camps 87
§3.14 Computing the Foreign Earned Income Exclusion 88
§3.15 Election Procedures 92
§3.16 Services of Partners 92
§3.17 Tax Treaties 97
§3.18 Section 911 Exclusion and Marginal Rates 97

Chapter 4 · Export Sales 99
§4.01 Introduction 99
§4.02 Background of DISCs 101
§4.03 DISC Qualification Requirements—Generally 102
§4.04 Gross Receipts Requirement for DISCs 102
§4.05 Assets Requirement for DISCs 103
§4.06 Deficiency Distribution to Meet DISC Qualification Requirements 104
§4.07 Termination of DISC Election 104
§4.08 Pricing Rules for DISCs and Related Suppliers—Section 994 Allocation Yardstick 105
§4.09 Imputation of DISC Corporate Income to Shareholders 106
§4.10 Interest Charge on DISC-Related Deferred Tax Liability 107

§4.11 Division of DISC Earnings and Profits 108
§4.12 Taxation upon Disqualification of DISC Status or Sale of DISC Stock 109
§4.13 Interaction of DISC Rules with Other Rules 109
§4.14 Restrictions on DISC Utilization 110
§4.15 Requirements for FSC Status 110
§4.16 Effect of FSC Status—Overview 112
§4.17 FSC Rules After Repeal 114
§4.18 Overview of the ETI Exclusion 114
§4.19 Phase Out of ETI 115
§4.20 Section 199 Deduction: Income Attributable to Domestic Production Activities 116

Chapter 5 · Tax Treaties 121
§5.01 Overview 121
§5.02 Interpretive and Supplementary Materials 122
§5.03 Tax Treaties and Double Taxation 123
§5.04 Persons Eligible for Treaty Benefits 124
§5.05 Anti-Treaty Shopping Clauses 126
§5.06 Non-Discrimination Clauses 128
§5.07 Competent Authority Procedures 130
§5.08 The Taxation of Business Profits—Generally 133
§5.09 Fixed Place of Business 134
§5.10 Duration of Permanent Establishment 135
§5.11 Use of Another's Fixed Place of Business 135
§5.12 Use of Agents 136
§5.13 Dependent Agents 137
§5.14 Agents versus Purchasers 137
§5.15 Agents versus Lessees 137
§5.16 Scope of Business Profits Article 137
§5.17 Business Profits Attributable to a Permanent Establishment 139
§5.18 Dependent Personal Services—Employees 141
§5.19 Independent Personal Services—Independent Contractors 142
§5.20 Students, Teachers, and Apprentices 143
§5.21 Artists and Athletes 143
§5.22 Passive Income 144
§5.23 Partnerships and LLCs in the Treaty Context 147

Chapter 6 · Foreign Tax Credit 151
§6.01 Introduction 151
§6.02 Credit versus Deduction 152
§6.03 Timing of the Credit: Section 905 154
§6.04 Persons Eligible to Take the Credit 157
§6.05 Creditable Taxes—General Principles 158
§6.06 Requirements for Credit 171
§6.07 Taxes on Business Income 175
§6.08 Taxes on Dividends, Interest, and Other Passive Income 179
§6.09 Taxes on Compensation 179
§6.10 Separate Levies 180
§6.11 Taxes In Lieu Of Income Taxes: Section 903 181
§6.12 Denial of Credit for Taxes Paid to Certain Countries 183

§6.13 Corporations Eligible to Utilize the Foreign Tax Credit—Domestic Stockholders in Foreign Corporations: Section 902 184
§6.14 Calculating the Taxes Deemed Paid by Domestic Corporations 187
§6.15 Section 78 Gross-Up 190
§6.16 Additional Issues Arising Under Section 902 191
§6.17 Section 904 Limitation Upon the Amount of Taxes Which May Be Credited—In General 191
§6.18 Separate Computations of the Overall Section 904 Limitation 195
§6.19 Two Variations on the Section 904 Limitation: Capital Gains and Losses 198
§6.20 Carryback and Carryover of Excess Taxes Paid: Section 904(c) 200
§6.21 Recapture of Foreign Losses: Section 904(f) 202
§6.22 Reduction of Credit for International Boycott Involvement: Section 908 209
§6.23 Dividends-Received Deduction—Generally 210
§6.24 Deduction for Dividends Received from Domestic Corporations 210
§6.25 Deduction for Dividends Received from Foreign Corporations 211
§6.26 Allocation and Apportionment of Expenses by United States Persons—In General 213
§6.27 Allocation Process 214
§6.28 Apportionment Process 215
§6.29 Interest Expense 216
§6.30 Research and Development Expenses 218
§6.31 Other Expenses 219
§6.32 Affiliated Groups 221

Chapter 7 · Controlled Foreign Corporations 223
§7.01 Introduction 224
§7.02 Advantages of Tax Deferral 225
§7.03 Intent Behind the Controlled Foreign Corporation (CFC) Provisions 226
§7.04 Overview of the Controlled Foreign Corporation Provisions 226
§7.05 United States Ownership Standard 227
§7.06 Stock Ownership for Purposes of Controlled Foreign Corporation Status: Section 958 231
§7.07 Modification to Controlled Foreign Corporation Status 234
§7.08 Amount of Imputed Income—In General 234
§7.09 Determining Ownership for Purposes of Income Inclusion: Section 958(a) 235
§7.10 Section 951 Inclusion and Computation: Basic Categories—In General 237
§7.11 Pro Rata Amount of Subpart F Income 238
§7.12 Subpart F Income—Generally 240
§7.13 Income from the Insurance of Foreign Risks 241
§7.14 Foreign Base Company Income—Generally 244
§7.15 Foreign Personal Holding Company Income 244
§7.16 Foreign Base Company Sales Income—In General 247
§7.17 Foreign Base Company Sales Income—Exempt Manufacturing and Same-Country Activities 250
§7.18 Branch Activity: Special Rules 254
§7.19 Foreign Base Company Services Income 258
§7.20 Foreign Base Company Oil Related Income 259

§7.21 Allocation of Deductions to Base Company Income: Rules and Limitations 260
§7.22 Special Exceptions to Foreign Base Company Income 260
§7.23 De Minimis and Full Inclusion Rules 261
§7.24 High-Taxed Income Exception 261
§7.25 Policy-Based Subpart F Categories: Amounts Attributable to International Boycotts, Foreign Bribes, and Restricted Countries 262
§7.26 Earnings and Profits Limitation on Subpart F Income 263
§7.27 Investment in United States Property 264
§7.28 Definition of United States Property 267
§7.29 Basis Adjustments—Increases 270
§7.30 Basis Adjustments—Decreases 271
§7.31 Exclusions from Gross Income—Previously-Taxed Earnings and Profits 271
§7.32 Earnings and Profits 273
§7.33 Priority Rules for Distributions 273
§7.34 Shareholder Taxation as a Domestic Corporation—Section 962 Election 274
§7.35 Controlled Foreign Corporation Interaction with the Foreign Tax Credit—Section 902 Implications 275
§7.36 Section 904 Implications 278
§7.37 Denial of Section 164 Deduction Where Section 960 Is Utilized 279
§7.38 Interaction of the CFC Provisions with Other Code Provisions 279
§7.39 Taxable Year of a Controlled Foreign Corporation 280
§7.40 Dispositions of Stock in Controlled Foreign Corporations—Section 1248 281
§7.41 Shareholders and Transactions Subject to Section 1248 282
§7.42 Transactions Exempt from Section 1248 284
§7.43 General Limitation on Amount of Gain Recaptured 284
§7.44 Controlled Foreign Corporation Earnings and Profits and Recapture Limitation 285
§7.45 Limitation on Individual Tax Liability: Basic Formula 286
§7.46 First Component of Individual Tax Liability Limitation 286
§7.47 Second Component of Individual Tax Liability Limitation 287

Chapter 8 · Passive Foreign Investment Companies and Other Anti-Deferral Measures 289
§8.01 Introduction 290
§8.02 Tax Consequences of Passive Foreign Investment Company (PFIC) Status—Sections 1291, 1293, and 1296 Regimes 291
§8.03 Pedigreed, Unpedigreed, and Non-Qualifying Funds 293
§8.04 Classification of a Passive Foreign Investment Company: The Passive Income and Passive Assets Tests 294
§8.05 Exceptions to Passive Foreign Investment Company Status 299
§8.06 Section 1291 Tax and Interest Regime—Excess Distributions and Dispositions 299
§8.07 Mechanics of Section 1291 302
§8.08 Deferred Tax Amount 304
§8.09 Taxation of Non-Recognition Transactions 305

§8.10 Removing the Section 1291 Taint—In General 306
§8.11 Deemed Sale Election 306
§8.12 Deemed Dividend Election 307
§8.13 Qualifying Electing Fund (QEF) Regime: Current Inclusion and Taxation of PFIC Earnings 308
§8.14 QEF Election 309
§8.15 Current Section 1293 Taxation of United States Shareholders Electing QEF Status 310
§8.16 Special Exclusions for Non-Tax Haven Income 311
§8.17 Persons Taxable 312
§8.18 Safeguards Against Double Taxation of PFIC Earnings 314
§8.19 Deemed Paid Credit 315
§8.20 Election to Extend Time for Payment of Tax on Section 1293 Imputed Income 315
§8.21 Annual Reporting Requirements for PFIC Shareholders 316
§8.22 Special Characterization and Basis Rules for PFIC Stock 317
§8.23 Co-Ordination of the PFIC Provisions and the Foreign Tax Credit Rules 318
§8.24 Interaction of Passive Foreign Investment Company Provisions and Other Code Sections 319
§8.25 Anti-Deferral and the Accumulated Earnings Tax on Foreign Corporations 319

Chapter 9 · Section 367: Outbound Transfers of Property 323
§9.01 Introduction 323
§9.02 Outbound Property Transfers: General Principles of Section 367(a) 324
§9.03 Gain Recognized Under Section 367(a) 325
§9.04 Active Trade or Business Exception to Section 367(a)—In General 326
§9.05 Leased Property 328
§9.06 Property Expected to be Sold or Disposed of by Transferee 329
§9.07 Foreign Branch Loss Recapture Provisions 330
§9.08 Outbound Transfers of Foreign Corporate Stock or Securities 333
§9.09 Outbound Transfers of Domestic Corporate Stock or Securities 338
§9.10 Transfers of Intangible Assets 339
§9.11 Treatment of Transfers of Foreign Transferee Stock as Sale of Intangible Property 341
§9.12 Dispositions of Transferred Intangible Property 344
§9.13 Election to Treat Intangible Asset Transfer as a Sale 344
§9.14 Anti-Abuse Rule 345
§9.15 Interaction Between Sections 367(d) and 482 346
§9.16 Partnerships and Section 367 346
§9.17 Outbound Transfers of Depreciated Property 348
§9.18 Contributions to Capital 348
§9.19 Divisive Reorganizations: Section 355 Transactions 349
§9.20 Section 332 Liquidations of Domestic Subsidiaries 350

Chapter 10 · Section 482: International Transactions Among Related Parties—Outbound 353
§10.01 Introduction—Section 482 354
§10.02 International Transactions and Section 482 354

§ 10.03 Common Control Standard 355
§ 10.04 Arm's-Length Standard 356
§ 10.05 Comparability 358
§ 10.06 Factors Considered in Assessing Comparability 358
§ 10.07 Special Circumstances 361
§ 10.08 Scope of Review under Section 482 362
§ 10.09 Limitations on Section 482: The Arm's-Length Range 363
§ 10.10 Primary and Correlative Adjustments 364
§ 10.11 Setoff Adjustments 364
§ 10.12 Conforming Adjustments 365
§ 10.13 Blocked Income 366
§ 10.14 Choice of the Best Method 367
§ 10.15 Sales of Tangible Property—In General 369
§ 10.16 Comparable Uncontrolled Price (CUP) Method 369
§ 10.17 Resale Price Method 371
§ 10.18 Cost Plus Method 372
§ 10.19 Comparable Profits Method (CPM) 374
§ 10.20 Profit Split Method 376
§ 10.21 Unspecified Methods 378
§ 10.22 Use of Tangible Property 378
§ 10.23 Transfers and Licenses of Intangible Property 379
§ 10.24 Ownership of Intangible Property 380
§ 10.25 Comparable Uncontrolled Transaction (CUT) Method 381
§ 10.26 Unspecified Methods in Intangible Property Transactions 382
§ 10.27 Form and Amount of Consideration 383
§ 10.28 Periodic Adjustments for Multi-Year Arrangements 384
§ 10.29 Intangible Property Embedded in Tangible Property 385
§ 10.30 Cost Sharing Arrangements for Intangible Property 386
§ 10.31 Provision of Services 390
§ 10.32 Loans or Advances—In General 391
§ 10.33 Interest Charge Period 392
§ 10.34 Application of Payments 394
§ 10.35 Rate of Interest 394
§ 10.36 Co-Ordination with Other Code Sections 395
§ 10.37 Effects of Section 482 on the Foreign Tax Credit 396
§ 10.38 Accuracy Related Penalties 396
§ 10.39 Tax Treaties and Section 482 397
§ 10.40 Co-ordination of Section 482 and Foreign Taxing Jurisdiction: Competent Authority and Statute of Limitations Issues 397
§ 10.41 Advance Pricing Agreements (APAs) 398
§ 10.42 Relief under Revenue Procedure 99-32 400

Chapter 11 · International Partnerships and Partners—Outbound Considerations 403
§ 11.01 Overview of International Partnerships 403
§ 11.02 Definition 404
§ 11.03 Aggregate versus Entity Theory in Partnerships 405
§ 11.04 Organization of Coverage 406
§ 11.05 Introduction to Classification Issues 407

§ 11.06 Classification of Partnerships in General 407
§ 11.07 Classification of Foreign Partnerships and Foreign Limited Liability Companies 410
§ 11.08 International Consequences of Classification 411
§ 11.09 Anti-Abuse Rule 413
§ 11.10 Gain/Loss Recognition on Contribution of Property to a Foreign Partnership by a Domestic Partner 416
§ 11.11 Reporting Requirements 417
§ 11.12 Determination of Income Source for Citizen and Resident Partners 418
§ 11.13 Partnerships and the Foreign Tax Credit 424
§ 11.14 Dispositions of Partnership Interest by Domestic Partners 428
§ 11.15 Overview of Tax Treaties 432
§ 11.16 Residence and Treaty Coverage 433
§ 11.17 Section 367 and Partnerships 435

Appendix A · United States Model Income Tax Convention of November 15, 2006 439

Appendix B · United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006 463

Statutes 543
Treasury Regulations 562
Revenue Rulings 584
Revenue Procedures 588
Private Letter Rulings 589
Technical Advice Memoranda 591
General Counsel Memoranda 592
Notices 593
Table of Cases 594
Index 606

Volume 2: Inbound

Preface xxi
Approach and Purpose xxi
Coverage xxii
Legislative Changes xxii
Abbreviations and Terms xxii
Relevant Dates and Reader Input xxiii
Acknowledgments xxiii

Introduction xxv
Overview xxv
Some Fundamental Questions xxv
Taxation of Domestic and Foreign Individuals and Corporations xxvi
Foreign Tax Credit xxvii
Certain Special Regimes xxvii
No Ruling Position of Service xxviii
The World Becomes Geometric xxix

Chapter 12 · Non-Residency 3
§ 12.01 Overview of Taxing Structure for Non-Resident Individuals 3
§ 12.02 Overview of Taxing Structure for Foreign Corporations 4
§ 12.03 Residency Classification for Foreign Entities 4
§ 12.04 Citizenship 10
§ 12.05 Residency Classification of Individuals 10
§ 12.06 Green Card Test 11
§ 12.07 Substantial Presence Test 12
§ 12.08 Thirty-Day De Minimis Rule 13
§ 12.09 Tax-Home Exception 13
§ 12.10 Exempt and Other Special Categories of Individuals 15
§ 12.11 First-Year Residency Election 17
§ 12.12 Residency Commencement and Termination 18
§ 12.13 Split Taxable Years 20
§ 12.14 Residency and Tax Treaties 23
§ 12.15 Residency Elections of Sections 6013(g) and 6013(h) 23
§ 12.16 Advantages and Disadvantages of Resident Status 25

Chapter 13 · Tax Treaties—An Overview 29
§ 13.01 Overview 29
§ 13.02 Negotiation of Treaties 29
§ 13.03 Ratification of Treaties 30
§ 13.04 Interpretive and Supplementary Materials 32
§ 13.05 Tax Treaties and Double Taxation 32
§ 13.06 Relationship of Tax Treaties to United States Federal Law 34
§ 13.07 Persons Eligible for Treaty Benefits 37
§ 13.08 Saving Clauses 39
§ 13.09 Anti-Treaty Shopping Clauses 40
§ 13.10 Non-Discrimination Clauses 43
§ 13.11 Competent Authority Procedures 45
§ 13.12 Exchange of Information and Enforcement of Tax Claims 49

Chapter 14 · Tax Treaties and Business Income 51
§ 14.01 The Taxation of Business Profits — Generally 51
§ 14.02 Carrying On a United States Business 52
§ 14.03 Fixed Place of Business 52
§ 14.04 Duration of Permanent Establishment 55
§ 14.05 Use of Another's Fixed Place of Business 56
§ 14.06 Use of Agents 56
§ 14.07 Dependent Agents 57
§ 14.08 Agents versus Purchasers 58
§ 14.09 Agents versus Lessees 58
§ 14.10 Scope of Business Profits Article 59
§ 14.11 Business Profits Attributable to a Permanent Establishment 60
§ 14.12 Determination of Income Attributable to a Permanent Establishment 61
§ 14.13 Allocation and Apportionment of Expenses to a Permanent Establishment 64
§ 14.14 Waiver of Business Profits Article Protection 66
§ 14.15 Tax Treaties and the Branch Profits Taxes 66
§ 14.16 The Branch Profits Tax on Earnings 67

§ 14.17 The Branch Profits Taxes on Interest 69
§ 14.18 Qualified Residents 69
§ 14.19 Tax Treaties and Section 482 70
§ 14.20 Dependent Personal Services — Employees 71
§ 14.21 Independent Personal Services — Independent Contractors 73
§ 14.22 Students, Teachers, and Apprentices 75
§ 14.23 Artists and Athletes 76

Chapter 15 · Tax Treaties and Passive Income 77
§ 15.01 Introduction 77
§ 15.02 Dividends 78
§ 15.03 Distributions Which Are Not Dividends 79
§ 15.04 Interest 80
§ 15.05 Treaty Exemptions versus Portfolio Interest Exception 82
§ 15.06 Royalties 82
§ 15.07 Cascading Royalties 83
§ 15.08 Gains from the Disposition of Property 85
§ 15.09 Income from Real Property 86
§ 15.10 Private Pensions 86
§ 15.11 Social Security Benefits and Other Public Pensions 87
§ 15.12 Annuities 87
§ 15.13 Alimony and Child Support 87
§ 15.14 Residual Income Clauses 88
§ 15.15 Passive Income and the Use of Partnerships and Limited Liability Companies 88
§ 15.16 Computation of United States Tax Liability under a Tax Treaty 97
§ 15.17 Disclosure of Treaty-Based Return Positions 98

Chapter 16 · Source Rules 101
§ 16.01 Introduction 101
§ 16.02 Source Rules for Interest 104
§ 16.03 Exceptions to Interest Source Rule 106
§ 16.04 Source Rules for Dividends—Generally 108
§ 16.05 Dividends from United States Corporations 109
§ 16.06 Dividends from Foreign Corporations 110
§ 16.07 Source Rules for Personal Services Compensation 111
§ 16.08 Source Rules for Rents and Royalties 115
§ 16.09 The Cascading Royalties Problem 118
§ 16.10 Source Rules for Dispositions of United States Real Property Interests 120
§ 16.11 Source Rules for Sales of Personal Property 121
§ 16.12 Sales of Inventory Property 121
§ 16.13 Sales of Non-Inventory Property 125
§ 16.14 Underwriting Income, Social Security Benefits, and Income from Guaranty of Debt 130
§ 16.15 Section 862—Income from Sources Without the United States 130
§ 16.16 Sources of Income Not Specifically Covered by Sections 861 and 862 131
§ 16.17 Section 863(b)—Mixed Source Income 132
§ 16.18 International Communications Income 133
§ 16.19 Transactions Involving Computer Programs 133
§ 16.20 Source Rules for Other Income 135

Chapter 17 · Trade or Business Status 137
§17.01 Introduction 137
§17.02 Trade or Business Status—Generally 138
§17.03 Performance of Services 140
§17.04 De Minimis Exception for Nominal Services 141
§17.05 Real Property 142
§17.06 Election to Tax Real Property Income on a Net Basis 143
§17.07 Dispositions of United States Real Property Interests 144
§17.08 Sales Activity 145
§17.09 Purchasing Activity 147
§17.10 Representative Office Activity 148
§17.11 Stewardship Activities of Foreign Parent Companies 149
§17.12 Board Meetings 149
§17.13 Oil and Gas Activity 150
§17.14 Pass Through Entities: Partnerships 150
§17.15 Use of Dependent and Independent Agents 151
§17.16 Licensees and Lessees 151
§17.17 Trading in Stocks and Securities 152
§17.18 Trading via United States Residents 153
§17.19 Trading for Own Account 153
§17.20 Real Property Interests 155
§17.21 Common Law Exemption for Trading in Stocks and Securities 156
§17.22 Trading in Commodities 157
§17.23 Common Law Exemption for Trading in Commodities 158
§17.24 Trading via Partnerships 158
§17.25 No Rulings Policy 159

Chapter 18 · Taxation of Foreign Persons 161
§18.01 General Taxing Pattern Applicable to Foreign Persons 161
§18.02 Taxation of Non-Resident Individuals 161
§18.03 Taxation of Foreign Corporations 163
§18.04 Income Described in Sections 871(a) and 881(a)—In General 165
§18.27 Interest Expense of Foreign Corporations 169
§18.28 Earnings Stripping Limitation on Interest 171
§18.29 Research and Development Expenses 172
§18.30 Other Expenses 173
§18.31 Affiliated Groups 175
§18.32 Tax Treaties 176
§18.33 Availability of the Foreign Tax Credit 177
§18.34 Expatriation 178
§18.35 Relationship of Section 877 to Tax Treaties 181
§18.36 Branch Profits Taxes—In General 184
§18.37 Branch Profits Tax on the Dividend Equivalent Amount 185

Chapter 19 · Dispositions of Investments in United States Real Property 187
§19.01 Background 187
§19.02 Congressional Response 189
§19.03 Section 897: Tax Consequences of Treating Income as Effectively Connected to a United States Trade or Business 191
§19.04 Direct Investment in United States Real Property 192

§19.05 United States Real Property Interests 192
§19.06 Dispositions 195
§19.07 Indirect Investment—Interests Held Through Domestic Corporations 196
§19.08 United States Real Property Holding Corporations 197
§19.09 Indirect Investment—Interests Held Through Foreign Corporations 200
§19.10 Distributions by Foreign Corporations 201
§19.11 Co-Ordination of Section 897 with Non-Recognition Rules 203
§19.12 Relationship of Section 897 to Tax Treaties 206
§19.13 Planning Under Section 897 208

Chapter 20 · Section 367: Inbound Transfers of Property 209
§20.01 Introduction 209
§20.02 Formation of Domestic Corporations by Foreign Transferors 210
§20.03 Inbound Reorganizations: Domestic Acquisitions of Foreign Corporations 211
§20.04 Triangular Reorganizations 214
§20.05 Section 332 Liquidations of Foreign Subsidiaries by Domestic Parents 215
§20.06 Foreign-to-Foreign Contributions, Reorganizations, and Liquidations 217
§20.07 Divisive Reorganizations: Section 355 Transactions 221

Chapter 21 · Section 482: International Transactions Among Related Parties—Inbound 225
§21.01 Introduction—Section 482 226
§21.02 International Transactions and Section 482 226
§21.03 Common Control Standard 227
§21.04 Arm's-Length Standard 228
§21.05 Comparability 230
§21.06 Factors Considered in Assessing Comparability 230
§21.07 Special Circumstances 233
§21.08 Scope of Review under Section 482 234
§21.09 Limitations on Section 482: The Arm's-Length Range 235
§21.10 Primary and Correlative Adjustments 236
§21.11 Setoff Adjustments 236
§21.12 Conforming Adjustments 237
§21.13 Choice of the Best Method 237
§21.14 Sales of Tangible Property—In General 239
§21.15 Comparable Uncontrolled Price (CUP) Method 240
§21.16 Resale Price Method 242
§21.17 Cost Plus Method 243
§21.18 Comparable Profits Method (CPM) 245
§21.19 Profit Split Method 246
§21.20 Unspecified Methods 249
§21.21 Use of Tangible Property 249
§21.22 Transfers and Licenses of Intangible Property 250
§21.23 Ownership of Intangible Property 251
§21.24 Comparable Uncontrolled Transaction (CUT) Method 252
§21.25 Unspecified Methods in Intangible Property Transactions 253
§21.26 Form and Amount of Consideration 254
§21.27 Periodic Adjustments for Multi-Year Arrangements 255

§21.28 Intangible Property Embedded in Tangible Property 256
§21.29 Cost Sharing Arrangements for Intangible Property 257
§21.30 Provision of Services 261
§21.31 Loans or Advances—In General 262
§21.32 Interest Charge Period 263
§21.33 Application of Payments 264
§21.34 Rate of Interest 264
§21.35 Co-ordination with Other Code Sections 265
§21.36 Co-ordination with Customs Pricing and Accuracy Related Penalties 266
§21.37 Tax Treaties and Section 482 267
§21.38 Co-ordination of Section 482 and Foreign Taxing Jurisdiction: Competent Authority and Statute of Limitations Issues 267
§21.39 Advance Pricing Agreements (APAs) 268

Chapter 22 · International Partnerships and Partners—Inbound Considerations 271
§22.01 Overview of International Partnerships 272
§22.02 Definition 272
§22.03 Aggregate v. Entity Theory of Partnerships 273
§22.04 Organization of Coverage 275
§22.05 Introduction to Classification Issues 276
§22.06 Classification of Partnerships in General 277
§22.07 Classification of Foreign Partnerships and Foreign Limited Liability Companies 280
§22.08 International Consequences of Classification 285
§22.09 Anti-Abuse Rule 286
§22.10 Gain/Loss Recognition on Contribution of Property to a Domestic Partnership by a Foreign Partner 288
§22.11 Liability Relief 288
§22.12 Contribution of Services 291
§22.13 Contribution of United States Real Property Interests 292
§22.14 Foreign Partners Engaged in Domestic Trade or Business 294
§22.15 Sales Partnerships and Trade or Business Standard 295
§22.16 Realty Partnerships and Trade or Business Standard 297
§22.17 Investment and Trading Partnerships and Trade or Business Standard 297
§22.18 Treaty Exceptions 299
§22.19 Determination of Income Source for Non-Resident Partners 301
§22.20 Sale of Property by a Partner to a Partnership 306
§22.21 Partnerships and the Foreign Tax Credit—Foreign Partners 307
§22.22 Current Distributions to a Foreign Partner—Generally 308
§22.23 Traditional Property Distributions to Foreign Partners 308
§22.24 Distributions of Section 751 Property or United States Real Property Interests to Foreign Partners 309
§22.25 Dispositions of Partnership Interests by Foreign Partners—Generally 310
§22.26 Dispositions Not Involving Section 751 or Section 897 Property 310
§22.27 Dispositions Involving Section 751 Property 314
§22.28 Dispositions Involving Section 897 Property 314
§22.29 Treaty Considerations 315
§22.30 Absence of Domestic Trade or Business 315
§22.31 Overview of Tax Treaties 316

§22.32 Residence and Treaty Coverage 318
§22.33 Hybrid Entities and Tax Treaty Entities 320
§22.34 No Ruling Policy 323
§22.35 Imputation of Permanent Establishment 324
§22.36 Disposition of a Partnership Interest 325

Appendix C · Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital 327

Appendix D · Treasury Department Technical Explanation of the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Signed at Washington, D.C. on September 26, 1980, as Amended by the Protocol Signed at Ottawa on June 14, 1983 and the Protocol Signed at Washington on March 28, 1984 367

Appendix E · Department of the Treasury Technical Explanation of The Protocol Done at Chelsea on September 21, 2007 Amending the Convention Between The United States of America and Canada with Respect to Taxes on Income and on Capital Done at Washington on September 26, 1980, as Amended by the Protocols Done on June 14, 1983, March 28, 1994, March 17, 1995, and July 29, 1997 461

Statutes 525
Treasury Regulations 544
Revenue Rulings 566
Revenue Procedures 570
Private Letter Rulings 571
Technical Advice Memoranda 573
General Counsel Memoranda 574
Notices 575
Table of Cases 576
Index 588

Preface

Approach and Purpose

The author intends 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 international 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 author's 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 author has 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.

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

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.*

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.

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 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 July 31, 2013. 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

The author thanks 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 I was introduced to the intersection of geometry and international taxation. As a consequence, I have attempted in the Ninth Edition to incorporate a more modern approach into the text. While my efforts pale by comparison to what they displayed in the classroom, I am building upon their foundation and, like fine wine, hope to improve with age. I can never thank them enough for permitting me to observe first-hand their introduction to life as an international tax lawyer.

Additional thanks is due to Stephanie Hoffer for her co-authorship assistance on the Sixth Edition, and to Olugbenga Ishmael and Gabriella Olteanu, who served as 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. I 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.

Philip F. Postlewaite
Chicago, Illinois

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.[1] A foreign corporation is any corporation which is not a United States corporation.[2]

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 general corporation law of one of the 50 states or that of a foreign country.[3] 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.[4]

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.[5]

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.[6] Foreign individuals and corporations are sub-

1. IRC §7701(a)(4); Reg §301.7701-5.

2. IRC §7701(a)(5); Reg §301.7701-5. See discussion at chapter 1.

3. 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).

4. 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.

5. 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.

6. 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.

ject 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.[7] 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.[8] 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).[9]

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.[10] Thus, from a policy standpoint, the United States generally regards the country of income source as having the primary right to tax such income.[11]

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

---

7. 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.

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

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

10. IRC §906. See discussion at chapter 18.

11. 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 frequently address the availability of the foreign tax credit.

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.[12]

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.[13] 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.[14] 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 2011-1[15] 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.[16] 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

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

13. See discussion at chapters 9 and 20.

14. See discussion at chapters 10 and 21.

15. 2011-1 CB 1.

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

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*.

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

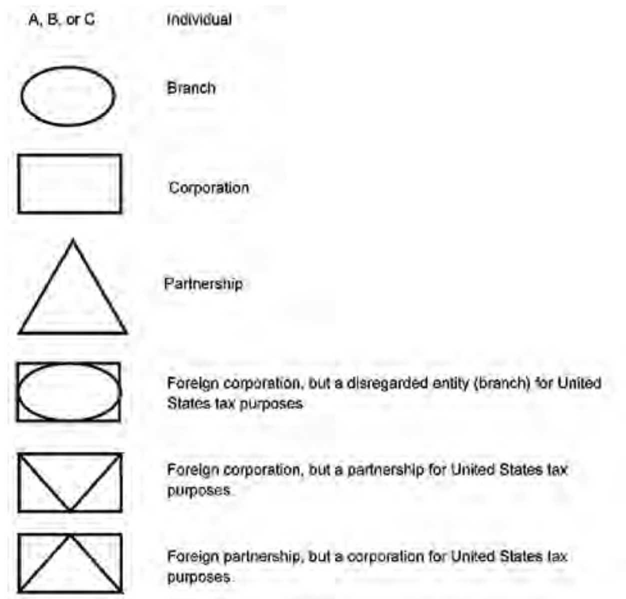
As the number of commercial transactions involving international tax transactions has increased exponentially over the last decade, their depiction diagrammatically is replete with geometric symbols. Much of this is attributable to the check-the-box Regulations and the rise of hybrid entities, i.e., 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).[17]

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.

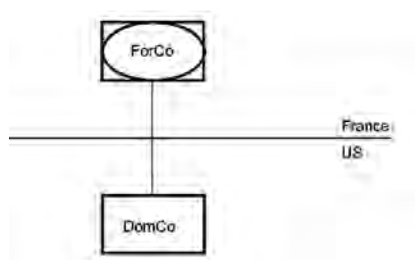
As presented below, various geometric shapes, ranging from the oval to the triangle to the rectangle, represent the tax states of various enterprises. While the legend presented below is that which will be utilized in this treatise, it is imperative, particularly when working with foreign lawyers, that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

17. See discussion at chapters 1 and 12.

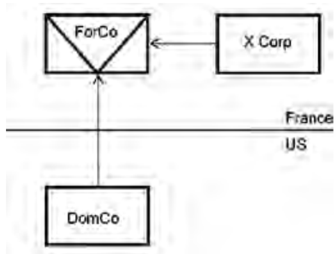


Typically, such symbols will not appear alone but will be accompanied by others. As a consequence, it is important to indicate the relevant jurisdictions involved. For example, if a domestic Corporation A formed a French subsidiary enterprise, Corporation W, which elected/defaulted to disregarded entity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



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.

International Taxation
Corporate and Individual

NINTH EDITION

Volume 2
Chapters 12–22

Philip Frederick Postlewaite
Professor of Law and
Director of the Graduate Tax Program
Northwestern University

Carolina Academic Press
Durham, North Carolina

ISBN 978-1-61163-625-3
Library of Congress Control Number 2014939598

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

They paved paradise
And put up a parking lot
With a pink hotel, a boutique
And a swinging hot spot

Don't it always seem to go
That you don't know what you've got
Till it's gone
They paved paradise
And put up a parking lot

Big Yellow Taxi
by Joni Mitchell

To
Northwestern Law School
For giving me a chance!

PFP

Contents

Volume 1: Outbound

Preface xxi
Approach and Purpose xxi
Coverage xxii
Legislative Changes xxii
Abbreviations and Terms xxii
Relevant Dates and Reader Input xxiii
Acknowledgments xxiii

Introduction xxv
Overview xxv
Some Fundamental Questions xxv
Taxation of Domestic and Foreign Individuals and Corporations xxvi
Foreign Tax Credit xxvii
Certain Special Regimes xxvii
No Ruling Position of Service xxviii
The World Becomes Geometric xxix

Chapter 1 · Residency 3
§1.01 Overview of Taxing Structure for Domestic Individuals 3
§1.02 Overview of Taxing Structure for Domestic Corporations 4
§1.03 Residency Classification for Foreign Entities 6
§1.04 Citizenship 12
§1.05 Residency Classification of Individuals 12
§1.06 Green Card Test 13
§1.07 Substantial Presence Test 14
§1.08 Thirty-Day De Minimis Rule 15
§1.09 Tax-Home Exception 16
§1.10 Exempt and Other Special Categories of Individuals 17
§1.11 First-Year Residency Election 19
§1.12 Residency Commencement and Termination 20
§1.13 Split Taxable Years 22
§1.14 Residency and Tax Treaties 25
§1.15 Residency Elections of Sections 6013(g) and 6013(h) 25
§1.16 Advantages and Disadvantages of Resident Status 27

Chapter 2 · Source Rules 31
§2.01 Introduction 31
§2.02 Source Rules for Interest 33
§2.03 Exceptions to Interest Source Rule 36
§2.04 Source Rules for Dividends—Generally 38
§2.05 Dividends from United States Corporations 39

§2.06 Dividends from Foreign Corporations 39
§2.07 Source Rules for Personal Services Compensation 40
§2.08 Source Rules for Rents and Royalties 44
§2.09 The Cascading Royalties Problem 46
§2.10 Source Rules for Dispositions of United States Real Property Interests 48
§2.11 Source Rules for Sales of Personal Property 49
§2.12 Sales of Inventory Property 49
§2.13 Sales of Non-Inventory Property 53
§2.14 Underwriting Income, Social Security Benefits, and Income from Guaranty of Debt 58
§2.15 Section 862—Income from Sources Without the United States 58
§2.16 Sources of Income Not Specifically Covered by Sections 861 and 862 59
§2.17 Section 863(b)—Mixed Source Income 59
§2.18 International Communications Income 60
§2.19 Transactions Involving Computer Programs 61
§2.20 Source Rules for Other Income 63

Chapter 3 · The Section 911 Exclusion: Taxation of United States Citizens Working Abroad 65
§3.01 Taxation of Americans Abroad—Introduction 65
§3.02 Eligibility for the Section 911 Exclusion 67
§3.03 Tax Home Standard 69
§3.04 Bona Fide Residence Test 71
§3.05 Physical Presence Test 77
§3.06 The Foreign Source Earned Income Limitation: Section 911(b) Generally 79
§3.07 Deferred Payments 81
§3.08 Amounts Received from a Sole Proprietorship or Partnership 81
§3.09 Other Amounts 82
§3.10 Limitation on the Amount of the Exclusion 83
§3.11 Employer-Provided Housing Exclusion 84
§3.12 Self-Provided Housing 87
§3.13 Camps 87
§3.14 Computing the Foreign Earned Income Exclusion 88
§3.15 Election Procedures 92
§3.16 Services of Partners 92
§3.17 Tax Treaties 97
§3.18 Section 911 Exclusion and Marginal Rates 97

Chapter 4 · Export Sales 99
§4.01 Introduction 99
§4.02 Background of DISCs 101
§4.03 DISC Qualification Requirements—Generally 102
§4.04 Gross Receipts Requirement for DISCs 102
§4.05 Assets Requirement for DISCs 103
§4.06 Deficiency Distribution to Meet DISC Qualification Requirements 104
§4.07 Termination of DISC Election 104
§4.08 Pricing Rules for DISCs and Related Suppliers—Section 994 Allocation Yardstick 105
§4.09 Imputation of DISC Corporate Income to Shareholders 106
§4.10 Interest Charge on DISC-Related Deferred Tax Liability 107

§4.11 Division of DISC Earnings and Profits 108
§4.12 Taxation upon Disqualification of DISC Status or Sale of DISC Stock 109
§4.13 Interaction of DISC Rules with Other Rules 109
§4.14 Restrictions on DISC Utilization 110
§4.15 Requirements for FSC Status 110
§4.16 Effect of FSC Status—Overview 112
§4.17 FSC Rules After Repeal 114
§4.18 Overview of the ETI Exclusion 114
§4.19 Phase Out of ETI 115
§4.20 Section 199 Deduction: Income Attributable to Domestic Production Activities 116

Chapter 5 · Tax Treaties 121
§5.01 Overview 121
§5.02 Interpretive and Supplementary Materials 122
§5.03 Tax Treaties and Double Taxation 123
§5.04 Persons Eligible for Treaty Benefits 124
§5.05 Anti-Treaty Shopping Clauses 126
§5.06 Non-Discrimination Clauses 128
§5.07 Competent Authority Procedures 130
§5.08 The Taxation of Business Profits—Generally 133
§5.09 Fixed Place of Business 134
§5.10 Duration of Permanent Establishment 135
§5.11 Use of Another's Fixed Place of Business 135
§5.12 Use of Agents 136
§5.13 Dependent Agents 137
§5.14 Agents versus Purchasers 137
§5.15 Agents versus Lessees 137
§5.16 Scope of Business Profits Article 137
§5.17 Business Profits Attributable to a Permanent Establishment 139
§5.18 Dependent Personal Services—Employees 141
§5.19 Independent Personal Services—Independent Contractors 142
§5.20 Students, Teachers, and Apprentices 143
§5.21 Artists and Athletes 143
§5.22 Passive Income 144
§5.23 Partnerships and LLCs in the Treaty Context 147

Chapter 6 · Foreign Tax Credit 151
§6.01 Introduction 151
§6.02 Credit versus Deduction 152
§6.03 Timing of the Credit: Section 905 154
§6.04 Persons Eligible to Take the Credit 157
§6.05 Creditable Taxes—General Principles 158
§6.06 Requirements for Credit 171
§6.07 Taxes on Business Income 175
§6.08 Taxes on Dividends, Interest, and Other Passive Income 179
§6.09 Taxes on Compensation 179
§6.10 Separate Levies 180
§6.11 Taxes In Lieu Of Income Taxes: Section 903 181
§6.12 Denial of Credit for Taxes Paid to Certain Countries 183

§6.13 Corporations Eligible to Utilize the Foreign Tax Credit—Domestic Stockholders in Foreign Corporations: Section 902 184
§6.14 Calculating the Taxes Deemed Paid by Domestic Corporations 187
§6.15 Section 78 Gross-Up 190
§6.16 Additional Issues Arising Under Section 902 191
§6.17 Section 904 Limitation Upon the Amount of Taxes Which May Be Credited—In General 191
§6.18 Separate Computations of the Overall Section 904 Limitation 195
§6.19 Two Variations on the Section 904 Limitation: Capital Gains and Losses 198
§6.20 Carryback and Carryover of Excess Taxes Paid: Section 904(c) 200
§6.21 Recapture of Foreign Losses: Section 904(f) 202
§6.22 Reduction of Credit for International Boycott Involvement: Section 908 209
§6.23 Dividends-Received Deduction—Generally 210
§6.24 Deduction for Dividends Received from Domestic Corporations 210
§6.25 Deduction for Dividends Received from Foreign Corporations 211
§6.26 Allocation and Apportionment of Expenses by United States Persons—In General 213
§6.27 Allocation Process 214
§6.28 Apportionment Process 215
§6.29 Interest Expense 216
§6.30 Research and Development Expenses 218
§6.31 Other Expenses 219
§6.32 Affiliated Groups 221

Chapter 7 · Controlled Foreign Corporations 223
§7.01 Introduction 224
§7.02 Advantages of Tax Deferral 225
§7.03 Intent Behind the Controlled Foreign Corporation (CFC) Provisions 226
§7.04 Overview of the Controlled Foreign Corporation Provisions 226
§7.05 United States Ownership Standard 227
§7.06 Stock Ownership for Purposes of Controlled Foreign Corporation Status: Section 958 231
§7.07 Modification to Controlled Foreign Corporation Status 234
§7.08 Amount of Imputed Income—In General 234
§7.09 Determining Ownership for Purposes of Income Inclusion: Section 958(a) 235
§7.10 Section 951 Inclusion and Computation: Basic Categories—In General 237
§7.11 Pro Rata Amount of Subpart F Income 238
§7.12 Subpart F Income—Generally 240
§7.13 Income from the Insurance of Foreign Risks 241
§7.14 Foreign Base Company Income—Generally 244
§7.15 Foreign Personal Holding Company Income 244
§7.16 Foreign Base Company Sales Income—In General 247
§7.17 Foreign Base Company Sales Income—Exempt Manufacturing and Same-Country Activities 250
§7.18 Branch Activity: Special Rules 254
§7.19 Foreign Base Company Services Income 258
§7.20 Foreign Base Company Oil Related Income 259

§7.21	Allocation of Deductions to Base Company Income: Rules and Limitations	260
§7.22	Special Exceptions to Foreign Base Company Income	260
§7.23	De Minimis and Full Inclusion Rules	261
§7.24	High-Taxed Income Exception	261
§7.25	Policy-Based Subpart F Categories: Amounts Attributable to International Boycotts, Foreign Bribes, and Restricted Countries	262
§7.26	Earnings and Profits Limitation on Subpart F Income	263
§7.27	Investment in United States Property	264
§7.28	Definition of United States Property	267
§7.29	Basis Adjustments—Increases	270
§7.30	Basis Adjustments—Decreases	271
§7.31	Exclusions from Gross Income—Previously-Taxed Earnings and Profits	271
§7.32	Earnings and Profits	273
§7.33	Priority Rules for Distributions	273
§7.34	Shareholder Taxation as a Domestic Corporation—Section 962 Election	274
§7.35	Controlled Foreign Corporation Interaction with the Foreign Tax Credit—Section 902 Implications	275
§7.36	Section 904 Implications	278
§7.37	Denial of Section 164 Deduction Where Section 960 Is Utilized	279
§7.38	Interaction of the CFC Provisions with Other Code Provisions	279
§7.39	Taxable Year of a Controlled Foreign Corporation	280
§7.40	Dispositions of Stock in Controlled Foreign Corporations—Section 1248	281
§7.41	Shareholders and Transactions Subject to Section 1248	282
§7.42	Transactions Exempt from Section 1248	284
§7.43	General Limitation on Amount of Gain Recaptured	284
§7.44	Controlled Foreign Corporation Earnings and Profits and Recapture Limitation	285
§7.45	Limitation on Individual Tax Liability: Basic Formula	286
§7.46	First Component of Individual Tax Liability Limitation	286
§7.47	Second Component of Individual Tax Liability Limitation	287
Chapter 8 ·	**Passive Foreign Investment Companies and Other Anti-Deferral Measures**	289
§8.01	Introduction	290
§8.02	Tax Consequences of Passive Foreign Investment Company (PFIC) Status—Sections 1291, 1293, and 1296 Regimes	291
§8.03	Pedigreed, Unpedigreed, and Non-Qualifying Funds	293
§8.04	Classification of a Passive Foreign Investment Company: The Passive Income and Passive Assets Tests	294
§8.05	Exceptions to Passive Foreign Investment Company Status	299
§8.06	Section 1291 Tax and Interest Regime—Excess Distributions and Dispositions	299
§8.07	Mechanics of Section 1291	302
§8.08	Deferred Tax Amount	304
§8.09	Taxation of Non-Recognition Transactions	305

§8.10 Removing the Section 1291 Taint—In General 306
§8.11 Deemed Sale Election 306
§8.12 Deemed Dividend Election 307
§8.13 Qualifying Electing Fund (QEF) Regime: Current Inclusion and Taxation of PFIC Earnings 308
§8.14 QEF Election 309
§8.15 Current Section 1293 Taxation of United States Shareholders Electing QEF Status 310
§8.16 Special Exclusions for Non-Tax Haven Income 311
§8.17 Persons Taxable 312
§8.18 Safeguards Against Double Taxation of PFIC Earnings 314
§8.19 Deemed Paid Credit 315
§8.20 Election to Extend Time for Payment of Tax on Section 1293 Imputed Income 315
§8.21 Annual Reporting Requirements for PFIC Shareholders 316
§8.22 Special Characterization and Basis Rules for PFIC Stock 317
§8.23 Co-Ordination of the PFIC Provisions and the Foreign Tax Credit Rules 318
§8.24 Interaction of Passive Foreign Investment Company Provisions and Other Code Sections 319
§8.25 Anti-Deferral and the Accumulated Earnings Tax on Foreign Corporations 319

Chapter 9 · Section 367: Outbound Transfers of Property 323
§9.01 Introduction 323
§9.02 Outbound Property Transfers: General Principles of Section 367(a) 324
§9.03 Gain Recognized Under Section 367(a) 325
§9.04 Active Trade or Business Exception to Section 367(a)—In General 326
§9.05 Leased Property 328
§9.06 Property Expected to be Sold or Disposed of by Transferee 329
§9.07 Foreign Branch Loss Recapture Provisions 330
§9.08 Outbound Transfers of Foreign Corporate Stock or Securities 333
§9.09 Outbound Transfers of Domestic Corporate Stock or Securities 338
§9.10 Transfers of Intangible Assets 339
§9.11 Treatment of Transfers of Foreign Transferee Stock as Sale of Intangible Property 341
§9.12 Dispositions of Transferred Intangible Property 344
§9.13 Election to Treat Intangible Asset Transfer as a Sale 344
§9.14 Anti-Abuse Rule 345
§9.15 Interaction Between Sections 367(d) and 482 346
§9.16 Partnerships and Section 367 346
§9.17 Outbound Transfers of Depreciated Property 348
§9.18 Contributions to Capital 348
§9.19 Divisive Reorganizations: Section 355 Transactions 349
§9.20 Section 332 Liquidations of Domestic Subsidiaries 350

Chapter 10 · Section 482: International Transactions Among Related Parties—Outbound 353
§10.01 Introduction—Section 482 354
§10.02 International Transactions and Section 482 354

§ 10.03 Common Control Standard 355
§ 10.04 Arm's-Length Standard 356
§ 10.05 Comparability 358
§ 10.06 Factors Considered in Assessing Comparability 358
§ 10.07 Special Circumstances 361
§ 10.08 Scope of Review under Section 482 362
§ 10.09 Limitations on Section 482: The Arm's-Length Range 363
§ 10.10 Primary and Correlative Adjustments 364
§ 10.11 Setoff Adjustments 364
§ 10.12 Conforming Adjustments 365
§ 10.13 Blocked Income 366
§ 10.14 Choice of the Best Method 367
§ 10.15 Sales of Tangible Property—In General 369
§ 10.16 Comparable Uncontrolled Price (CUP) Method 369
§ 10.17 Resale Price Method 371
§ 10.18 Cost Plus Method 372
§ 10.19 Comparable Profits Method (CPM) 374
§ 10.20 Profit Split Method 376
§ 10.21 Unspecified Methods 378
§ 10.22 Use of Tangible Property 378
§ 10.23 Transfers and Licenses of Intangible Property 379
§ 10.24 Ownership of Intangible Property 380
§ 10.25 Comparable Uncontrolled Transaction (CUT) Method 381
§ 10.26 Unspecified Methods in Intangible Property Transactions 382
§ 10.27 Form and Amount of Consideration 383
§ 10.28 Periodic Adjustments for Multi-Year Arrangements 384
§ 10.29 Intangible Property Embedded in Tangible Property 385
§ 10.30 Cost Sharing Arrangements for Intangible Property 386
§ 10.31 Provision of Services 390
§ 10.32 Loans or Advances—In General 391
§ 10.33 Interest Charge Period 392
§ 10.34 Application of Payments 394
§ 10.35 Rate of Interest 394
§ 10.36 Co-Ordination with Other Code Sections 395
§ 10.37 Effects of Section 482 on the Foreign Tax Credit 396
§ 10.38 Accuracy Related Penalties 396
§ 10.39 Tax Treaties and Section 482 397
§ 10.40 Co-ordination of Section 482 and Foreign Taxing Jurisdiction: Competent Authority and Statute of Limitations Issues 397
§ 10.41 Advance Pricing Agreements (APAs) 398
§ 10.42 Relief under Revenue Procedure 99-32 400

Chapter 11 · International Partnerships and Partners—Outbound Considerations 403
§ 11.01 Overview of International Partnerships 403
§ 11.02 Definition 404
§ 11.03 Aggregate versus Entity Theory in Partnerships 405
§ 11.04 Organization of Coverage 406
§ 11.05 Introduction to Classification Issues 407

§ 11.06 Classification of Partnerships in General 407
§ 11.07 Classification of Foreign Partnerships and Foreign Limited Liability Companies 410
§ 11.08 International Consequences of Classification 411
§ 11.09 Anti-Abuse Rule 413
§ 11.10 Gain/Loss Recognition on Contribution of Property to a Foreign Partnership by a Domestic Partner 416
§ 11.11 Reporting Requirements 417
§ 11.12 Determination of Income Source for Citizen and Resident Partners 418
§ 11.13 Partnerships and the Foreign Tax Credit 424
§ 11.14 Dispositions of Partnership Interest by Domestic Partners 428
§ 11.15 Overview of Tax Treaties 432
§ 11.16 Residence and Treaty Coverage 433
§ 11.17 Section 367 and Partnerships 435

Appendix A · United States Model Income Tax Convention of November 15, 2006 439

Appendix B · United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006 463

Statutes 543
Treasury Regulations 562
Revenue Rulings 584
Revenue Procedures 588
Private Letter Rulings 589
Technical Advice Memoranda 591
General Counsel Memoranda 592
Notices 593
Table of Cases 594
Index 606

Volume 2: Inbound

Preface xxi
Approach and Purpose xxi
Coverage xxii
Legislative Changes xxii
Abbreviations and Terms xxii
Relevant Dates and Reader Input xxiii
Acknowledgments xxiii

Introduction xxv
Overview xxv
Some Fundamental Questions xxv
Taxation of Domestic and Foreign Individuals and Corporations xxvi
Foreign Tax Credit xxvii
Certain Special Regimes xxvii
No Ruling Position of Service xxviii
The World Becomes Geometric xxix

Chapter 12 · Non-Residency 3
§ 12.01 Overview of Taxing Structure for Non-Resident Individuals 3
§ 12.02 Overview of Taxing Structure for Foreign Corporations 4
§ 12.03 Residency Classification for Foreign Entities 4
§ 12.04 Citizenship 10
§ 12.05 Residency Classification of Individuals 10
§ 12.06 Green Card Test 11
§ 12.07 Substantial Presence Test 12
§ 12.08 Thirty-Day De Minimis Rule 13
§ 12.09 Tax-Home Exception 13
§ 12.10 Exempt and Other Special Categories of Individuals 15
§ 12.11 First-Year Residency Election 17
§ 12.12 Residency Commencement and Termination 18
§ 12.13 Split Taxable Years 20
§ 12.14 Residency and Tax Treaties 23
§ 12.15 Residency Elections of Sections 6013(g) and 6013(h) 23
§ 12.16 Advantages and Disadvantages of Resident Status 25

Chapter 13 · Tax Treaties—An Overview 29
§ 13.01 Overview 29
§ 13.02 Negotiation of Treaties 29
§ 13.03 Ratification of Treaties 30
§ 13.04 Interpretive and Supplementary Materials 32
§ 13.05 Tax Treaties and Double Taxation 32
§ 13.06 Relationship of Tax Treaties to United States Federal Law 34
§ 13.07 Persons Eligible for Treaty Benefits 37
§ 13.08 Saving Clauses 39
§ 13.09 Anti-Treaty Shopping Clauses 40
§ 13.10 Non-Discrimination Clauses 43
§ 13.11 Competent Authority Procedures 45
§ 13.12 Exchange of Information and Enforcement of Tax Claims 49

Chapter 14 · Tax Treaties and Business Income 51
§ 14.01 The Taxation of Business Profits — Generally 51
§ 14.02 Carrying On a United States Business 52
§ 14.03 Fixed Place of Business 52
§ 14.04 Duration of Permanent Establishment 55
§ 14.05 Use of Another's Fixed Place of Business 56
§ 14.06 Use of Agents 56
§ 14.07 Dependent Agents 57
§ 14.08 Agents versus Purchasers 58
§ 14.09 Agents versus Lessees 58
§ 14.10 Scope of Business Profits Article 59
§ 14.11 Business Profits Attributable to a Permanent Establishment 60
§ 14.12 Determination of Income Attributable to a Permanent Establishment 61
§ 14.13 Allocation and Apportionment of Expenses to a Permanent Establishment 64
§ 14.14 Waiver of Business Profits Article Protection 66
§ 14.15 Tax Treaties and the Branch Profits Taxes 66
§ 14.16 The Branch Profits Tax on Earnings 67

§ 14.17 The Branch Profits Taxes on Interest 69
§ 14.18 Qualified Residents 69
§ 14.19 Tax Treaties and Section 482 70
§ 14.20 Dependent Personal Services — Employees 71
§ 14.21 Independent Personal Services — Independent Contractors 73
§ 14.22 Students, Teachers, and Apprentices 75
§ 14.23 Artists and Athletes 76

Chapter 15 · Tax Treaties and Passive Income 77
§ 15.01 Introduction 77
§ 15.02 Dividends 78
§ 15.03 Distributions Which Are Not Dividends 79
§ 15.04 Interest 80
§ 15.05 Treaty Exemptions versus Portfolio Interest Exception 82
§ 15.06 Royalties 82
§ 15.07 Cascading Royalties 83
§ 15.08 Gains from the Disposition of Property 85
§ 15.09 Income from Real Property 86
§ 15.10 Private Pensions 86
§ 15.11 Social Security Benefits and Other Public Pensions 87
§ 15.12 Annuities 87
§ 15.13 Alimony and Child Support 87
§ 15.14 Residual Income Clauses 88
§ 15.15 Passive Income and the Use of Partnerships and Limited Liability Companies 88
§ 15.16 Computation of United States Tax Liability under a Tax Treaty 97
§ 15.17 Disclosure of Treaty-Based Return Positions 98

Chapter 16 · Source Rules 101
§ 16.01 Introduction 101
§ 16.02 Source Rules for Interest 104
§ 16.03 Exceptions to Interest Source Rule 106
§ 16.04 Source Rules for Dividends—Generally 108
§ 16.05 Dividends from United States Corporations 109
§ 16.06 Dividends from Foreign Corporations 110
§ 16.07 Source Rules for Personal Services Compensation 111
§ 16.08 Source Rules for Rents and Royalties 115
§ 16.09 The Cascading Royalties Problem 118
§ 16.10 Source Rules for Dispositions of United States Real Property Interests 120
§ 16.11 Source Rules for Sales of Personal Property 121
§ 16.12 Sales of Inventory Property 121
§ 16.13 Sales of Non-Inventory Property 125
§ 16.14 Underwriting Income, Social Security Benefits, and Income from Guaranty of Debt 130
§ 16.15 Section 862—Income from Sources Without the United States 130
§ 16.16 Sources of Income Not Specifically Covered by Sections 861 and 862 131
§ 16.17 Section 863(b)—Mixed Source Income 132
§ 16.18 International Communications Income 133
§ 16.19 Transactions Involving Computer Programs 133
§ 16.20 Source Rules for Other Income 135

Chapter 17 · Trade or Business Status 137
§17.01 Introduction 137
§17.02 Trade or Business Status—Generally 138
§17.03 Performance of Services 140
§17.04 De Minimis Exception for Nominal Services 141
§17.05 Real Property 142
§17.06 Election to Tax Real Property Income on a Net Basis 143
§17.07 Dispositions of United States Real Property Interests 144
§17.08 Sales Activity 145
§17.09 Purchasing Activity 147
§17.10 Representative Office Activity 148
§17.11 Stewardship Activities of Foreign Parent Companies 149
§17.12 Board Meetings 149
§17.13 Oil and Gas Activity 150
§17.14 Pass Through Entities: Partnerships 150
§17.15 Use of Dependent and Independent Agents 151
§17.16 Licensees and Lessees 151
§17.17 Trading in Stocks and Securities 152
§17.18 Trading via United States Residents 153
§17.19 Trading for Own Account 153
§17.20 Real Property Interests 155
§17.21 Common Law Exemption for Trading in Stocks and Securities 156
§17.22 Trading in Commodities 157
§17.23 Common Law Exemption for Trading in Commodities 158
§17.24 Trading via Partnerships 158
§17.25 No Rulings Policy 159

Chapter 18 · Taxation of Foreign Persons 161
§18.01 General Taxing Pattern Applicable to Foreign Persons 161
§18.02 Taxation of Non-Resident Individuals 161
§18.03 Taxation of Foreign Corporations 163
§18.04 Income Described in Sections 871(a) and 881(a)—In General 165
§18.27 Interest Expense of Foreign Corporations 169
§18.28 Earnings Stripping Limitation on Interest 171
§18.29 Research and Development Expenses 172
§18.30 Other Expenses 173
§18.31 Affiliated Groups 175
§18.32 Tax Treaties 176
§18.33 Availability of the Foreign Tax Credit 177
§18.34 Expatriation 178
§18.35 Relationship of Section 877 to Tax Treaties 181
§18.36 Branch Profits Taxes—In General 184
§18.37 Branch Profits Tax on the Dividend Equivalent Amount 185

Chapter 19 · Dispositions of Investments in United States Real Property 187
§19.01 Background 187
§19.02 Congressional Response 189
§19.03 Section 897: Tax Consequences of Treating Income as Effectively Connected to a United States Trade or Business 191
§19.04 Direct Investment in United States Real Property 192

§ 19.05 United States Real Property Interests 192
§ 19.06 Dispositions 195
§ 19.07 Indirect Investment—Interests Held Through Domestic Corporations 196
§ 19.08 United States Real Property Holding Corporations 197
§ 19.09 Indirect Investment—Interests Held Through Foreign Corporations 200
§ 19.10 Distributions by Foreign Corporations 201
§ 19.11 Co-Ordination of Section 897 with Non-Recognition Rules 203
§ 19.12 Relationship of Section 897 to Tax Treaties 206
§ 19.13 Planning Under Section 897 208

Chapter 20 · Section 367: Inbound Transfers of Property 209
§ 20.01 Introduction 209
§ 20.02 Formation of Domestic Corporations by Foreign Transferors 210
§ 20.03 Inbound Reorganizations: Domestic Acquisitions of Foreign Corporations 211
§ 20.04 Triangular Reorganizations 214
§ 20.05 Section 332 Liquidations of Foreign Subsidiaries by Domestic Parents 215
§ 20.06 Foreign-to-Foreign Contributions, Reorganizations, and Liquidations 217
§ 20.07 Divisive Reorganizations: Section 355 Transactions 221

Chapter 21 · Section 482: International Transactions Among Related Parties—Inbound 225
§ 21.01 Introduction—Section 482 226
§ 21.02 International Transactions and Section 482 226
§ 21.03 Common Control Standard 227
§ 21.04 Arm's-Length Standard 228
§ 21.05 Comparability 230
§ 21.06 Factors Considered in Assessing Comparability 230
§ 21.07 Special Circumstances 233
§ 21.08 Scope of Review under Section 482 234
§ 21.09 Limitations on Section 482: The Arm's-Length Range 235
§ 21.10 Primary and Correlative Adjustments 236
§ 21.11 Setoff Adjustments 236
§ 21.12 Conforming Adjustments 237
§ 21.13 Choice of the Best Method 237
§ 21.14 Sales of Tangible Property—In General 239
§ 21.15 Comparable Uncontrolled Price (CUP) Method 240
§ 21.16 Resale Price Method 242
§ 21.17 Cost Plus Method 243
§ 21.18 Comparable Profits Method (CPM) 245
§ 21.19 Profit Split Method 246
§ 21.20 Unspecified Methods 249
§ 21.21 Use of Tangible Property 249
§ 21.22 Transfers and Licenses of Intangible Property 250
§ 21.23 Ownership of Intangible Property 251
§ 21.24 Comparable Uncontrolled Transaction (CUT) Method 252
§ 21.25 Unspecified Methods in Intangible Property Transactions 253
§ 21.26 Form and Amount of Consideration 254
§ 21.27 Periodic Adjustments for Multi-Year Arrangements 255

§21.28 Intangible Property Embedded in Tangible Property 256
§21.29 Cost Sharing Arrangements for Intangible Property 257
§21.30 Provision of Services 261
§21.31 Loans or Advances—In General 262
§21.32 Interest Charge Period 263
§21.33 Application of Payments 264
§21.34 Rate of Interest 264
§21.35 Co-ordination with Other Code Sections 265
§21.36 Co-ordination with Customs Pricing and Accuracy Related Penalties 266
§21.37 Tax Treaties and Section 482 267
§21.38 Co-ordination of Section 482 and Foreign Taxing Jurisdiction: Competent Authority and Statute of Limitations Issues 267
§21.39 Advance Pricing Agreements (APAs) 268

Chapter 22 · International Partnerships and Partners—Inbound Considerations 271
§22.01 Overview of International Partnerships 272
§22.02 Definition 272
§22.03 Aggregate v. Entity Theory of Partnerships 273
§22.04 Organization of Coverage 275
§22.05 Introduction to Classification Issues 276
§22.06 Classification of Partnerships in General 277
§22.07 Classification of Foreign Partnerships and Foreign Limited Liability Companies 280
§22.08 International Consequences of Classification 285
§22.09 Anti-Abuse Rule 286
§22.10 Gain/Loss Recognition on Contribution of Property to a Domestic Partnership by a Foreign Partner 288
§22.11 Liability Relief 288
§22.12 Contribution of Services 291
§22.13 Contribution of United States Real Property Interests 292
§22.14 Foreign Partners Engaged in Domestic Trade or Business 294
§22.15 Sales Partnerships and Trade or Business Standard 295
§22.16 Realty Partnerships and Trade or Business Standard 297
§22.17 Investment and Trading Partnerships and Trade or Business Standard 297
§22.18 Treaty Exceptions 299
§22.19 Determination of Income Source for Non-Resident Partners 301
§22.20 Sale of Property by a Partner to a Partnership 306
§22.21 Partnerships and the Foreign Tax Credit—Foreign Partners 307
§22.22 Current Distributions to a Foreign Partner—Generally 308
§22.23 Traditional Property Distributions to Foreign Partners 308
§22.24 Distributions of Section 751 Property or United States Real Property Interests to Foreign Partners 309
§22.25 Dispositions of Partnership Interests by Foreign Partners—Generally 310
§22.26 Dispositions Not Involving Section 751 or Section 897 Property 310
§22.27 Dispositions Involving Section 751 Property 314
§22.28 Dispositions Involving Section 897 Property 314
§22.29 Treaty Considerations 315
§22.30 Absence of Domestic Trade or Business 315
§22.31 Overview of Tax Treaties 316

§22.32 Residence and Treaty Coverage 318
§22.33 Hybrid Entities and Tax Treaty Entities 320
§22.34 No Ruling Policy 323
§22.35 Imputation of Permanent Establishment 324
§22.36 Disposition of a Partnership Interest 325

Appendix C · Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital 327

Appendix D · Treasury Department Technical Explanation of the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Signed at Washington, D.C. on September 26, 1980, as Amended by the Protocol Signed at Ottawa on June 14, 1983 and the Protocol Signed at Washington on March 28, 1984 367

Appendix E · Department of the Treasury Technical Explanation of The Protocol Done at Chelsea on September 21, 2007 Amending the Convention Between The United States of America and Canada with Respect to Taxes on Income and on Capital Done at Washington on September 26, 1980, as Amended by the Protocols Done on June 14, 1983, March 28, 1994, March 17, 1995, and July 29, 1997 461

Statutes 525
Treasury Regulations 544
Revenue Rulings 566
Revenue Procedures 570
Private Letter Rulings 571
Technical Advice Memoranda 573
General Counsel Memoranda 574
Notices 575
Table of Cases 576
Index 588

Preface

Approach and Purpose

The author intends 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 international 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 author's 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 author has 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.

---

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

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.*

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.

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 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 July 31, 2013. 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

The author thanks 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 I was introduced to the intersection of geometry and international taxation. As a consequence, I have attempted in the Ninth Edition to incorporate a more modern approach into the text. While my efforts pale by comparison to what they displayed in the classroom, I am building upon their foundation and, like fine wine, hope to improve with age. I can never thank them enough for permitting me to observe first-hand their introduction to life as an international tax lawyer.

Additional thanks is due to Stephanie Hoffer for her co-authorship assistance on the Sixth Edition, and to Olugbenga Ishmael and Gabriella Olteanu, who served as 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. I 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.

Philip F. Postlewaite
Chicago, Illinois

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.[1] A foreign corporation is any corporation which is not a United States corporation.[2]

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 general corporation law of one of the 50 states or that of a foreign country.[3] 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.[4]

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.[5]

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.[6] Foreign individuals and corporations are sub-

1. IRC §7701(a)(4); Reg §301.7701-5.

2. IRC §7701(a)(5); Reg §301.7701-5. See discussion at chapter 1.

3. 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).

4. 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.

5. 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.

6. 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.

ject 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.[7] 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.[8] 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).[9]

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.[10] Thus, from a policy standpoint, the United States generally regards the country of income source as having the primary right to tax such income.[11]

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

7. 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.

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

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

10. IRC §906. See discussion at chapter 18.

11. 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 frequently address the availability of the foreign tax credit.

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.[12]

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.[13] 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.[14] 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 2011-1[15] 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.[16] 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

---

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

13. See discussion at chapters 9 and 20.

14. See discussion at chapters 10 and 21.

15. 2011-1 CB 1.

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

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*.

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

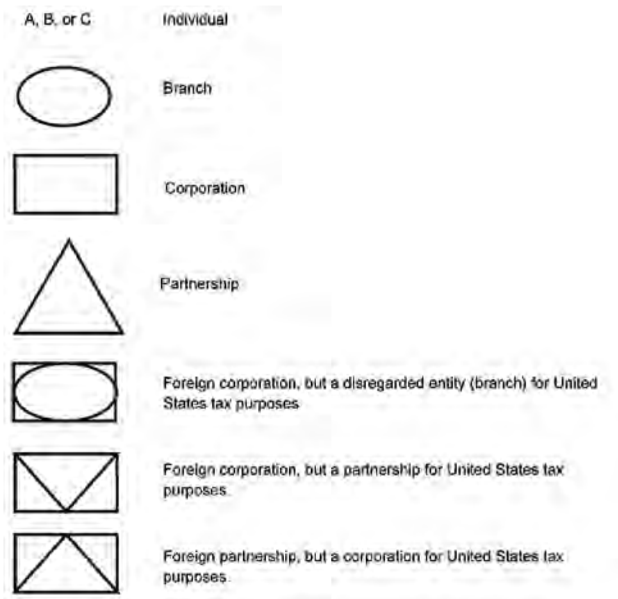
As the number of commercial transactions involving international tax transactions has increased exponentially over the last decade, their depiction diagrammatically is replete with geometric symbols. Much of this is attributable to the check-the-box Regulations and the rise of hybrid entities, i.e., 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).[17]

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.

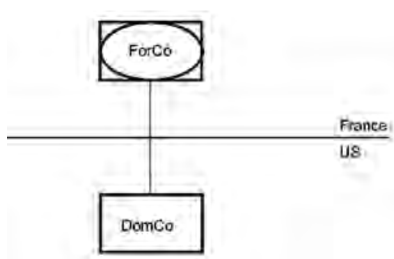
As presented below, various geometric shapes, ranging from the oval to the triangle to the rectangle, represent the tax states of various enterprises. While the legend presented below is that which will be utilized in this treatise, it is imperative, particularly when working with foreign lawyers, that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

17. See discussion at chapters 1 and 12.

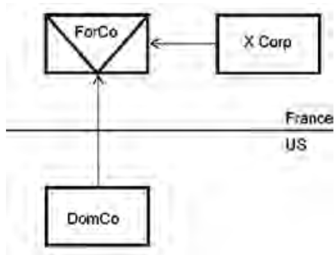


Typically, such symbols will not appear alone but will be accompanied by others. As a consequence, it is important to indicate the relevant jurisdictions involved. For example, if a domestic Corporation A formed a French subsidiary enterprise, Corporation W, which elected/defaulted to disregarded entity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



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.