TAXATION OF INTERNATIONAL TRADE
AND INVESTMENT

by

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TAXATION OF INTERNATIONAL TRANSACTIONS

A. Introduction

1. Importance of Tax Law and Practice

The profits from transactions involving international trade and investment are almost always subject to potential income taxation by at least two countries. Although marginal tax rates have tended to decline during the past decade in most countries of the world, it is still possible that more than half of the income generated by international transactions could be taxed by one or more national taxing systems. On the other hand, because the rules of national taxing systems differ, there are often opportunities to structure international transactions to reduce or avoid income taxes. In either event, investors and potential investors need to be fully aware of the tax consequences of any contemplated transaction.

Tax issues are not restricted to trade and investment transactions. It should be noted that the mobility of labor also raises important problems and opportunities in the tax area as citizens and residents of one country work in increasing numbers in other countries.

The tax rules in most countries are very complex and are usually handled by lawyers and accountants who specialize in these matters. While everyone does not have the time and/or inclination to be such a specialist, no one involved in the negotiation, structuring or implementation of international transactions can afford to be unaware of at least the principal considerations that attend the taxation of those transactions. It is obviously impossible in the time here available to delve very deeply into all of the details of tax law and practice. The purpose here rather is to provide an introduction to the basic tax issues and
basic tax principles that should be considered when planning an international transaction.

As you read through these materials and consider the issues raised by them, keep in mind that there are two essential objectives for the tax planner in any country:

—Reduce or eliminate taxes.
—Postpone the time when taxes must be paid.

The interests of tax administrators are exactly the opposite. Generally speaking, their goal is to collect all of the taxes prescribed by their laws at the earliest possible time.

2. Structure of These Materials

International tax experts often refer to “inbound” and “outbound” transactions. Inbound transactions are those in which foreign individuals and entities participate in the local economy. Outbound transactions are those in which domestic individuals and entities realize income from foreign economic activities. We shall focus initially upon the ways in which foreign taxpayers are taxed when they participate in the U.S. economy. We shall then turn to the ways in which U.S. taxpayers are taxed when they profit from foreign economic activities. In both instances we shall advert to different approaches used in other countries.

3. Tax Policy Issues--Inbound Transactions

An understanding of the effect of tax laws in specific situations depends in part upon an understanding of the economic, social or political questions that arise in the formulation of tax policy in a country and the policies that are reflected in the tax law.
One of the most important issues for any country attending the establishment of the system of taxing foreign taxpayers is whether the tax burden on foreign interests should be greater than, equal to or less than those for domestic interests. There are arguments for all three positions. Some might suggest that a higher tax should be imposed on foreign interests for the privilege of participating in the local economy. Others argue that the tax burden on foreign interests should approximate that of domestic competitors to maximize the effects of competition and an open economy. Many governments, particularly in developing countries, have established a substantially lower tax burden for foreign investment, at least in some sectors of the economy or some areas of the country, to attract investment from abroad to enlarge the availability of capital for investment.

A second important issue arising from the taxation of foreign interests is procedural. How can the government collect taxes from foreign taxpayers, particularly if they have no obvious assets in the country?

4. Tax Policy Issues--Outbound Transactions

Is it fair or wise to tax the foreign profits of domestic citizens and entities? Some suggest that the failure to tax foreign profits would unfairly penalize those who invest at home. Others are concerned that the imposition of tax burdens on foreign profits will impose additional costs on international transactions, thereby reducing the net value of a globalized economy. Moreover, in countries that insist upon taxing foreign profits of domestic taxpayers, it is often argued that the government is penalizing local participants in the international marketplace to the benefit of competitors in other countries that do not seek to tax the foreign income of domestic taxpayers.
B. General Matters

1. Sources of Income Tax Law

Depending upon the legal culture of the country, the tax rules will be reflected by a series of legislative actions, administrative interpretations and, at least in common law countries, judicial interpretations. For many countries, however, there is another source of law that must be considered. The world economy is punctuated by the interaction of hundreds of bilateral tax treaties that have been concluded between various governments. For example, the rules by which the United States taxes income produced by international transactions derive from the usual sources of U.S. income tax law: the U.S. Constitution (which authorizes a federal income tax); the Internal Revenue Code (referred to herein as the “Code”), which is the statutory basis for the income tax); regulations issued by the Internal Revenue Service (called the “IRS,” which is the principal tax collector); rulings issued both publicly and privately by the IRS; judicial decisions (by trial and appellate courts) and legislative histories (hearings, reports and explanations issued by the tax-writing committees of the U.S. Congress). Moreover, the U.S. is party to more than 60 bilateral tax treaties which, if applicable, may vary the provisions of the usual sources of law and must, therefore, be considered when analyzing the income tax consequences of any international transaction.

The 2006 U.S. Model Tax Treaty (“U.S. Model Treaty”), developed by the U.S. Treasury Department for use in negotiations with other countries, is attached hereto as Appendix A. Since the content of all treaties in force results from the process of negotiation, the U.S. Model Treaty is not in effect with any other country. It is useful as a guide, however, because it reflects the subjects
most commonly addressed by tax treaties around the world. Accordingly, it will be used here for illustrative purposes to demonstrate the impact of treaty provisions on tax planning and tax determinations.

As noted, there are hundreds of bilateral tax treaties in effect among the nations of the world. While specific provisions differ, they share common characteristics. One is a commitment of the parties to mitigate the double taxation of income produced from international transactions. It should be noted in this connection that tax treaties may reduce the income taxes otherwise payable, but will almost never result in an increase of income tax burdens for corporations and individuals engaged in international transactions.

2. Relevant Principles of International Law and Practice

a. Jurisdictional Limitations

The permissible authority of a nation to exercise legal power, including the power to tax, is limited according to principles of customary international law. These principles permit the exercise of jurisdiction to tax where one or more of the following factors establish a nexus with the nation that seeks to tax:

--Nationality
--Domicile or residence
--Presence or doing business within the country
--Location within the country of property or transactions from which income is derived

Note that the different nexi would permit two or more countries to tax the same income to the same taxpayer without violating customary international law.
b. Role of Tax Treaties

Bilateral income tax treaties tend to deal with the same issues and contain similar or congruent language. Because of their impact on the general taxing rules, however, it is essential to know whether a treaty exists, its specific terms, and whether modifications in treaty relationships are being contemplated by the government.

As indicated previously, there are in force bilateral income tax treaties between the United States and approximately 60 other countries. There are, in addition, ongoing negotiations with respect to possible treaties with a number of other countries. The U.S. Treasury Department regularly reports to the tax community with respect to ongoing negotiations regarding new treaties or amendments to existing ones.

Virtually all tax treaties include a commitment by both governments to take steps to mitigate double taxation by effectively favoring the country in which income is earned or the country of which the taxpayer is a citizen or resident.

The treaties also provide for cooperation in tax administration. Such cooperation is likely to include agreements for the exchange of relevant information and undertakings to resolve differences in the treatment of transfer pricing disputes. As indicated previously, the U.S. Treasury Department released the latest version of the U.S. model income tax treaty in 2006. Other model treaties have been developed by the OECD, the United Nations and by several other countries.

The interpretation and administration of tax treaties are subject to the normal treaty rules and practice established under international law. However, the
posture of treaties within any legal system may differ. For example, in the United States, the “later-in-time” doctrine applies. Thus, if legislation is adopted that is inconsistent with a prior treaty commitment, courts in the United States will apply the legislation even if it results in a breach of a treaty commitment by the United States as a nation-state.

c. International Enforcement

Comity in international relations often permits one nation to sue in the courts of another nation. This practice, however, generally has not been extended to matters of tax law enforcement. As a result, special problems sometimes arise in the enforcement of tax liabilities against absent foreign taxpayers.

Some bilateral treaties provide generally for cooperation between the treaty partners in the collection of taxes. However, only a few such treaties to which the United States is a party provide in general for such cooperation, and even these treaties have not been used extensively by the treaty partners.

3. Basic Principles: Taxation of Foreign Taxpayers

Foreign taxpayers generally are taxed only on income earned from investments or business activities in a particular country. In some countries, foreign taxpayers may be subjected to a taxing regime structured specifically for them. For example, in some countries domestic citizens and enterprises are not subject to income taxes even though foreign investors are taxed. In the United States the net income of a foreign taxpayer’s U.S. trade or business operations is taxed at the usual U.S. rates. Under current law, there is a progressive rate structure for individuals that reaches a maximum of about 40 percent. Certain capital gains are, however, often taxed at preferential rates (often 20 percent) that
are substantially less than the rates applicable to ordinary income. The maximum marginal rate of tax on corporations under present law is 35 percent. There are no preferential rates for capital gains realized by corporations. Although there are a number of exceptions, the gross amount of certain periodic investment income from the United States that is not connected with the operation of a U.S. trade or business is generally subject under the Code to a tax of 30 percent.

4. Basic Principles: Taxation of Foreign Income of Domestic Taxpayers

Many countries do not tax the foreign earnings of its citizens and/or companies. Others will defer taxing foreign income until the foreign profits are repatriated into the country. In such cases, no tax may ever be imposed by the investor’s country if the foreign earnings are perpetually reinvested abroad.

United States taxpayers are in general subject to the rule of worldwide taxability. However, a foreign tax credit is usually available in respect of foreign income taxes paid in connection with income earned in another country. There is a limited exclusion for certain income earned in other countries by U.S. individual taxpayers who reside abroad or who spend substantial time outside of the United States.

C. Inbound Transactions--Taxation of Foreign Taxpayers

1. Who or What is a Foreign Taxpayer

In virtually every country, it is necessary to distinguish legally between those domestic taxpayers that will be subject to the usual taxing rules and foreign taxpayers that may be subject to special rules or, in some cases, completely different taxing regimes. There are a number of obvious criteria that might be
used. One could rely upon the citizenship, residence or domicile of individuals. One could rely upon the situs of incorporation, assets or equity holders of corporations.

The taxation of international transactions under U.S. law also depends initially upon whether the taxpayer is foreign or domestic. Foreign taxpayers are taxed (with a few exceptions) only upon income earned from U.S. sources. Foreign taxpayers consist primarily of foreign corporations and nonresident aliens.

\textbf{a. Foreign Corporations}

Foreign corporations are corporations organized under the laws of any country other than the United States, regardless of the location of the corporation’s residence or management or source of capital.

\textbf{b. Nonresident Aliens}

Nonresident aliens are essentially defined by negative inference as noncitizens who are not “resident aliens.” A resident alien (for U.S. tax purposes) includes (Code Sec. 7701(b)):

\begin{itemize}
  \item Aliens who are permanent residents of the United States for immigration purposes (green card holders)
  \item Aliens who pass (or flunk, depending upon one’s perspective) the "substantial presence test." This test is satisfied if the alien is present within the United States during the taxable year on at least 31 days and was present within the United States for 183 days during the current and two preceding taxable years, as determined under the following formula:
    \begin{align*}
      \text{Current year} & \text{-- one day is one day} \\
      \text{First preceding year} & \text{-- one day is } 1/3 \text{ day}
    \end{align*}
\end{itemize}
Second preceding year--one day is 1/6 day

However, if such alien is present in the United States for fewer than 183 days during the current year and maintains a "tax home" in a foreign country with which a "closer connection" exists, the alien will not be treated as a U.S. tax resident for tax purposes. The Regulations provide that a taxpayer will have a "closer connection" to a foreign country if the individual "has maintained more significant contacts" with the foreign country than with the United States. Reg. Sec. 301.7701(b)-2(d)(1). Relevant factors to be weighed in the comparison include:

--Taxpayer's permanent home
--Location of taxpayer's family
--Location of taxpayer's personal belongings
--Social, political, cultural or religious organizations with which the taxpayer has current relationship
--Place of routine personal banking activities
--Location of business activities
--Taxpayer's driving license
--Voting by taxpayer
--Place designated as residence on official forms and documents

Time spent in the United States by certain persons (including diplomats, teachers, students and certain medical patients) will not be counted for purposes of the substantial presence test.

2. Source Rules
The taxation of foreign taxpayers in most countries usually depends upon whether income has been derived from domestic or foreign sources. While the source rules of many countries are similar, they are not congruent. It is important, therefore, to inquire into the source rules in effect in any country where economic activity is contemplated. The principal source rules in force in the U.S. are set forth here to illustrate a fairly typical approach used in OECD countries.

Source rules for most (but not all) forms of income have been prescribed statutorily in the United States.

**a. Compensation**

The source of income for the performance of services is the place where the services are performed. Code Sec. 861(a)(3). Section 861(a)(3) provides a *de minimis* exception for compensation not in excess of $3,000 earned by a nonresident alien in the United States while temporarily working for a foreign principal not engaged in a U.S. trade or business for periods not exceeding 90 days during a tax year.

**b. Dividends**

Dividends from U.S. corporations are generally treated as U.S.-source income. Code Sec. 861(a)(2). Dividends from foreign corporations will generally be treated as foreign-source income.

**c. Interest**

The source of interest income generally depends upon the residence of the borrower. Interest payments from U.S. residents and domestic corporations are generally characterized as U.S.-source income. Code Sec. 861(a)(1). There are exceptions for interest paid by U.S. residents which may be attributable to a foreign trade or business. For example, interest on deposits paid by the foreign
branch of a U.S. bank will be treated as foreign-source income. Code Sec.
861(a)(1)(B). Interest paid by the U.S. trade or business of a foreign corporation
will generally be treated as U.S.-source income. Code Sec. 884(f)(1).

d. **Rents and Royalties**

The source of rental and royalty income is determined by the place
where the property is located or used. Code Sec. 861(a)(4). The source of rental
income for tangible property will depend upon the location of the property. The
source of royalty income for intangible property will depend upon where the rights
are to be used.

e. **Sale of Real Property**

The source of income realized from the sale or other disposition of
real property is the location of the property. Code Secs. 861(a)(5), 862(a)(5). In
U.S. practice, “real property” includes land, buildings and mineral rights.

f. **Sale of Personal Property**

In U.S. practice, all property not characterized as real property is
called “personal property.” The source of income realized from the purchase and
sale or other disposition of personal property (other than inventory) is generally
the residence of the taxpayer. Code Sec. 865. There are, however, a number of
exceptions primarily intended to assure that certain facile opportunities for tax
avoidance are limited.

The source of income from the purchase and sale of inventory
depends upon the location of the property when title passes from the buyer to the
seller. Note that the "passage-of-title" test permits a substantial degree of
flexibility. The IRS has successfully challenged the application of the test where
formal title passage is not accompanied by the transfer of the normal risks of

The source of income realized from the manufacture and sale of personal property will be divided between the country of manufacture (production portion) and the country of sale (sales portion). Code Sec. 863(b).

g. Other Forms of Income

When foreign taxpayers realize forms of income not covered by a statutory source rule, courts have been required to develop an appropriate interpretation of the sourcing principles. For example, alimony (which is taxed to the recipient under U.S. law) is sourced at the residence of the payor. Rev. Rul. 69-108, 1969-1 C.B. 192, explains this conclusion by analogy to the interest source rule.

3. Trade or Business Income

a. Taxing Scheme

In most countries, there is a difference between the way in which income produced by economic business activity is taxed and the way in which passive investment income is taxed. The U.S. approach is described herein as an example of one way in which this distinction leads to quite different tax consequences.

The net income "effectively connected" with the operation of a U.S. trade or business by a foreign taxpayer (e.g., the U.S. branch of a foreign corporation) is subject to normal U.S. income tax rates. Code Secs. 871(b)(1), 882(a)(1). Appropriate deductions and credits attributable to the operation of the U.S. trade or business may be taken by the foreign taxpayer in determining U.S. tax liability. Under present law, the maximum nominal rates are 35 percent for
both individuals and corporations. Code Secs. 1, 11. However, effectively connected long-term capital gains realized by individuals will be taxed at substantially lower rates.

Although foreign taxpayers are generally taxed only on U.S.-source income, certain foreign-source income, gains and losses in rare instances may be held to be effectively connected with the U.S. trade or business (and, therefore, subject to tax) when such income is attributable to an "office or other fixed place of business within the United States." Code Sec. 864(c).

b. U.S. Trade or Business

In many countries, the income generated by the active conduct of a trade or business by foreign interests will not be taxed unless the foreign individual or entity operates through a “permanent establishment” within the country. While the definition of permanent establishment varies among countries using such a standard, it generally means that the foreign taxpayer must operate through some kind of permanent physical facility within the country.

There is no general definition of a "U.S. trade or business" in the Code. The performance of personal services within the United States is deemed a U.S. trade or business unless the de minimis exception applies. Code Sec. 864(b). The use of a stock or commodities broker in the United States will not be treated as a U.S. trade or business even if the broker has discretionary authority to act on behalf of the foreign principal. Code Sec. 864(b)(2).

In all other instances, the existence of a U.S. trade or business will be determined by an examination of all the relevant facts and circumstances to determine whether the business activities are “regular,” “continuous” and “considerable.” Reg. Sec. 1.864-2(e). There are two guiding principles derived
from the common law when a foreign person is engaged in a trade or business in the United States. First, the foreign taxpayer’s U.S. activities must rise to the level of a “business.” The mere passive investment or holding of property or isolated or occasional transactions in the U.S. would not suffice. Secondly, the activities in the United States must be central to the derivation of profit. Thus, if the activities are “incidental, ministerial or clerical,” they will not constitute a U.S. trade or business.

The term "trade or business" is used in various parts of the Code and, therefore, has been addressed in many cases. The principal distinction is between doing something to produce income (operator of trade or business) and merely owning something to produce income (passive investor). In general, a taxpayer would not be found to be conducting a U.S. trade or business without a systematic operation involving the production and/or sale of goods and/or services within the United States. The ownership and rental of real property in the United States does not necessarily constitute a U.S. trade or business. Lewenhaupt v. Commissioner, 20 T.C. 151, aff’d per curiam, 221 F.2d 227 (9th Cir. 1955). Occasional transactions in the United States normally would not be treated as a U.S. trade or business.

Under the Code, a U.S. trade or business can exist in certain situations even though the foreign taxpayer does not operate out of a permanent establishment. Moreover, the activities of an agent in the United States may result in a finding that the principal is operating a U.S. trade or business. See Hanfield v. Commissioner, 23 T.C. 633 (1955).
c. Effective Connection

Only income "effectively connected" with the U.S. trade or business will be taxed under this regime. A foreign taxpayer may have other U.S. source income that is not so connected. Such income will be taxed under the other taxing regime (withholding tax on gross income), or not at all. Whether the effective connection exists will depend upon a nexus between the transaction giving rise to the income and the U.S. trade or business.

d. Allocation of Deductions and Credits

Appropriate deductions and credits (those effectively connected with the U.S. trade or business) are generally available to the foreign taxpayer. Code Sec. 882(c)(1). Substantial controversy, however, attends many situations in which costs are allocated between the U.S. and foreign operations of the foreign taxpayer.

Because loan proceeds in effect help to finance all the assets of a company, special rules were adopted to allocate interest payments. Section 864(e)(2) provides that all "allocations and apportionments of interest expense shall be made on the basis of assets rather than gross income." The amount of interest attributable to the U.S. trade or business will thus be determined by a comparison of asset values (U.S. trade or business/worldwide).

e. Branch Profits Tax

To narrow the difference in tax burdens for foreign corporations that operate in the United States as a branch (rather than through a subsidiary), Section 884 imposes a tax of 30 percent on the repatriated earnings of a U.S. branch of a foreign corporation.
f. Use of U.S. Partnership

A foreign taxpayer that is a partner in a U.S. partnership operating a U.S. trade or business will be treated as if the foreign taxpayer is conducting the U.S. trade or business. As a result, income and losses allocable to the foreign partner will be treated for U.S. tax purposes as if the partner had realized the gain or loss directly.

4. Withholding Tax on Non-Trade or Business Income

a. Tax on Gross Income

In most countries at least certain forms of passive investment income will be subject to a flat tax regardless of the fact that progressive rate structures normally apply. Moreover, primarily because of the difficulty in collecting taxes from foreign taxpayers that do not maintain operating assets within the country, the flat tax is customarily collected through the establishment of a withholding obligation on the individual or entity within the country that is making the payment that is considered to be income to the foreign taxpayer from domestic sources.

The approach used in the United States, including the statutory rate, is fairly representative of the approaches used in many countries. Foreign taxpayers are subject to a 30 percent tax on the "amount received from sources within the United States . . . as . . . interest . . ., dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income . . ." if such amounts are not effectively connected with a U.S. trade or business. Code Secs. 871(a), 881(a). Such items of income are referred to herein as FDAP income (from fixed or determinable annual or periodic income).
The withholding tax is imposed upon the gross amount of the payment. No deductions are allowed. A single, lump-sum royalty payment, for example, has been held to be "annual or periodical" and, therefore, subject to the tax. Commissioner v. Wodehouse, 337 U.S. 369 (1949).

Not all U.S.-source income received by a foreign taxpayer will be effectively connected to the taxpayer’s U.S. trade or business. Accordingly, a foreign taxpayer may be subject to tax under both taxing regimes in the same taxable year.

b. Exemption for Certain Interest

To encourage foreign taxpayers to use U.S. banks and savings institutions, interest earned on certain deposits is exempt from tax even though constituting U.S. source interest income. Code Secs. 871(i), 881(d).

Interest on "portfolio debt investments" is also exempt from tax. Code Secs. 871(b), 881(c). As a result, most interest payments to foreign taxpayers on publicly traded debt securities issued by U.S. companies will not be taxed. The exemption does not apply, however, if interest is paid to a lender that owns 10 percent or more of the voting power of the corporate borrower. Code Secs. 871(h)(3), 881(c)(3)(B).

c. Exemption for Gains from the Sale of Property

Gains realized from the sale of property are not treated as FDAP income and historically have not been subject to either taxing regime, even though deriving from U.S. sources, unless effectively connected to a U.S. trade or business. Reg. Sec. 1.1441-2(a)(3). Contingent gains attributable to the sale of intangible property will, however, be treated under the rules prescribed for royalty income. Code Secs. 871(a)(1)(D), 881(a)(4).
d. The Withholding Mechanism

The 30 percent tax is usually collected from the "withholding agent." Code Sec. 1441, 1442. This includes "all persons, in whatever capacity acting . . . having the control, receipt, custody, disposal, or payment of any of the items of income specified . . ." in Sections 1441(b) (for nonresident aliens) and 1442(a) (for foreign corporations).

The items of income specified generally track the language defining FDAP income. Except in the case of compensation, no withholding is required if the item of income is effectively connected with a U.S. trade or business. The 30 percent withholding requirement may apply to compensation income earned in the United States even though the performance of services constitutes the conduct of a U.S. trade or business. In such cases, the amount withheld is unlikely to be exactly equal to the tax liability. In such event the foreign taxpayer may be required to pay additional taxes or may be entitled to a refund.

The withholding obligation applies even if the withholding agent mistakenly pays the entire amount to the foreign taxpayer.

5. Treatment of Gains from U.S. Real Property Interests

Prior to 1981, many foreign taxpayers were able to invest in U.S. real property without incurring any material income tax burdens on their gains. The principal reason was that the ownership of real property did not necessarily constitute the conduct of a U.S. trade or business. When the real property was eventually sold for gain, therefore, no tax would apply even though the gain constituted U.S. source income. A number of complicated transactions and/or treaty provisions further assisted in the achievement of tax avoidance.
In 1980, Congress adopted the Foreign Investment in Real Property Tax Act ("FIRPTA"). Section 897 now provides that gain or loss realized by foreign taxpayers on the disposition of U.S. real property interests will be treated generally as if such gain or loss were effectively connected with a U.S. trade or business. In some instances FIRPTA will also tax gains on the sale of stock in U.S. corporations that have held a substantial percentage of assets in the form of U.S. real property.

6. Effect of Tax Treaties

a. Permanent Establishment Clause

The treaties usually provide some clarification of situations that might be ambiguous under the generally applicable rules. The most dramatic example is the provision limiting the right of one treaty partner to tax trade or business income earned by residents of the other treaty partner. No trade or business income generally will be taxed under treaty provisions unless the foreign taxpayer has a "permanent establishment." U.S. Model Treaty, Art. 7. The treaties define "permanent establishments" so that foreign investors have a clearer indication of the extent to which they can engage in activities in the United States without incurring U.S. taxes. U.S. Model Treaty, Art. 5.

b. Reduction or Elimination of Withholding Taxes

Most of the treaties provide for the reciprocal reduction or elimination of withholding taxes on specified items of FDAP income. More recent treaties also include an "anti-treaty-shopping" provision to defend against the exploitation of these benefits by nonresidents of the treaty partner. U.S. Model Treaty, Arts. 10, 11 and 12.
D. Outbound Transactions-- Taxation of Foreign Income of Domestic Taxpayers

1. Who or What is a Domestic Taxpayer

As indicated earlier, every taxing system that would distinguish between foreign and domestic taxpayers for any purpose must define the difference. It follows from the earlier discussion that in the U.S. domestic taxpayers include primarily U.S. citizens, resident aliens (as defined for tax purposes) and U.S. corporations. A partnership is not a taxpayer. Tax items attributable to a partnership’s operations are allocated to the various partners, usually according to the terms of the partnership agreement. Whether a foreign entity is a corporation or a partnership will be determined for U.S. tax purposes by U.S. law.

2. Policy Options

Different countries have adopted radically different approaches to taxing the foreign income of domestic taxpayers. Some simply do not tax foreign earnings. Others defer the tax on foreign earnings until income is repatriated into the country. Some propose to tax foreign income in the same way that domestic income is taxed. Some apply a hybrid of the several approaches described above. It is particularly important for counsel in a country representing or negotiating with a potential foreign investor to understand the tax requirements of the country from which is investor is coming. The importance of this understanding is particularly strong in situations when the possibility of a tax holiday is present.

The discussion that follows is focused on the tax posture confronting a U.S. individual or corporation contemplating foreign investment because the
U.S. is the most aggressive country in seeking to tax foreign income of its domestic taxpayers.

3. **U.S. Rule of Worldwide Taxability**

   U.S. taxpayers are generally subject to U.S. tax on income earned from any place in the world, regardless of the currency in which the income is paid and regardless of where the income is deposited.

4. **Exception for Certain Foreign Earned Income**

   Individual U.S. taxpayers who reside overseas or remain outside the United States for at least 330 days during any twelve month period may exclude up to $100,800 (for 2015; the amount is indexed for inflation) of foreign earned income plus a housing cost allowance. Code Sec. 911. The exclusion applies in lieu of the foreign tax credit that otherwise might be available. It applies only to earned (as distinguished from investment) income.

5. **Deferral of U.S. Tax through Foreign Subsidiary**

   The operation of a foreign branch by a U.S. corporation will result in an immediate U.S. tax liability because of the rule of worldwide taxability. The foreign subsidiary of a U.S. corporation is not, however, a U.S. taxpayer. U.S. taxes, therefore, generally may be deferred through the use of a foreign corporation. In that event, no U.S. income tax liability will generally arise until profits are repatriated from the foreign corporation.

   Whether a foreign entity is a corporation or partnership for U.S. tax purposes affects the availability of deferral. If a foreign entity is regarded as a partnership, the income accruing to a U.S. participant will be immediately taxable by the United States, even if no profits are repatriated. If the foreign entity is regarded as a corporation, U.S. taxes are deferred until repatriation. The “check-
the-box” regulations promulgated in 1997 remove almost all of the uncertainty as to the characterization of foreign business entities and provide, in effect, that taxpayers can often choose whether to have many foreign entities treated as corporations or partnerships for U.S. income tax purposes. Reg. Sec. 301.7701-1, -2, -3.

6. The Foreign Tax Credit

a. Rationale for Basic Mechanism

The rule of worldwide taxability makes it very likely that income realized by U.S. taxpayers abroad will be subject to potential double taxation because the country in which the activity or transaction occurs is also entitled to exercise its taxing jurisdiction. To avoid the imposition of additional tax burdens on international transactions, the U.S. taxpayer is entitled to a foreign tax credit in respect of income taxes paid abroad on foreign source income as well as foreign taxes paid “in lieu” of income taxes. Code Sec. 901. Although other foreign taxes may be deducted as a business expense by the U.S. taxpayer operating abroad, no credit is available except in the case of income taxes or taxes in lieu thereof.

Note that the many countries who choose not to tax the foreign income of their domestic taxpayers need not be concerned with double taxation.

b. The Direct Credit

The foreign tax credit is best demonstrated by a simple example. Suppose that USCo is a U.S. corporation with a branch in Oz, that the U.S. corporate tax rate is 35 percent, and that the Oz corporate tax rate is 20 percent. The Oz branch earns the equivalent of $100,000 and pays a tax of $20,000 in Oz. The U.S. tax on the income of $100,000 is $35,000, but USCo is entitled to a credit of $20,000. USCo must pay only $15,000 to the U.S. Treasury.
c. The Indirect Credit

To remove an unintended incentive to use foreign branches, a U.S. corporation may enjoy a credit for taxes paid by a foreign corporation in which it owns at least a 10 percent interest. Code Sec. 902. This "indirect" credit also may be explained by a simple example. Suppose that USCo decided to organize a subsidiary in Oz (OzCo) to operate there. When OzCo earns $100,000, it pays a tax of $20,000 to Oz. It then declares a dividend of the remaining $80,000 to USCo. USCo will report income of $100,000 for U.S. tax purposes (the actual dividend of $80,000 "grossed up" by the taxes paid in Oz in respect thereto), but will receive a credit for the $20,000 in fact paid by OzCo. Note in this instance that the advantage of deferral may be coupled with the availability of the foreign tax credit.

d. The Overall Limitation

The foreign tax credit is not intended to serve as a device for reducing the U.S. tax on U.S. source income. Accordingly, the foreign tax credit (whether direct or indirect) is limited to the U.S. tax on foreign source income. Accordingly, if the Oz tax were 40 percent in the foregoing example so that taxes of $40,000 were paid by the Oz branch or subsidiary, the maximum foreign tax credit would be limited to $35,000 (the maximum U.S. corporate tax on the foreign source income). The excess credit of $5,000 could be carried back to the previous tax year and then forward the ensuing ten tax years. Code Sec. 904(c).

The overall foreign tax credit limitation is calculated on a worldwide basis. This provides an opportunity for tax avoidance by a U.S. taxpayer with excess credits. In the foregoing example, USCo might use the excess credits paid to Oz if it also realized other foreign source income that was subject to a lower or
no foreign tax. The result is commonly known as “cross-crediting.” Thus, if USCo also earned $100,000 in Paradiso but paid no income tax there, its foreign source income would be $200,000 and its maximum credit would be $70,000. As a result, the entire $40,000 paid to Oz would be available as a credit.

e. Attempts to Narrow the Loophole--Separate Basket Limitations

Concerned that the overall limitation was not sufficient to deter excessive tax avoidance through cross-crediting, additional limitations were imposed by the Tax Reform Act of 1986. As a result, separate limitations (each of which operates in the manner described above) were created for eight different categories (or “baskets”) of income where transactions could be most easily arranged to use excess credits. Code Sec. 904(d). The eight separate categories (or "baskets") and the general basket were:

--Passive income
--High withholding tax interest
--Financial services income
--Shipping income
--Dividends from certain noncontrolled foreign corporations
--Foreign trade income
--Distributions from a Foreign Sales Corporation
--All other income

U.S.-based multinational companies complained that these provisions imposed too much complexity. Congress eventually agreed. The American Jobs Creation Act of 2004 (“JOBS Act”) reduced the categories to two for years beginning after 2006: passive income and all other income.
f. Effect of Treaties

Virtually all tax treaties include a commitment by both governments to take steps to mitigate double taxation. Because the foreign tax credit provides such statutory mitigation for U.S. taxpayers, the principal effect of the treaty commitment is to assure mitigation for foreign investors by their own governments in respect of taxes paid to the United States on U.S. income.

E. Transfer Pricing

1. Background

All tax officials in every country worry about the loss of revenues through transactions arranged between related entities. Because the amounts paid and received in such transactions do not necessarily derive from the normal desire of the seller to obtain the highest price and the buyer to pay the lowest price, they are referred to as “transfer prices.” When the normal economic pricing motives are absent, tax administrators fear that the prices have been arranged to avoid taxes in one or more countries.

Once again, the U.S. has for decades been the most aggressive opponent of transfer pricing abuses. The IRS has fought a long battle over issues of transfer pricing. The results of the battle are mixed. Historically, the IRS was concerned primarily with the use of transfer pricing by U.S. shareholders to "remove" income to lower taxed jurisdictions. In recent years, as foreign investment in the United States has increased, concern has partially shifted to the U.S. subsidiaries of foreign investors. In fact President Clinton, during the 1992 presidential campaign, contended that there were $45 billion of uncollected tax
revenues attributable to transfer pricing practices by foreign companies which the IRS was failing to take adequate measures to collect.

2. The Statutory Weapon--Section 482

Section 482, long a part of the U.S. income tax laws, has served as a prototype statute for dealing with transfer pricing matters in most of the countries who have seriously dealt with the matter:

"In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interest, the [IRS] may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses if [it] determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses."

The determinations of the IRS agents are presumptively correct and must be disproved by the taxpayer if the question is litigated.

The principal standard has been the arm's length test: whether the price is the same as that which would have been paid to or by an unrelated party. However, other techniques, such as resale price and cost plus, are authorized by the regulations. In a number of recent decisions, the courts seem to be simply splitting profits between the relevant entities.
3. **Additional Penalties**

In an attempt to bolster the position of the IRS, a number of new reporting requirements and significant penalties have been imposed with respect to issues of transfer pricing. Code Secs. 6038A, 6038B, 6038C.

4. **Advance Pricing Agreements (APAs)**

The IRS has traditionally declined to grant advance rulings on issues of fact. During the past several years, however, it has begun to implement a program of granting APAs to taxpayers in advance of the conclusion of transactions between the related entities. If a taxpayer obtains an APA and follows the pricing procedures set forth in it, the transfer price will not later be challenged under Section 482.

5. **Effect of Treaties**

As indicated previously, tax treaties provide for cooperation in tax administration. Such cooperation is likely to include agreements for the exchange of relevant information and undertakings to resolve differences in the treatment of transfer pricing disputes. Treaty arrangements have also been used to negotiated APA’s among a corporate taxpayer and several governments. Since the early 1990's, many treaties including language contemplating the possibility of arbitrating such transfer pricing disputes where the respective authorities cannot agree. During the past few years, the United States has concluded a number of treaties (e.g. Belgium, Germany, Canada, France and Spain) that prescribe mandatory arbitration if negotiations between the treaty parties is unsuccessful.
F. Limitations on Deferral of Taxes

1. Value of Tax Deferral

While taxpayers are most enthusiastic about advisors who can avoid all tax burdens, the value of deferring taxes that will inevitably come due is clear. For the taxpayer who can defer taxes without paying a penalty therefore, it is the equivalent of an interest-free loan from the government.

2. Concerns with Easy Avenues for Tax Deferral

Countries that tax the foreign income of domestic taxpayers have become increasingly concerned about the opportunities to defer income taxes presented by the existence of a wide variety of tax haven jurisdictions that operate in many parts of the world. As is so often the case, the U.S. Treasury Department has since the 1930's been the most aggressive advocate of provisions that would deny U.S. taxpayers of tax deferrals on foreign income. Because the U.S. is serving as the prototype for other taxing jurisdictions for dealing with issues of deferral, the U.S. approach is described herein in some detail.

3. Foreign Personal Holding Companies (FPHCs)

The basic rules for taxing foreign income earned by U.S. investors provide an opportunity to defer U.S. taxes by using foreign corporations as the vehicle for investment. During the past several decades, some legislators have sought to end this deferral benefit. Although there has been no general limitation on this deferral opportunity, a number of provisions have been adopted to mitigate deferral benefits in circumstances deemed to be abusive. The FPHC provisions were adopted in the late 1930s to respond to arrangements wherein U.S. investors simply established companies in tax haven jurisdictions to serve as vehicles for their investments.
United States shareholders of FPHCs were taxed on the undistributed foreign personal holding company income even though no dividend payment has been made. The adjusted basis of the taxpayer's shares in the foreign corporation was increased to reflect the fact that income has been taxed even though no dividend in fact has been paid. The net result was the same as if a dividend were paid and then contributed as capital back to the foreign corporation.

A foreign corporation was treated as a FPHC if two conditions are met:

--More than 50 percent of the value or of the total combined voting power of all classes of the stock of the foreign corporation was owned, directly or indirectly, by five or fewer individuals who are U.S. citizens or residents (the ownership test); and

--At least 60 percent of its gross income for the taxable year was "foreign personal holding company income" ("FPHCI") (the income test).

Rules of attribution applied in connection with the ownership test so that an individual may be treated as owning stock in fact held by certain relatives or entities.

FPHCI includes dividends, interest, royalties, gains from the sale or exchange of securities, certain income from trusts and estates, gains from futures transactions, and, in certain cases, rents, amounts received for the use of personal property, and amounts received under certain personal services contracts. Code Secs. 543, 553.
The FPHC provisions lead to the adoption of Subpart F of the Code, which is discussed in the next section. The 2004 JOBS Act repealed the FPHC provisions because Congress came to believe that Subpart F provided an adequate defense against unacceptable deferral mechanisms.

4. Subpart F
   
   a. Background
   
   During the early 1960s, the mechanism of the FPHC provisions was applied to a broader array of corporations and transactions by the adoption of Subpart F of the Code. As a result, Subpart F income earned by controlled foreign corporations (CFCs) and certain other amounts will be taxed to U.S. shareholders even though no dividend has been paid. Again, the adjusted bases of the U.S. shareholders will be increased by the amount of the constructive dividend. There are a number of mechanical differences between the application of the FPHC provisions and Subpart F that are beyond the scope of this introductory outline.

   b. Definition of CFC
   
   A foreign corporation is a CFC if "U.S. shareholders" own more than 50 percent of the combined voting power of all classes of stock entitled to vote or of the total value of the stock of the corporation. Code Sec. 957(a). A U.S. shareholder is a U.S. person that owns 10 percent or more of the total combined voting power of the foreign corporation. A "U.S. person" includes U.S. citizens, residents, corporations and partnerships. Code Sec. 7701(a)(30). Rules of attribution apply so that shares held by one person or entity may be deemed held by others.

   c. Subpart F Income
   
   Section 954(a) defines Subpart F income to include:
---FPHCI
---Foreign Base Company Sales Income
---Foreign Base Company Services Income
---Foreign Base Company Oil Related Income

The definitions of each form of Subpart F income are rather complicated. FPHCI for Subpart F purposes is generally the same as for FPHC purposes, but a number of differences exist. Code Sec. 954(c). Foreign base company sales income arises when a foreign corporation buys from, or sells to, a related corporation a product that is not to be used in the country where the CFC has been organized. Code Sec. 954(d). Foreign base company services income arises when a CFC performs services for a related entity in a place other than the place where the CFC was organized. Code Sec. 954(e).

Subpart F income also includes certain insurance income, certain bribes and kickbacks, income derived from participation with certain foreign boycotts, and income from certain countries with respect to which economic sanctions have been imposed. Code Sec. 952.

d. Investment in U.S. Property

Subpart F also will treat as a constructive dividend amounts invested in U.S. property by CFCs. Code Secs. 951(a)(1)(A)(iii), 958.

5. Passive Foreign Investment Companies

Section 1291 effectively imposes an interest charge on deferred income created when U.S. shareholders invest in a passive foreign investment company (PFIC). A PFIC is any foreign corporation in which 75 percent or more of gross income is passive income, or the average percentage of the value of assets of the corporation producing passive income is at least 50 percent of all assets.
The interest charge is imposed when the U.S. taxpayer receives distributions, or when the shares are sold or exchanged. The interest is charged on the taxes that effectively were deferred from prior taxable years through the use of the foreign investment vehicle. A taxpayer may elect to mark-to-market each year in the case of marketable stock in a PFIC. Code Secs. 1291-1298.

G. The Impact of Other International Norms and Tax Policy—Export Incentives

1. Low Taxes for Trade Advantage?

The use of tax incentives to stimulate exports from a country has been the subject of substantial controversy. Many countries establish such incentives. Value added taxes are, for example, often not applied with respect to exports. Some countries, such as the United States, have established income tax incentives to reduce the burdens on exporters so that they will be induced to increase exports and, thereby, generate more foreign exchange. The controversy arises because some incentives have been characterized as “illegal subsidies,” initially under the GATT and now under the WTO Agreement. There follows a description of the way in which the debate has affected U.S. policy in establishing tax incentives to reward exports.

2. Background—DISCs

During the early 1970s, the Congress adopted provisions intended to stimulate exports by which a portion of income attributable to Domestic International Sales Corporations (DISCs) would be deferred for tax purposes. The mechanism was challenged before the GATT on the ground that it represented an illegal trade subsidy. Largely in response to a determination that the DISC
deferral arrangement was inconsistent with GATT, the FSC provisions were adopted during the early 1980s. Code Secs. 921-927.

3. Son of DISC--Foreign Sales Corporations

a. What Was a FSC?

A FSC was a foreign corporation organized in certain jurisdictions that satisfies a series of rather specific requirements. The FSC had to be organized under the laws of a "qualified" foreign country or certain U.S. possessions. A foreign country would so qualify by effecting an appropriate exchange of information agreement with the United States.

The FSC was required to:

---Have no more than 25 shareholders
---Have no preferred stock
---Have a nonresident director
---Maintain a foreign office in a qualified jurisdiction
---Maintain certain tax records within the United States
---Elect to be treated as a FSC

The benefits would apply if the income is export-related, the management of the FSC is carried on outside the United States, and the economic process from which the income is earned takes place outside the United States.

b. Mechanism—from Deferral to Exemption

An FSC was subject to tax even though it was a foreign corporation with no U.S. source income not engaged in a U.S. trade or business. However, a portion of the export-related income was exempt from U.S. taxation, and dividends to the U.S. parent were not subject to U.S. tax. The net effect, therefore, was to convert the deferral advantages of the DISC to a clear reduction in taxes.
The advantage was not limited to the income attributable to the FSC under normal pricing standards. "Administrative pricing" techniques could be employed to allocate a share of combined income of the FSC and its related supplier to the FSC. This permits either 23 percent of the combined income or 1.83 percent of the foreign trading gross receipts to the FSC. In the unlikely circumstance that arm's length pricing standards provided a greater benefit, such standards may be used.

The exemption was substantial, amounting to between 68 and 70 percent of the income allocable to the FSC. However, foreign tax credits were not permitted.

4. Grandson of DISC—Exclusion of Extraterritorial Income

Unsurprisingly, the FSC arrangements were also challenged by the European Union as illegal subsidies under the WTO agreements. In early 2000 a WTO Appellate Body confirmed an earlier determination that the United States had violated the WTO treaties by adopting the subsidies reflected in the FSC provisions. In response to this decision, the FSC system was repealed and a new system of tax incentives for exports was established late in 2000 by the adoption of the FSC Repeal and Extraterritorial Income Exclusion Act, and is now in place.

The heart of the new regime was an exclusion from gross income of ‘qualifying foreign trade income.” Such income would include:

— The sale or other disposition of “qualifying foreign trade property” ("QFTP")
— The lease of QFTP for use outside of the United States.
— Services related and subsidiary to such sale or lease.
— Managerial services for an unrelated person in furtherance of such sale, lease or service income.

The amount of the exclusion can be based upon net income (15%) or gross income (1.2%) or 30% of foreign sale and leasing income. The effective reduction of tax roughly approximated the advantages established under the replaced FSC regime.

The legislative history accompanying the 2000 Act explains that it was designed to respond to European criticisms of the FSC regime because:
— No separate entities were required which could be criticized as “shams.”
— Since no separate entities were required, there was no question about dubious transfer pricing arrangements.
— Administration was simplified because no separate entity was required.

The Report of the House Ways and Means Committee concluded with an observation about the trade dispute:

“The Committee believes that this legislation complies with the WTO decisions and honors U.S. obligations under the WTO. The Committee is of the view that repealing the FSC provisions provides an opportunity to revise the Code in a manner that rationalizes tax treatment for extraterritorial income. The Committee is confident that, should the bill be challenged in WTO dispute settlement proceedings, the legislation would withstand scrutiny under the trade agreements. The Committee contrasts the timely and thorough action by the United States represented by this legislation with the response of certain foreign nations to findings of other WTO dispute settlement panels in recent cases involving trade in beef and

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bananas—findings dealing with pure trade issues and not with the fundamental nature of a country’s tax regime.”

The optimism of the Ways and Means Committee was, however, misplaced. On August 20, 2001, the WTO Panel issued its written report holding that the ETI Act also constituted an illegal export subsidy. In addition, the tax exclusion was held to violate US. Obligations under the Agreement on Agriculture and national treatment provisions of the GATT. Moreover, the Panel concluded that the transition rules failed to withdraw the FSC subsidies by the recommended date. On January 14, 2002, the WTO Appellate Body effectively affirmed the Panel’s decision.

5. The Never-ending Story?—The 2004 JOBS Act

In the heat of the national election campaign of 2004, Congress adopted a provision repealing the ETI regime. All the news was not bad for U.S. manufacturers, however, because the legislation also provided for up to a 10 percent reduction in the rate of tax on production income. This action did not necessarily end the battle of Geneva. The 2004 JOBS Act also contained provisions continuing the benefit for a phase out period. EU representatives contended that these provisions maintain the United States in a position of noncompliance. The EU position was sustained in further WTO proceedings, and the EU indicated that the trade sanctions would be reimposed.

6. The Story Ends . . . Finally

In May, 2006, Congress responded to the threat of renewed European tariffs by finally repealing all aspects of the ETI regime. This story seems, thus, to have ended. It may, however, provide to be but one chapter in a series of disputes involving tax incentives in many countries around the world that affect
international trade and that could be challenged as inconsistent with treaty obligations established in the WTO context.

H. Political Considerations

1. General Observations

The international provisions of U.S. tax law have been structured in a number of instances to advance political policies of the United States Government. In such instances tax advantages are denied or tax burdens increased by taxpayers who engage in activities that contravene the policy in question.

2. Denial of Foreign Tax Credits

Foreign tax credits have been denied for income taxes paid to certain countries that are the object of U.S. economic sanctions. Section 901(j) denies credits for taxes paid to any foreign country:

--The government of which the U.S. does not recognize (with certain exceptions to cover situations like Taiwan).
--Where diplomatic relations have been severed or are not conducted.
--Where the Secretary of State decides that the country repeatedly provides support for acts of international terrorism.

Countries that have been subject to this limitation in past years include Cuba, Iran, Iraq, Libya, North Korea, Sudan and Syria. Income tax payments to South Africa (during the Apartheid era) and Viet Nam were formally deemed noncreditable.

3. Foreign Corrupt Practices Act
The payment of illegal bribes, kickbacks of other amounts prohibited by the Foreign Corrupt Practices Act to an official, employee or agent in fact of a foreign government by a U.S. taxpayer will not be deductible as a business expense. Code Sec. 162(c). Moreover, such payments by a CFC will be treated as Subpart F income immediately taxable to U.S. shareholders as if a dividend had been paid. Code Sec. 952(a)(4).

4. **Anti-Boycott Provisions**

The tax system was used as a part of a response by the United States to the Arab Boycott of Israel. U.S. taxpayers and CFC’s who agree to cooperate with that boycott will suffer additional tax burdens through the loss of foreign tax credits and the immediate attribution of the income of the CFC to U.S. shareholders even though no dividends have in fact been paid.