# International Taxation

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U.S./MEXICO INCOME TAX TREATY

REV. RULE 92-106

SELECTED AUTHORITIES FROM PROFESSIONAL AND ETHICAL STANDARDS

# I. INTRODUCTION

**A. Foreign Persons Doing Business or Investing in the U.S.**. Foreign persons who plan to do business in the United States or invest in a new or existing U.S. business entity are faced with a myriad of business, legal and tax issues. U.S. counsel advising foreign persons regarding the ownership structure for a contemplated business or investment in the United States should have a basic understanding of the U.S. system of international taxation of foreign persons.

Nonresident aliens and foreign corporations are subject to U.S. federal income taxation on their taxable income that is effectively connected with the conduct of a U.S. trade or business. The U.S. also imposes a 30% tax (or such lesser rate as is provided by an applicable income tax treaty) on the gross amount of U.S. source interest, dividends, rents, royalties and other fixed, determinable, annual or periodical income from U.S. sources of nonresident aliens and foreign corporations if such income is not effectively connected with the conduct of a U.S. trade or business. In addition, foreign corporations doing business in the U.S. are subject to the branch profits tax.

U.S. income tax treaties often modify the general rules of taxation for nonresident aliens and foreign corporations doing business or investing in the U.S. An applicable income tax treaty may reduce or eliminate the 30% gross-basis tax imposed on nonresident aliens and foreign corporations. In addition, an applicable income tax treaty may limit the imposition of U.S. tax on business operations of a foreign person to cases where the business is conducted through a permanent establishment.

For U.S. federal estate and gift tax purposes, nonresident aliens are subject to U.S. federal estate and gift tax on their "property situated in the U.S." U.S. estate tax treaties may affect the determination of whether an alien is domiciled in the U.S. for U.S. estate tax purposes.

The general pattern of U.S. international taxation of foreign persons gives rise to a host of issues that a U.S. advisor should consider when developing the structure for a business or investment in the U.S., including:

**1.** How is income sourced for U.S. federal income tax purposes?

**2.** Will the foreign person be engaged in the conduct of a U.S. trade or business?

**3.** Will income generated by the foreign person be treated as effectively connected with a trade or business conducted by such foreign person?

**4.** If a foreign person does business or invests in the U.S. through a U.S. or foreign entity, how will the entity be treated for U.S. federal income tax purposes?

**5.** If a foreign person's taxable income is effectively connected with the conduct of a U.S. trade or business, what is the method and rate of U.S. federal income taxation of such income?

**6.** What is the branch profits tax and how does it apply to foreign corporations doing business in the U.S.?

**7.** What is the method and rate of U.S. federal income taxation on a foreign person's U.S. source fixed or determinable annual periodical income?

**8.** What special U.S. federal income tax considerations apply to foreign persons owning or disposing of a U.S. real property interest?

**9.** What is the function of income tax treaties and how do they modify the general U.S. rules of federal income taxation?

**10.** What special U.S. federal estate and gift tax considerations apply to foreign persons doing business or investing in the U.S.

**11.** What special financing considerations apply to foreign-owned U.S. corporations?

**B. U.S. Taxation of U.S. Citizens and Residents and U.S. Corporations**. U.S. citizens, resident aliens and U.S. corporations are generally subject to U.S. income taxation on their worldwide income. To avoid double taxation of income earned abroad, the U.S. allows a credit for income taxes paid to foreign countries with respect to foreign source income. The U.S. also allows certain U.S. corporate shareholders in foreign corporations to claim a credit (known as the indirect or deemed-paid credit), generally in the year the foreign corporation pays a dividend, for foreign income taxes paid by the foreign corporation.

## II. SOURCES OF INCOME

**A. Statutory Framework.** The Internal Revenue Code[1] generally divides income into two categories -- domestic source income, which is income from sources within the U.S., and foreign source income, which is income from sources outside the U.S.[2] Sections 861 through 865 of the Code set forth the rules for determining whether the source of income is domestic or foreign for U.S. federal income tax purposes.[3] Section 861(a) lists specific types of gross income that are treated as income from sources within the United States, while Section 862(a) lists specific types of gross income that are treated as income from sources without the United States.[4] The specific types of income listed within Sections 861(a) and 862(a) include interest, dividends, compensation for personal services, rentals and royalties, income from sales of real property, and income from sales of inventory property.

Section 863 provides source rules for those items of gross income, expenses, losses, and deductions not listed in Sections 861(a) and 862(a) of the Code.[5] Section 863(a) requires that items not enumerated in Sections 861(a) and 862(a) "shall be allocated or apportioned to sources within or without the United States." This treatment is mandatory for determining the source of all items governed by Section 863.[6] Section 863, however, does not prescribe the specific sourcing rules for nonenumerated items, but rather gives the Secretary of the Treasury the authority to promulgate regulations covering such sourcing rules.[7]

Section 863(b) describes certain types of transactions that create "income partly [from] within and partly [from] without the United States." The types of transactions described within Section 863(b) include income from the sale of inventory property produced by the taxpayer within and sold without the United States, or produced without and sold within the United States.[8] For taxable income arising from these types of transactions, Section 863(b) provides that a portion of such taxable income be sourced domestically as determined by "processes or formulas of general apportionment prescribed by the Secretary." The remainder is foreign source income.[9]

Section 864 provides certain definitions and special rules for purposes of Sections 861 through 865. Section 865 provides special sourcing rules for income from the sale of certain personal property.

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[1]All references in this outline to the "Internal Revenue Code" or to the "Code" refer to the Internal Revenue Code of 1986, as amended. Unless otherwise noted, all "Section" references are to the Internal Revenue Code.

[2]*See* I.R.C. §§ 861-865; *Intel Corp. v. Commissioner*, 100 T.C. 616, 621-22 (1993) (discussion of statutory framework and legislative history underlying source rules), *aff'd*, 76 F.3d 976 (9th Cir. 1995); *see generally* 3 Boris I. Bittker & Lawrence Loken, *Federal Income Taxation of Income, Estates and Gifts* ¶ 73.1 (3rd ed. 2010) (overview of source rules).

[3]*Intel Corp.*, 100 T.C. at 621.

[4]*Id.* at 621-22.

[5]*Id.* at 622.

[6]*Id.* at 623.

[7]*Id.* at 623.

[8]I.R.C. § 863(b)(2).

[9]I.R.C. § 863(b); *Intel Corp.*, 100 T.C. at 623.

**B. Sources of Specific Types of Income.** The most common types of income that require a determination of source include interest, dividends, personal services income, rents and royalties, income from real estate sales, income from sales of non-inventory personal property and income from sales of inventory.

**1. Interest.**

**a. U.S.-Source Interest.** Interest from the United States is from U.S. sources.[10] Also, interest is generally from U.S. sources if such interest is accrued on an obligation of a noncorporate U.S. resident[11] or a domestic corporation.[12] This general rule is subject to an exception, with respect to tax years beginning before January 1, 2011,[13] for interest accrued on an obligation of a resident alien or domestic corporation if such individual or corporation meets the 80-percent foreign business requirement of Section 861(c)(1)(A) of the Code (the "80/20 rule"). An individual or corporation meets the 80-percent foreign business requirement of the 80/20 rule if, for the three prior tax years, at least 80-percent of the gross income of such individual or corporation (i) is foreign source; and (ii) attributable to the active conduct of a trade or business in a foreign country by the individual or corporation.[14] If the obligee is a related person, a special look-through rule applies.[15] The 80/20 rule has been

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[10]I.R.C. § 861(a)(1); Treas. Reg. § 1.861-2(a)(1).

[11]The Treasury Regulations expand the scope of the type of obligors that are subject to this sourcing rule. Treasury Regulation Section 1.861-2(a) provides that gross income from the U.S. includes interest from a "resident of the United States . . . ." The term "resident of the United States," as used in this regulation, includes (i) an individual who at the time of payment of the interest is a resident of the United States; (ii) a domestic corporation; (iii) a domestic partnership which at any time during its tax year is engaged in a U.S. trade or business; or (iv) a foreign corporation or foreign partnership which at any time during its tax year is engaged in a U.S. trade or business. Treas. Reg. § 1.861-2(a)(2).

[12]I.R.C. § 861(a)(1); *see Housden v. Commissioner*, 63 T.C.M. (CCH) 2063, 2066 (1992) ("The home base of the payor, rather than the place of payment or location of the debt instrument, is the critical factor in determining the source of interest."); *see also Container Corp. v. Commissioner*, 134 T.C. 122, 140 (2010) (We do not choose International as the source of the income because the guaranty fees were not like alimony: Alimony is only an obligation to pay, because once a court orders one spouse to pay alimony, nothing more is required of the other spouse. Guaranty fees are different--they are payments for a possible future action. We think that makes guaranties more analogous to services. Guaranties, like services, are produced by the obligee and so, like services, should be sourced to the location of the obligee. *See* secs. 861(a)(3), 862(a)(3); Hunt, 90 T.C. at 1301. We realize that we are deciding a close question, but an analogy to interest has too many shortcomings: Guaranty fees do not approximate the interest on a loan; Vitro, not International, produced the guaranty fees; and Vitro's guaranty was not an obligation to pay immediately, but a promise to possibly perform a future act."); *cf.* F.S.A. 200147033 (Nov. 23, 2001) ("There is no explicit sourcing rule for guarantee fees. Guarantees must instead be sourced by analogy to the closest enumerated income item. Interest income is the closest such item. Under section 861(a)(1), interest paid by a U.S. corporation, such as taxpayer, generally is treated as income from sources within the United States. Although the fees are sourced like interest, they are not characterized as interest, because they are not payments for the use or forbearance of money. Accordingly, guarantee fees are other FDAP potentially subject to tax at the rate of 30%. * * * The guarantee fees are not interest within the meaning of Article A of the U.S.-Country A treaty. The payments constitute "other income" taxable at the full U.S. statutory rate of 30 percent unless sufficient facts establish that the payments constitute industrial and commercial profits to A."). Private letter rulings, technical advice memoranda and field service advice are not binding as "precedent." These published administrative positions, however, are often a substantial indication of the position of the Internal Revenue Service on an issue.

[13]Pub. L. No. 111-226, § 217(d)(1). 124 Stat. 2389.

[14]I.R.C. § 861(c).

[15]I.R.C. § 861(c)(2).

repealed effective for tax years beginning after December 31, 2010.[16] The new law provides a grandfather rule for any domestic corporation that (1) meets the 80/20 rule for its last taxable year beginning before January 1, 2011 ("an existing 80/20 company"), (2) meets a "new 80/20 test" with respect to each taxable year beginning after December 31, 2010, and (3) has not added a substantial line of business with respect to such corporation after the date of enactment of this provision.[17] Any payment of dividend or interest after December 31, 2010, by an existing 80/20 company that meets the grandfather rule will be exempt from withholding tax to the extent of the existing 80/20 company's active foreign business percentage.[18] Nonetheless, any payment of interest will be treated as U.S.-source income.[19]

In the case of foreign corporations and foreign partnerships engaged in the conduct of a trade or business in the United States, interest paid by such U.S. trade or business is treated as U.S. source income.[20]

**b. Foreign-Source Interest.** Interest if from a foreign source if it is not U.S.-source interest.[21]

**2. Dividends.**

**a. U.S.-Source Dividends.**

**(1) General Rule.** Dividends are generally from a U.S. source if such dividends are generated by a domestic corporation or a qualifying foreign corporation.[22]

**(2) Qualifying Foreign Corporation.** A portion of the dividends paid by a foreign corporation are U.S.-source if 25 percent or more of the foreign corporation's gross income for the preceding three years was effectively connected with the conduct of a U.S. trade or business.[23] A statutorily-prescribed ratio determines the portion of the dividends that is treated as U.S. source income.

**b. Foreign-Source Dividends.** Dividends are treated as foreign source income if not derived from U.S. sources.[24]

**3. Personal Service Income.**

**a. U.S.-Source Income.** Income from personal services performed in the U.S. is from U.S. sources unless the following three requirements are met:

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[16] Pub. L. No. 111-226, § 217(a). 124 Stat. 2389.

[17] *See Pub L. No.* 111-226, § 217(b)(2), enacting new I.R.C. §§ 871(i)(2)(B), 871(l). 124 Stat. 2389.

[18] New I.R.C. § 871(i)(2)(B), 871(l).

[19] Joint Committee on Taxation Report [JCS-2-10] (8/16/2010).

[20] *See* I.R.C. § 884(f)(1);§ 861(a)(1)(C) (added by the American Jobs Creation Act of 2004).

[21] I.R.C. § 862(a)(1).

[22] I.R.C. § 861(a)(2)(A).

[23] I.R.C. § 861(a)(2)(B).

[24] I.R.C. § 862(a)(2).

**(1)** The services were performed by a nonresident alien who was not present in the U.S. for more than 90 days during the taxable year;

**(2)** The service income does not exceed $3,000 in the aggregate; and

**(3)** The income is from services performed as an employee of or under a contract with either:

**(a)** A nonresident alien, foreign partnership or corporation that is not engaged in business in the U.S.; or

**(b)** A U.S. citizen, resident, or domestic partnership or corporation if such services are for its foreign office.[25]

**b. Foreign-Source Income.** Income from personal services performed outside the U.S. is from a foreign source.[26]

**c. Services Performed Partly Within and Partly Without the U.S.** If performance of services is partly within and partly without the U.S., the amount of compensation included in U.S. source income is determined on the basis that most correctly reflects the proper source of income under the facts and circumstances.[27] The Treasury regulations provide that, in many cases, the facts and circumstances will be such that an apportionment on a time basis will be acceptable.[28]

The Treasury regulations contain special rules applicable to individuals. The regulations contain the facts and circumstances basis as the general rule for determining the source of compensation for labor and personal services performed partly within and partly without the United States received by persons other than individuals and by individuals who are not employees.[29] The regulations, however, provide two general bases for determining the proper source of compensation that an individual receives as an employee for such labor or personal services.[30] Under the first general basis, an individual who receives compensation, other than compensation in the form of certain fringe benefits, as an employee for labor or personal services performed partly within and partly without the United States is required to source such compensation on a time basis.[31] Under the second general basis, an individual who receives

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[25]I.R.C. § 861(a)(3).

[26]I.R.C. § 862(a)(3).

[27]Treas. Reg. § 1.861-4(b)(1); *cf.* PLR 200244017 (May 24, 2002) (25% contingency fee paid by law firm to nonresident alien lawyer allocated between U.S. and foreign sources on a time basis).

[28]Treas. Reg. § 1.861-4(b)(1)(i); *see Bailey v. United States*, 1997 WL 759654 (Ct. Fed. Cl. 1997) ("Without evidence of how many days plaintiff spent in Canada and how many he spent in the United States, this court has no information by which it may determine, with accuracy, the portion of income subject to United States tax. Because the plaintiff has failed to provide any such evidence, all compensation should be included in United States gross income, pursuant to Treas. Reg. § 1.861-4(a) & (b)."), *aff'd,* 200 F.3d 785 (Fed. Cir. 1999).

[29]Treas. Reg. § 1.861-4(b)(1)(i).

[30]Treas. Reg. § 1.861-4(b)(2)(ii).

[31]Treas. Reg. § 1.861-4(b)(2)(ii)(A).

compensation as an employee for labor or personal services performed partly within and partly without the United States in the form of fringe benefits is required to source such compensation on a geographical basis.[32]

Treasury and the Revenue Service recognize that there are circumstances in which these two general bases may not be the most appropriate basis for determining the source of an employee's compensation for labor or personal services performed partly within and partly without the United States. Accordingly, the regulations provide that an employee may use an alternative basis, based upon the facts and circumstances, to source such compensation if he or she establishes to the satisfaction of the Commissioner that such an alternative basis more properly determines the source of the compensation.[33] For example, when an employee's compensation is tied to the performance of specific actions rather than earned ratably over a specific time period, an alternative basis may more properly determine the source of compensation than the bases for determining source of compensation.[34]

On October 17, 2007, the Service published proposed regulations to clarify the determination of source of compensation of a person, including an artist or athlete, who is compensated for labor or personal services performed at an event.[35]

**4. Rents and Royalties.**

**a. U.S.-Source Income.** Rents and royalties are from U.S. sources if derived from one of the following:

**(1)** The rental of real or tangible personal property situated in the U.S.; or

**(2)** The use of intangible property (for example, copyright, patent, secret process or formula) in the U.S.[36]

**b. Foreign-Source Income.** Rents and royalties are from foreign sources if derived from one of the following:

**(1)** The rental of real or tangible personal property situated outside the U.S.; or

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[32]Treas. Reg. §1.861-4(b)(2)(ii)(B) and (D).

[33]Treas. Reg. §1.861-4(b)(2)(ii)(C)(1)(i).

[34]*See* Preamble to Withdrawal of Notice of Proposed Rulemaking and Notice of Proposed Rulemaking, Reg-136481, 69 F.R. 47816-47822, *reprinted at* 2004 TNT 152-3.

[35]*See* REG-114125-07, 72 F.R. 58787-58790, *reprinted at* 2007 TNT 201-10.

[36]I.R.C. § 861(a)(4); *cf.* F.S.A. 200222201 (Feb. 26, 2001) (contingent royalties paid by domestic licensee to foreign corporation licensor for worldwide computer software rights constitute U.S. source income where licensee modifies, may reproduce, and sublicenses software wholly within the U.S. to a domestic licensee for integration into the sublicensees computers sold to customers both within and outside the U.S.); F.S.A. 200139022 (Sept. 28, 2001) (lump sum payment made pursuant to settlement agreement executed to settle patent infringement litigation characterized as U.S.-source royalty income).

**(2)** The use of intangible property outside the U.S.[37]

On September 30, 1998, the Internal Revenue Service issued final regulations effective October 2, 1998, clarifying "the treatment under certain provisions of the Code and tax treaties of income from transactions involving computer programs."[38] Under the final regulations, the determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership of the copyrighted article have been transferred. A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease generating rental income.[39]

**5. Real Estate Sales.**

**a. U.S.-Source Income.** Gain from the sale of real property located in the U.S. is considered U.S.-source gain.[40]

**b. Foreign-Source Income.** Gain from the sale of real property located outside the U.S. is considered foreign-source gain.[41]

**6. Sales of Non-Inventory Property.**

**a. U.S.-Source Income.** With certain exceptions, income realized by a U.S. resident from the sale of non-inventory personal property is generally treated as U.S.-source income.[42] For purposes of Section 865, a "U.S. resident" generally means a U.S. citizen or a resident alien who does not have a tax home (as defined in Section 911(d)(3)) in a foreign

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[37]I.R.C. § 862(a)(4).

[38]T.D. 8785, 1998-2 C.B. 494, *corrected by* 1998-2 C.B. 741. Income from transactions that are classified as sales or exchanges of copyrighted articles will be sourced under sections 861(a)(6), 862(a)(6), 863, 865(a), (b), (c), or (e), as appropriate. Income derived from the leasing of a copyrighted article will be sourced under section 861(a)(4) or section 862(a)(4), as appropriate. Treas. Reg. § 1.861-18(f)(2).

[39]Treas. Reg. § 1.861-18(f)(2).

[40]I.R.C. § 861(a)(5).

[41]I.R.C. § 862(a)(5).

[42]I.R.C. §§ 865(a)(1), 865(b); *cf.* I.R.C. §§ 865(c)(exception for depreciable personal property), 865(d)(exception for intangibles). Under Section 865(d), gain derived from the sale of an intangible asset (in excess of amortization deductions) by a U.S. resident will generally be sourced in the United States to the extent the payments in consideration for the sale are not contingent on the production, use or disposition of the property. I.R.C. § 865(d)(1)(A). If payments are so contingent, the source rule for royalties applies to the gain. I.R.C. § 865(d)(1)(B). Section 865(d)(2) defines "intangible" to include, among other things, secret processes, or formulas, goodwill, trademarks, and franchises. Section 865(d)(3) then provides a special rule for goodwill, sourcing it in the country in which it was generated. *See also International Multifoods Corp. v. Commissioner*, 108 T.C. 25, 37 (1997), *supplemental opinion at* 108 T.C. 579 ("[W]e believe that Congress' enumeration of goodwill in section 865(d)(2) as a separate intangible asset necessarily indicates that the special sourcing rule contained in section 865(d)(3) is applicable only where goodwill is separate from the other intangible assets that are specifically listed in section 865(d)(2).").

country; a nonresident alien who has a tax home in the U.S.; and any corporation, trust or estate which is a U.S. person.[43]

**b. Foreign-Source Income.** With certain exceptions, income realized by a nonresident from the sale of non-inventory personal property is generally sourced outside the U.S.[44] For purposes of Section 865, a "nonresident" means a person other than a U.S. resident (as defined in Section 865(g)(1)(A)).[45] A U.S. citizen or resident alien will not be treated as a nonresident with respect to a sale of non-inventory personal property unless an income tax of at least 10% of the gain on the sale is paid to a foreign country.[46]

**7. Sales of Inventory.** The source of income derived from the sale of inventory property is generally determined by the place where all right, title and interest in the inventory passes to the purchaser.[47] This general rule of sourcing income, often referred to as the "title-passage" rule, does not apply in cases where (1) inventory is produced within and sold without the United States; (2) inventory is produced without and sold within the U.S.; and (3) inventory is purchased within a U.S. possession and sold within the U.S.[48]

**a. Title-Passage Rule.** Under the title passage test, a sale of property is generally "consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss."[49]

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[43]I.R.C. § 865(g)(1)(A).

[44]I.R.C. § 865(a)(2); *see* Rev. Rul. 91-32, 1991-1 C.B. 107, ("A foreign partner of a partnership that is engaged in a trade or business through a fixed place of business in the United States itself has a fixed place of business in the United States, since the foreign partner is considered to be engaged in such trade or business pursuant to section 875(1). Income from the disposition of a partnership interest by the foreign partner will be attributable to the foreign partner's fixed place of business in the United States . . . Accordingly, to the extent provided below, income from [a foreign partner's] disposition of his partnership interest will be sourced in the United States.") Ann. 91-86, 1991-24 I.R.B. 120; *cf.* I.R.C. §§ 865(c), 865(d).

[45]I.R.C. § 865(g)(1)(B).

[46]I.R.C. § 865(g)(2).

[47]I.R.C. §§ 865(b), 861(a)(6), 862(a)(6).

[48]I.R.C. § 863(b).

[49]Treas. Reg. § 1.861-7(c); *see also Kates Holding Co. v. Commissioner*, 79 T.C. 700, 706 (1982) ("[T]he country in which personal property is sold is the place where rights, title, and interest pass from seller to buyer, or under certain circumstances, where beneficial ownership and risk of loss pass from seller to buyer."); *Liggett Group, Inc. v. Commissioner*, 58 T.C.M. (CCH) 1167, 1172 (1990) ("The regulations thus adopt a practical test of locating the point of a sale . . . the seller's retention of bare legal title will not affect the determination that a sale has taken place, so long as the buyer has assumed the beneficial ownership and risk of loss."); *cf.* T.A.M. 200539026 (Sept. 30, 2005) (We consider the case law to be clear that under C.I.F. terms of sale — i.e. , where all incidents of ownership pass to the buyer before shipment, but the seller agrees to pay certain costs including insurance against the buyer's in-transit risk of loss — the sale is consummated at the point of shipment. The difference between the risks insured in a C.I.F. sale and the risk borne by USCorp in this case is that insurance in a C.I.F. sale does not cover the risk of certain in-transit losses such as certain losses due to force majeure, whereas USCorp in this case did bear the risk of in-transit losses due to force majeure. Taxpayer has represented that insurance coverage was commercially available against the type of in-transit risk of loss or damage that it bore with respect to Products during the taxable years at issue. * * * We note that, whereas in a C.I.F. sale risk of loss passes to the buyer at the point of shipment, in this

**(1) U.S.-Source Income.** If title to an item of "purchased" inventory (as opposed to inventory "produced" by the taxpayer) passes inside of the U.S., then income from the sale of such item of inventory will generally be U.S.-source income.[50]

**(2) Foreign-Source Income.**

**(a) General Rule.** If title to an item of "purchased" inventory passes outside of the U.S., then income from the sale will generally be foreign-source income.[51]

**(b) Exception for Nonresidents.** In the case of nonresidents, if title to an inventory item passes outside the U.S., then income from the sale will be U.S.-source income if the gain is attributable to a U.S. office or U.S. fixed place of business of the seller.[52] This exception does not apply, however, if the inventory is sold for use, disposition, or consumption outside the U.S. and a foreign office or other fixed place of business materially participated in the sale.[53]

**b. Comments Concerning Passage of Title.** An understanding of commercial law principles is essential in determining the place where title passes under the "title passage" test. Under conflict-of-law rules, foreign law sometimes may determine title passage in a cross-border sale. If U.S. law applies, however, reference should be made to the Uniform Commercial Code[54] with respect to passage of title in the commercial context, as well as to common law.[55]

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case, certain risk of loss was borne by USCorp during shipment. However, we also observe that, from the point of view of the buyer in both scenarios, risk of casualty loss does not pass to the buyer until delivery at the buyer's place of business. Thus, the two scenarios may be viewed as economically similar with respect to risk of loss. * * * We conclude that, taking into account the factual similarities between the present case and a C.I.F. case — particularly the economic similarity from the perspective of the buyer — the title passage determination in the present case is governed by the C.I.F. title passage rule case law. Therefore, on the facts described in this memorandum, the sales of Products by USCorp to Distributors are consummated outside the United States."); F.S.A. 200052002 (Dec. 29, 2000) (analysis of title-passage test). [Footnote omitted.]

[50]I.R.C. §§ 865(b), 861(a)(6); Treas. Reg. § 1.861-7(c).

[51]I.R.C. §§ 865(b), 865(e), 862(a)(6).

[52]I.R.C. §§ 865(b), 865(e)(2)(A), 862(a)(6).

[53]I.R.C. § 865(e)(2)(B).

[54]State law generally determines the passage of rights and interests between parties, while Federal law determines the effect of these rights and interests on income taxation. *Kates Holding Co. v. Commissioner*, 79 T.C. 700, 706 (1982).

[55]*See generally* Treasury Department Study, "Report to the Congress on the Sales Source Rules" (January 13, 1993, at L-1 (hereinafter "Treasury Study"). The United States is a party to the "United Nations Convention for the International Sale of Goods," 19 I.L.M. 671 (the "Sales Convention"), which entered into force for the United States on January 1, 1988. As of January 1, 2002, 62 countries, including Mexico, were signatories to the Sales Convention. U.S. Dep't of State, *Treaties in Force* (2002).

The Sales Convention generally applies to contracts for the sale of goods between parties whose places of business are in countries that are parties to the Sales Convention. *See* Sales Convention art. 1(1); Treasury Study at 8. Under Article 6 of the Sales Convention, the parties to a sales contract may exclude the application of the Sales Convention by expressly providing in the sales contracts that the Sales Convention does not apply. Although the Sales

The Uniform Commercial Code generally allows the parties to the sale to agree when and where title will pass, and, absent an agreement, makes title pass upon performance of delivery.[56] Under the Uniform Commercial Code, where a buyer and seller are located at a considerable distance apart so that the services of a common carrier are required for transportation, title will generally pass either when the seller places the goods aboard the carrier for shipment to the buyer (a "shipment contract"), or when the carrier arrives at the buyer's location with the goods (a "destination contract").

By way of example of Texas law on the subject, the last sentence of Section 2.401(a) of the Texas Business and Commerce Code provides that "[s]ubject to these provisions and to the provisions of the chapter on Secured Transactions (Chapter 9), title to goods passes from the seller to the buyer in any manner and on any conditions explicitly agreed on by the parties."[57] Section 2.401(b) of the Texas Business and Commerce Code provides as follows:

> Unless otherwise explicitly agreed, title passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods, despite any reservation of a security interest and even though a document of title is to be delivered at a different time or place; and in particular and despite any reservation of a security interest by the bill of lading
>
> (1) if the contract requires or authorizes the seller to send the goods to the buyer but does not require him to deliver them at destination, title passes to the buyer at the time and place of shipment; but
>
> (2) if the contract requires delivery at destination, title passes on tender there.[58]

Parties to a sales transaction can indicate their intent as to title passage. Accordingly, parties to a sales contract should state clearly their intent regarding title passage on contractual documents (for example, order forms, invoices, bills of lading). Often, parties use short-hand terms such as "F.O.B.," "F.A.S.," "C.I.F.," and "Ex-Ship." These terms are often controlling in determining the source of income. The question of title passage is also influenced by negotiable documents of title which are frequently involved in an international sale. Parties should be familiar with the legal ramifications involved in an international sale and with the legal

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Convention does not provide rules for determining title passage, Articles 66 through 70 of the Sales Convention contain rules with respect to the time when the risk of loss passes in a sale transaction.

The Internal Revenue Service has suggested that the Sales Convention is a fairly significant development in the area of U.S. commercial law. The Service has indicated that, in cases where the Sales Convention applies, the Sales Convention rather than state UCC law "is likely to be important in future international title passage issues." Action on Decision, 1991-03 (February 11, 1991).

[56]*See* U.C.C. §§ 2-401(1), 2-401(2), 1A U.L.A. (West Supp. 2009).

[57]Tex. Bus. & Com. Code Ann. § 2.401(a) (Vernon Supp. 2012).

[58]Tex. Bus. & Com. Code Ann. § 2.401(b) (Vernon Supp. 2012).

ramifications of, for example, a "bill of lading." A "bill of lading" is a document of title as well as a contract of shipment and a receipt.

**c. Source Rules for Inventory Produced in One Jurisdiction and Sold in Another Jurisdiction.** Income from the sale of inventory *produced* or manufactured in one jurisdiction and sold in another jurisdiction is allocated and apportioned between both jurisdictions pursuant to certain allocation and apportionment methods described in the Treasury regulations.[59]

**8. Guarantee Income.** The Small Business Lending Fund Act of 2010 Small Business Lending Fund Act of 2010[60] enacted new Section 861(a)(9), which applies to guarantees issued after the date of the enactment of the Act (9/27/2010).[61]

**a. U.S.-Source Income.**

**(1) New Section 861(a)(9)(A).** Under new Section 861(a)(9), income from sources within the United States includes amounts received, whether directly or indirectly, from a noncorporate resident or a domestic corporation for the provision of a guarantee of any indebtedness of such person.[62] The legislative history to this section states that the scope of the provision includes payments that are made indirectly for the provision of a guarantee. For example, the provision would treat as income from U.S. sources a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for example, additional interest charged on the indebtedness.[63] The legislative history also indicates that, for purposes of this provision, the phrase "noncorporate residents" has the same meaning as for purposes of Section 861(a)(1), except that foreign partnerships are not included.[64]

**(2) New Section 861(a)(9)(B).** Under new Section 861(a)(9)(B), income from U.S. sources includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person which is effectively connected with conduct of a U.S. trade or business. (Payments received from a foreign partnership for the provision of a guarantee of indebtedness of that foreign partnership are U.S. source if the amounts received are connected with income which is effectively connected with the conduct of a U.S. trade or business.[65]) Certain amounts received, whether directly or indirectly, for the provision of a guarantee are deemed to be effectively connected with the

[59] *See* I.R.C. § 863(b); Treas. Reg. § 1.863-3.

[60] Pub. L. No. 111-240 (9/27/2010).

[61] Pub. L. No. 111-240, § 2122(d).

[62] I.R.C. § 861(a)(9)(A).

[63] Joint Committee on Taxation Report [JCX-47-10] (9/16/2010).

[64] Joint Committee on Taxation Report [JCX-47-10] (9/16/2010).

[65] Joint Committee on Taxation Report [JCX-47-10] (9/16/2010).

conduct of a U.S. trade or business if derived in the active conduct of a banking, financing or similar business.[66]

**b. Foreign-Source Income.** Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign source income if they are not from sources within the United States as determined under new Section 861(a)(9).[67]

[66] I.R.C. § 864(c)(4)(B)(ii).

[67] I.R.C. § 862(a)(9).

## III. U.S. TRADE OR BUSINESS STATUS OF FOREIGN PERSONS IN THE UNITED STATES

**A. What Is the Significance of a Nonresident Alien or Foreign Corporation Engaging in a U.S. Trade or Business?** The method and rate of taxation of the U.S.-source income of a nonresident alien and foreign corporation generally depends upon whether or not the taxpayer is engaged in a trade or business in the U.S. and whether the item of income is effectively connected with the conduct of that trade or business.

**B. How Is "Trade or Business" Status Determined?**

**1. Relevant Factors in Determining Trade or Business Status**. The existence of a U.S. trade or business is generally determined on a case-by-case basis.[68] The question of whether a foreign person is engaged in a U.S. trade or business has generated a significant body of case law.[69] Several factors are considered in determining "trade or business" status, including the following:

- **a.** Continuity and regularity of activity;
- **b.** Presence of personnel with discretionary authority;
- **c.** Significance of activity in producing income;
- **d.** Nature and function of U.S. facilities and personnel; and
- **e.** Number of transactions completed in the U.S.

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[68]*See* Rev. Rul. 88-3, 1988-1 C.B. 268 ("[T]he determination whether a taxpayer is engaged in a trade or business within the United States is highly factual. Such a determination is not ordinarily made in an advance ruling.").

[69]*See, e.g., Spermacet Whaling & Shipping Co. v. Commissioner*, 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960)*; Consolidated Premium Iron Ores, Ltd. v. Commissioner*, 28 T.C. 127, 150-52 (1957) (suggesting that "engaged in business" conveys the idea of "progression, continuity, or sustained activity"), *aff'd*, 265 F.2d 320 (6th Cir. 1959); *Continental Trading, Inc. v. Commissioner*, 265 F.2d 40 (9th Cir. 1959) *cert. denied*, 361 U.S. 827 (1959); *European Naval Stores Co., S.A. v. Commissioner,* 11 T.C. 127, 133 (1948) (suggesting that "engaged in business" conveys the idea of "progression, continuity, or sustained activity"); *Linen Thread Co., Ltd. v. Commissioner*, 14 T.C. 725, 736 (1950) ("The character of [the American] office and the purpose for which that office was established are determinative of whether petitioner was engaged in trade or business within the United States.'"); *Scottish American Inv. Co. v. Commissioner,* 12 T.C. 49, 59 (1949) ("In cases such as these, it is a matter of degree, based upon both a quantitative and a qualitative analysis of the services performed, as to where the line of demarcation should be drawn. It is not so much the volume of the activities of the Jersey City office, although volume of activities may, in some cases, be a factor, but rather their character and the purpose for which the office is established that we believe are determinative."); *Perez v. Commissioner*, 56 T.C.M. (CCH) 312, 317 (1988) ("A foreign taxpayer is engaged in a trade or business within the United States if the taxpayer, continuously and regularly, transacts a substantial portion of its ordinary business within the United States during a substantial portion of the taxable year . . . The term 'engaged in a trade or business' has been interpreted to mean 'doing business' which conveys the idea of a continued and sustained activity."); *Inverworld, Inc. v. Commissioner*, 71 T.C.M. (CCH) 3231, 3237-30 (1996) ("[W]e conclude that [the foreign taxpayer] 'engaged in *** substantial, regular, or continuous ordinary business activity in the United States.'"). For an excellent article analyzing the term "trade or business" from the standpoint of the foreign person, *see* Isenbergh, *The "Trade or Business" of Foreign Taxpayers in the United States*, 61 Taxes 972 (1983).

**2. Activities of Agent Attributed to Nonresident Alien or Foreign Corporation**. The U.S. activities of a nonresident alien or foreign corporation's dependent agent in the U.S. will be attributed to the nonresident alien or foreign corporation in determining whether or not the nonresident alien or foreign corporation is conducting a trade or business in the U.S.[70] A nonresident alien or foreign corporation that is a partner in a partnership or a beneficiary of an estate or trust is treated as engaged in the conduct of a trade or business in the United States if the partnership, estate or trust is so engaged.[71]

**3. Trade or Business Includes Performance of Personal Services in the U.S**. The Code contains specific rules with respect to the application of the trade or business standard to certain activities. For example, trade or business within the United States expressly includes the performance of personal services within the United States.[72] An exception applies, however, in the case of a nonresident alien individual's performance of services for a foreign employer, where the total compensation received for such services during the year is $3,000 or less and the period in which the individual is present in the U.S. does not exceed 90 days.[73]

**4. Special Rules Apply to Trading in Stocks or Securities**. Detailed rules govern the determination of whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.[74]

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[70]*Cf. Taisei Fire & Marine Ins. Co., Ltd. v. Commissioner*, 104 T.C. 535, 554 (1995), *acq.* 1995-2 C.B. 1, (case addresses whether agent qualified as an "independent agent" under U.S./Japan Income Tax Treaty); *see generally* Hannes, "Achieving Transfer Pricing Objectives Without Creating a U.S. Business for a Foreign Person," 2003 TNT 92-57 (May 9, 2003) (article explores the federal source-basis income tax ramifications when a foreign supplier distributes goods in the United States through a U.S. corporation and the foreign supplier protects the U.S. corporation against financial risks).

[71]I.R.C. § 875.

[72]I.R.C. § 864(b)(1).

[73]I.R.C. § 864(b)(1).

[74]I.R.C. § 864(b)(2).

## IV. EFFECTIVELY CONNECTED INCOME

**A. The Significance of Effectively Connected Income**. A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on the income that is "effectively connected" with such business.[75]

**B. Rules Governing the Determination of Whether Income is Effectively Connected.** Specific statutory rules govern the determination of whether income is effectively connected.[76]

**1. U.S.-Source Income.** In determining whether income is effectively connected with the conduct of a U.S. trade or business, "income from sources within the United States generally is segregated between two categories, pursuant to section 864(c)(2) and (3)."[77] The first category consists of U.S.-source capital gain or loss and U.S.-source income subject to gross-basis taxation. The second category consists of all other U.S.-source income.

**a. U.S.-Source Capital Gain or Loss and U.S.-Source Income Subject to Gross-Basis Taxation.** In the case of U.S.-source capital gain or loss and U.S.-source income of a type that would be subject to gross-basis U.S. taxation, "[s]ection 864(c)(2) provides two general 'factors' to consider in determining whether income from sources within the United States falling under its purview is effectively connected:"[78](1) the amount is derived from assets used in or held for use in the conduct of the U.S. trade or business (the "asset-use test"); and (2) the activities of the trade or business were a material factor in the realization of the amount (the "business-activities test").[79] Additionally, in determining whether income is effectively connected with a U.S. trade or business, due regard is given to whether the asset or income, gain or loss was accounted for through the U.S. trade or business.[80]

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[75]I.R.C. § 882(a)(1); cf. PLR. 201228013 (Apr. 17, 2012) ("[I]t is held that: 1) The portion of Taxpayer's unused net operating losses from Business X that were generated while he was taxed as a U.S. resident, and that would have been allocated and apportioned, in accordance with the rules in Treas. Reg. § 1.8618(e)(8), to the gross income of Business X had he been taxed on such income as a nonresident alien for such years, may be used to the extent provided in Treas. Reg. § 1.861-8 to offset gross income effectively connected with the conduct of Business X in the United States while he is a nonresident alien. 2) Taxpayer may carry over any unused net operating losses from Business X allocated and apportioned to income effectively connected with the conduct of Business X in the United States while he is taxed as a nonresident alien, and may apply such losses against gross income from Business X after he reacquires U.S. resident status. 3) Taxpayer may carry over any unused net operating losses from Business X generated while he was taxed as a U.S. resident, if still available, against his gross income after he reacquires U.S. resident status. The years in which Taxpayer is a nonresident alien will be taken into account in determining whether any such unused net operating losses from Business X are still available under section 172(b)(1).").

[76]I.R.C. § 864(c).

[77]*Inverworld, Inc. v. Commissioner*, 71 T.C.M. (CCH) 3231, 3237-36 (1996).

[78]*Ibid*.

[79]I.R.C. § 864(c)(2); *see* Rev. Rul. 91-32, 1991-1 C.B. 107 ("Gain or loss of a foreign partner that disposes of its interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States will be United States source ECI gain or will be ECI loss that is allocable to United States source ECI gain, to the extent that the partner's distributive share of unrealized gain or loss of the partnership would be attributable to ECI (United States source) property of the partnership.") *corrected by* Ann. 91-86, 1991-24 I.R.B. 120; *see also* Treas. Reg. § 1.864-4(c)(5)("Special rules relating to banking, financing, or similar business activity.").

[80]I.R.C. § 864(c)(2).

**(1) Asset-Use Test.** The asset-use test ordinarily applies "in making a determination with respect to income, gain, or loss of a passive type where the trade or business activities as such do not give rise directly to the realization of the income, gain, or loss."[81] The regulations state that the test is "of primary significance where, for example, interest or dividend income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the United States."[82]

**(2) Business-Activities Test.** The business activities test ordinarily applies in "making a determination with respect to income, gain, or loss which, even though generally of the passive type, arises directly from the active conduct of the taxpayer's trade or business in the United States."[83] The regulations provide that the business-activities test is of primary significance in cases in which: (a) dividends or interest are derived by a dealer in stocks or securities, (b) gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business by an investment company, (c) royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, or (d) service fees are derived in the active conduct of a servicing business.[84]

**b. All Other U.S.-Source Income.** In the case of any other U.S. -source income, gain, or loss (not otherwise included above), such amounts are all treated as effectively connected with the conduct of the trade or business in the United States.[85]

**2. Foreign-Source Income.** Certain prescribed types of foreign-source income of a foreign person may be taxed by the U.S. if the income is effectively connected with the conduct of a trade or business in the United States.[86] Foreign-source income, gain, or loss generally is considered to be effectively connected with a U. S. business only if the person has an office or other fixed place of business within the United States[87] to which such income, gain, or loss is attributable and such income falls into one of the following three categories:[88]

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[81]Treas. Reg. § 1.864-4(c)(2)(i).

[82]Treas. Reg. § 1.864-4(c)(2)(i).

[83]Treas. Reg. § 1.864-4(c)(3)(i).

[84]Treas. Reg. § 1.864-4(c)(3)(i).

[85]I.R.C. § 864(c)(3).

[86]I.R.C. § 864(c)(4)(B); *see also* I.R.C. § 906(a) (allowing credit for foreign income taxes paid or accrued with respect to income effectively connected with the conduct of a trade or business within the United States).

[87]*See* I.R.C. § 864(c)(4) (special rules for use in determining whether a nonresident alien individual or a foreign corporation has an office or other fixed place of business in the U.S. and whether income and to what extent income, gain or loss is attributable to an office or other fixed place of business in the U.S.).

[88]I.R.C. § 864(c)(4)(B); *see also* I.R.C. § 864(c)(4)(C) (special rules apply for purposes of determining the effectively-connected income of an insurance company).

**a.** Rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trade-marks, trade brands, franchises, or other like intangible properties derived in the active conduct of the U.S. trade or business;[89]

**b.** Interest, dividends or amounts received for the provision of guarantees of indebtedness derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account;[90]

**c.** Income, gain, or loss derived from the sale or exchange (outside the U.S.) of inventory or property held primarily for sale to customers in the ordinary course of business where the sale or exchange was made through the foreign person's U.S. office or other fixed place of business.[91] Such amounts, however, are not treated as effectively connected if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country participated materially in the sale or exchange.[92]

Foreign-source income of a type not specified above generally is not subject to U.S. federal income tax.[93]

**3. Treatment of Deferred Payments.** Income, gain, or loss for a particular year generally is not treated as effectively connected if the foreign person is not engaged in a U.S. trade or business in that year.[94] If, however, income or gain taken into account for a tax year is attributable to the sale or exchange of property, the performance of services, or any other transaction which occurred in a prior taxable year, the determination whether such income or gain is taxable on a net basis is required to be made as if the income were taken into account in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year.[95]

**4. Special Treatment of Certain Property Transactions.** If any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States and the property is disposed of within 10 years after the cessation, the determination of whether any income or gain attributable to the disposition of the property is taxable on a net basis is required to be made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a trade or

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[89]I.R.C. § 864(c)(4)(B)(i); *but see* I.R.C. § 864(c)(4)(D)(limited exception applies to foreign source income if it either (i) consists of dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns more than 50% of the total voting stock or (ii) is Subpart F income).

[90]I.R.C. § 864(c)(4)(B)(ii); *but see* I.R.C. § 864(c)(4)(D)(limited exception applies to foreign source income if it either (i) consists of dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns more than 50% of the total voting stock or (ii) is Subpart F income).

[91]I.R.C. § 864(c)(4)(B)(iii).

[92]I.R.C. § 864(c)(4)(B)(iii).

[93]I.R.C. § 864(c)(4)(A).

[94]I.R.C. § 864(c)(1)(B).

[95]I.R.C. § 864(c)(6).

business in the U.S. and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year for which the income or gain is taken into account.[96]

[96] I.R.C. § 864(c)(7).

## V. CLASSIFICATION OF INDIVIDUALS AND ENTITIES FOR U.S. FEDERAL INCOME TAX PURPOSES

### A. Definition of Nonresident Alien for U.S. Federal Income Tax Purposes.

**1. Nonresident Alien is an Individual Who is Neither a U.S. Citizen Nor a U.S. Resident**. For U.S. federal income tax purposes, a "nonresident alien" is an individual who is neither a U.S. citizen nor a U.S. resident.[97]

**a. Determining Residency of an Individual for U.S. Income Tax Purposes.** An alien individual is treated as a U.S. resident with respect to any calendar year if (and only if) such individual either:

**(1)** Is a lawful permanent resident of the U.S. at any time during the calendar year (the "green card test"); or

**(2)** Such individual meets a "substantial presence test."[98]

**b. The Green Card Test.** A lawful permanent resident is an individual who has been granted the privilege of residing permanently in the U.S. as an immigrant under U.S. immigration laws.[99] The test is called the "green card test" because lawful permanent residence is evidenced by possession of a U.S. Immigration and Naturalization Service Form I-151 or I-551 (Alien Registration Receipt Card, commonly called a "green card").

**c. The Substantial Presence Test.**

**(1) General Rule.** An individual meets the "substantial presence test" if:

**(a)** Such individual is physically present in the U.S. for 31 days during the current calendar year; and

**(b)** The sum of the following equals or exceeds 183 days:

**i)** the number of days that the nonresident alien is present in the U.S. during the current calendar year; plus

**ii)** 1/3 of the days in the first preceding calendar year; plus

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[97] I.R.C. § 7701(b)(1)(B).

[98] I.R.C. § 7701(b)(1)(A).

[99] I.R.C. § 7701(b)(1)(A)(i).

**iii)** 1/6 of the days in the second preceding calendar year.[100]

**(2) Closer Connection Exception to Substantial Presence Test.** An individual is not treated as meeting the substantial presence test (and, thus, may be treated as a nonresident alien) if the individual meets a "closer-connection" test. An individual meets the closer connection test if he meets all three of the following conditions:

**(a)** The individual is present in the U.S. for less than 183 days during the current year;

**(b)** The individual has a tax home in a foreign country during the current year; and

**(c)** The individual has a closer connection to a foreign country than to the U.S.[101]

The factors considered in determining whether a person has a closer connection include the location of the person's permanent home, family and personal bank accounts, the location of cultural and religious organizations to which he or she belongs, his or her type of driver's license, and where he or she votes.[102] The closer connection exception will not apply with respect to any current year if the taxpayer had an application for adjustment of status pending with the Immigration and Naturalization Service, or such individual took other steps to apply for status as a lawful permanent resident of the U.S.[103] In order to claim the closer connection exception, a foreign person must timely file a statement with the IRS on I.R.S. Form 8840.[104]

**(3) Other Exceptions to Substantial Presence Test.** In addition to the closer-connection exception, other exceptions to the substantial presence test are provided for certain medical conditions, foreign-government related individual, teacher or trainee, and students.

**2. Treaties.** With regard to individuals who reside in countries with whom the U.S. has an income tax treaty, reference should also be made to such treaty. For example, if a green card holder is living in a treaty country, it is possible that the alien will not be treated as a U.S. resident under the treaty's "tie breaker rules."

**B. Classification of Entities for Federal Income Tax Purposes.**

**1. Background.** The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes.[105] For example, a partnership is defined to

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[100]I.R.C. § 7701(b)(3); *see, e.g., Lujan v. Commissioner*, 80 T.C.M. (CCH) 780 (2000) (alien met substantial presence test for both years in issue).

[101]I.R.C. § 7701(b)(3)(B)(ii).

[102]Treas. Reg. § 301.7701(b)-2(d).

[103]I.R.C. § 7701(b)(3)(C).

[104]Treas. Reg. § 301.7701(b)-8(b)(1)(i).

[105]Treas. Reg. § 301.7701-1(a)(1).

include a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and that is not a trust or estate or a corporation.[106] A corporation is defined to include associations, joint-stock companies, and insurance companies.[107]

**2. Final Check-The-Box Regulations.** On December 17, 1996, the IRS adopted final entity classification changes (known as the "check-the-box regulations"), generally effective as of January 1, 1997.[108] Under the prior regulations, the classification of an unincorporated organization as a partnership or a corporation depended on whether the entity had a majority of certain prescribed corporate characteristics.[109] The check-the-box regulations replaced these rules with a four-step process for classifying an entity for federal tax purposes.

**3. Step One: Determine Whether a Separate Entity Exists for Federal Tax Purposes.** The first step in the check-the-box classification process is to determine whether there is a separate entity for federal tax purposes (which is a matter of federal tax law).[110]

**(1) Federal Tax Law Controls Whether Entity Is Separate from Owners.** The issue of whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.[111]

**(2) Certain Joint Undertakings May Constitute Separate Entities for Tax Purposes.** The check-the-box regulations retain the pre-check-the-box rules regarding joint undertakings. Certain joint undertakings that are not entities under local law may nonetheless constitute separate entities for federal tax purposes. A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the individuals actively carry on a trade, business, financial operation, or venture and divide the profits therefrom.[112] For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent; however, a joint undertaking "merely to share expenses" does not create a separate entity.[113] The regulations state that a separate entity would not exist for federal tax purposes if two or more persons jointly constructing a ditch merely to drain surface water from their properties. As another example, the regulations provide that "mere co-ownership of

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[106]I.R.C. § 7701(a)(2).

[107]I.R.C. § 7701(a)(3).

[108]Treas. Reg. §§ 301.7701-1(f), 301.7701-2(e), 301.7701-3(f)(1).

[109]Former Treas. Reg. §§ 301.7701-2 and -3; *Larson v. Commissioner*, 66 T.C. 159 (1976), acq. 1979-2 C.B.1.

[110]T.D. 8697, 1997-2 I.R.B. 12; Notice of Proposed Rulemaking, PS-43-95, 1996-1 C.B. 865, 866 [hereinafter "Reg. Notice"].

[111]Treas. Reg. § 301.7701-1(a)(1).

[112]Treas. Reg. § 301.7701-1(a)(2).

[113]Treas. Reg. § 301.7701-1(a)(2).

property" that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.[114]

**(3) Certain Single-Owner Organizations Can Choose Whether to be Recognized.** Under the check-the-box regulations, certain organizations (discussed below) that have a single owner can choose to be recognized or disregarded as entities separate from their owners.[115] If an entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.[116]

**4. Step Two: If a Separate Entity Exists, Determine Whether the Entity Is a Trust or a Business Entity.** The regulations provide that an organization that is recognized as a separate entity for federal tax purposes is either a trust or a "business entity" (unless a provision of the Code expressly provides for special treatment, such as the real estate mortgage investment conduit rules). Thus, the second step in the classification process is to determine whether a separate entity for federal tax purposes is a trust or a "business entity." A "business entity" is defined in the regulations as "any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner . . .) that is not properly classified as a trust . . . or otherwise subject to special treatment under the Internal Revenue Code."[117] The classification of organizations as trusts is governed by Treas. Reg. § 301.7701-4. That section restates the distinction between trusts and business entities that existed prior to the issuance of the check-the-box regulations. The check-the-box regulations were not intended to change the pre-check-the-box rules for determining whether an organization is classified as a trust for federal tax purposes.[118]

**5. Step Three: If an Entity Is a Business Entity, Determine Whether It Is Automatically Classified as a Corporation.** If an entity is a business entity, the third step in the classification process is to determine whether it is automatically classified as a corporation.[119] Treas. Reg. § 301.7701-2 specifies eight types of business entities that are automatically classified as corporations for federal tax purposes and also prescribes certain special rules applicable to foreign entities. The eight types of entities that are automatically classified as corporations are as follows:

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[114]Treas. Reg. § 301.7701-1(a)(2); *see also* Rev. Proc. 2002-22, 2002-1 C.B. 733 modified by Rev. Proc. 2003-3, 2003-1 C.B. 113 (specifies conditions under which the Revenue Service will consider a request for ruling that an undivided fractional interest in rental real property is not an interest in a business entity).

[115]Treas. Reg. § 301.7701-1(a)(4).

[116]Treas. Reg. § 301.7701-2(a).

[117]Treas. Reg. § 301.7701-2(a).

[118]*See* T.D. 8697, 1997-2 I.R.B. 12; Reg. Notice, 1996-1 C.B. at 866; *cf.* PLR. 201245003 (July 30, 2012) ("The [Mexican Land Trust] described here is similar to an Illinois Land Trust. The sole purpose of the MLT is to satisfy the Mexican Federal Constitution by vesting legal title to the property in the name of the trustee. The trustee's sole responsibility for the property is to hold and transfer title at the exclusive direction of the taxpayer. The trustee has no duty and no right to defend, maintain, or manage the property. Taxpayer retains sole authority to manage and control the property, the direct right to collect any rents or proceeds generated by the property, and the direct obligation to pay all taxes and liabilities related to the property. We also note that there is no arrangement between Bank, X, A, B or any other person to utilize the condominium in an activity for profit, such that ownership of the condominium could be classified as a business entity.").

[119]*See* Treas. Reg. § 301.7701-3(a); Reg. Notice, 1996-1 C.B. at 866.

**(1)** A business entity organized under a Federal or State statute (or under a statute of a federally recognized Indian tribe) describing or referring to the entity as incorporated or as a corporation, body corporate, or body politic;[120]

**(2)** A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;[121]

**(3)** An insurance company;[122]

**(4)** A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended,[123] or a similar federal statute;[124]

**(5)** A business entity wholly owned by a State or any political subdivision thereof, or a business entity wholly owned by a foreign government or certain integral parts or controlled entities of a foreign sovereign;[125]

**(6)** A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3),[126] including a business entity that is publicly traded within the meaning of section 7704 (and not within the exception in section 7704(c)) and a business entity that is a taxable mortgage pool under section 7701(i);[127]

**(7)** An entity created or organized under the laws of more than one jurisdiction if the check-the-box rules would treat it as a corporation as a result of its formation in any one of the jurisdictions in which it is created or organized;[128] and

**(8)** Certain foreign entities listed in the regulations, including the following:[129]

American Samoa, Corporation
Argentina, Sociedad Anonima
Australia, Public Limited Company
Austria, Aktiengesellschaft
Barbados, Limited Company
Belgium, Societe Anonyme
Belize, Public Limited Company

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[120]Treas. Reg. § 301.7701-2(b)(1); Reg. Notice, 1996-1 C.B. at 866-67.

[121]Treas. Reg.§ 301.7701-2(b)(3).

[122]Treas. Reg. § 301.7701-2(b)(4).

[123]12 U.S.C. § 1811.

[124]Treas. Reg. § 301.7701-2(b)(5).

[125]Treas. Reg. § 301.7701-2(b)(6); *see* Treas. Reg. § 1.892-2T.

[126]Treas. Reg. § 301.7701-2(b)(7).

[127]Reg. Notice, 1996-1 C.B. at 867.

[128]Temp. Treas. Reg. § 301.7701-2(b)(9).

[129]Treas. Reg. § 301.7701-2(b)(8).

Bolivia, Sociedad Anonima
Brazil, Sociedade Anonima
Bulgaria, Aktsionerno Druzhestvo.
Canada, Corporation and Company
Chile, Sociedad Anonima
People's Republic of China, Gufen Youxian Gongsi
Republic of China (Taiwan), Ku-fen Yu-hsien Kung-szu
Colombia, Sociedad Anonima
Costa Rica, Sociedad Anonima
Cyprus, Public Limited Company
Czech Republic, Akciova Spolecnost
Denmark, Aktieselskab
Ecuador, Sociedad Anonima or Compania Anonima
Egypt, Sharikat Al-Mossahamah
El Salvador, Sociedad Anonima
Estonia, Aktsiaselts
European Economic Area/European Union, Societas Europaea
Finland, Julkinen Osakeyhtio/Publikt Aktiebolag
France, Societe Anonyme
Germany, Aktiengesellschaft
Greece, Anonymos Etairia
Guam, Corporation
Guatemala, Sociedad Anonima
Guyana, Public Limited Company
Honduras, Sociedad Anonima
Hong Kong, Public Limited Company
Hungary, Reszvenytarsasag
Iceland, Hlutafelag
India, Public Limited Company
Indonesia, Perseroan Terbuka
Ireland, Public Limited Company
Israel, Public Limited Company
Italy, Societa per Azioni
Jamaica, Public Limited Company
Japan, Kabushiki Kaisha
Kazakstan, Ashyk Aktsionerlik Kogham
Republic of Korea, Chusik Hoesa
Latvia, Akciju Sabiedriba
Liberia, Corporation
Liechtenstein, Aktiengesellschaft
Lithuania, Akcine Bendroves
Luxembourg, Societe Anonyme
Malaysia, Berhad
Malta, Public Limited Company
Mexico, Sociedad Anonima
Morocco, Societe Anonyme

Netherlands, Naamloze Vennootschap
New Zealand, Limited Company
Nicaragua, Compania Anonima
Nigeria, Public Limited Company
Northern Mariana Islands, Corporation
Norway, Allment Aksjeselskap
Pakistan, Public Limited Company
Panama, Sociedad Anonima
Paraguay, Sociedad Anonima
Peru, Sociedad Anonima
Philippines, Stock Corporation
Poland, Spolka Akcyjna
Portugal, Sociedade Anonima
Puerto Rico, Corporation
Romania, Societe pe Actiuni
Russia, Otkrytoye Aktsionernoy Obshchestvo
Saudi Arabia, Sharikat Al-Mossahamah
Singapore, Public Limited Company
Slovak Republic, Akciova Spolocnost
Slovenia, Delniska Druzba
South Africa, Public Limited Company
Spain, Sociedad Anonima
Surinam, Naamloze Vennootschap
Sweden, Publika Aktiebolag
Switzerland, Aktiengesellschaft
Thailand, Borisat Chamkad (Mahachon)
Trinidad and Tobago, Limited Company
Tunisia, Societe Anonyme
Turkey, Anonim Sirket
Ukraine, Aktsionerne Tovaristvo Vidkritogo Tipu
United Kingdom, Public Limited Company
United States Virgin Islands, Corporation
Uruguay, Sociedad Anonima
Venezuela, Sociedad Anonima or Compania Anonima

**6. Step Four: If an Entity Is a Business Entity and Is Not Automatically Classified as a Corporation, Classify the Entity According to the Regulations.** If an entity is a business entity and is not automatically classifiable as a corporation, such an entity (referred to as an "eligible entity" in the regulations) may elect its classification for federal tax purposes.[130]

**(1) General Classification Rules.** An eligible entity with two or more members may elect to be classified as a corporation or a partnership.[131] An eligible

[130]*See* Treas. Reg. § 301-7701-3.

[131]Treas. Reg. § 301.7701-3(a).

entity with a single member may elect to be classified as a corporation or to be "disregarded" as an entity separate from its owner.[132] (Certain special rules apply to banks.[133]) A disregarded entity is treated in the same manner as a sole proprietorship, in the case of an entity owned by individuals, and in the same manner as a branch or division, in the case of an entity owned by a corporation.[134] The Regulations provide a default classification for an eligible entity that does not make an election.[135] Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification.[136]

**(2) Default Classification Rules (For Eligible Entities That Do Not File an Election).**

**(a) Domestic Eligible Entities.** For domestic eligible entities formed on or after January 1, 1997, the default rules are as follows: (1) a domestic entity with two or more members is classified as a partnership;[137] and (2) a domestic single-member eligible entity is disregarded as separate from its owner.[138] For domestic eligible entities in existence prior to January 1, 1997, the default classification is generally the classification claimed by the entity under the pre-check-the-box regulations[139] subject to a special rule for single-member entities. Single-member entities that claimed to be a partnership under the pre-check-the-box regulations are treated as disregarded entities.[140]

Revenue Procedure 2002-69 provides guidance on the classification of a "qualified entity" that is owned by a husband and wife as community property under the laws of a U.S. state, a foreign country or a possession of the United States.[141] A business entity is a qualified entity if: (1) the business entity is wholly owned by a husband and wife as community property under the laws of a U.S. state, a foreign country, or a U.S. possession; (2) no person other than one or both spouses would be considered an owner for federal tax purposes; and (3) the business entity is not treated as a corporation under the check-the-box regulations.[142] The Revenue Procedure provides that: (1) if a qualified entity, and the husband and wife, as community property owners, treat the entity as a disregarded entity for federal tax purposes, the Internal Revenue Service will accept the position that the entity is a disregarded entity for federal tax

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[132]Treas. Reg. §§ 301.7701-3(a), 301.7701-2(b)(2).

[133]*See* Treas. Reg. § 301.7701-2(c)(2)(ii).

[134]Treas. Reg. § 301.7701-2(a).

[135]Treas. Reg. Sec. 301.7701-3(a).

[136]Treas. Reg. Sec. 301.7701-3(a).

[137]Treas. Reg. § 301.7701-3(b)(1)(i).

[138]Treas. Reg. § 301.7701-3(b)(1)(ii); *but cf.* Treas. Reg. § 301.7701-2T(c)(2)(iii)(A)("An entity that is disregarded as separate from its owner for any purpose under § 301.7701-2 is treated as an entity separate from its owner for purposes of (1) Federal tax liabilities of the entity with respect to any taxable period for which the entity was not disregarded; (2) Federal tax liabilities of any other entity for which the entity is liable. (3) refunds or credits of Federal tax.").

[139]Treas. Reg. § 301.7701-3(b)(3)(i).

[140]Treas. Reg. § 301.7701-3(b)(3)(i)).

[141]Rev. Proc. 2002-69, § 1, 2002-44 I.R.B. 1 (Oct. 9, 2002).

[142]Rev. Proc. 2002-69, § 3.02.

purposes;[143] (2) if a qualified entity, and the husband and wife as community property owners, treat the entity as a partnership for federal tax purposes and file the appropriate partnership returns, the Internal Revenue Service will accept the position that the entity is a partnership for federal tax purposes;[144] and (3) a change in reporting position will be treated for federal tax purposes as a conversion of the entity.[145]

**(b) Foreign Eligible Entities.** For foreign eligible entities formed on or after January 1, 1997, unless the entity elects otherwise, a foreign eligible entity is (1) a partnership if it has two or more members and at least one member does not have limited liability; (2) a corporation if all members have limited liability; (3) disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.[146] For foreign eligible entities in existence prior to January 1, 1997, the default classification is generally the classification claimed by the entity under the pre-check-the-box regulations[147] subject to a special rule for single-member entities. Single-member entities that claimed to be a partnership under the pre-check-the-box regulations are treated as disregarded entities.[148] A foreign eligible entity is treated as being in existence prior to January 1, 1997, only if the entity's classification was relevant at any time during the 60 months prior to January 1, 1997.[149] The regulations provide special rules for determining the relevancy of an entity's classification.[150]

**(3) Procedural Rules for Filing Election.** The Treasury regulations prescribe the procedure for filing an election to classify an eligible entity.[151] An eligible entity makes a classification election by filing Form 8832 with the Internal Revenue Service.[152] The regulations provide that "[a]n election will not be accepted unless all of the information required by the form and instructions, including the taxpayer identifying number of the entity, is provided on Form 8832."[153] An entity may file its initial election at any time, but the regulations generally prohibit filing of more than one election to change an entity's classification during any 60-month period.[154] An election is effective on the date specified on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 cannot be more than 75 days prior to the date on which the election is filed and cannot be more than 12 months after the election is filed.[155]

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[143]Rev. Proc. 2002-69, § 4.01.

[144]Rev. Proc. 2002-69, § 4.02.

[145]Rev. Proc. 2002-69, § 4.03.

[146]Treas. Reg. § 301.7701-3(b)(2).

[147]Treas. Reg. § 301.7701-3(b)(3)(i).

[148]Treas. Reg. § 301.7701-3(b)(3)(i).

[149]Treas. Reg. § 301.7701-3(b)(ii).

[150]Treas. Reg. § 301.7701-3(d)(1).

[151]Treas. Reg. § 301.7701-3(c).

[152]Treas. Reg. § 301.7701-3(c)(1)(i).

[153]Treas. Reg. § 301.7701-3(c)(1)(i).

[154]Treas. Reg. § 301.7701-3(c)(1)(iv).

[155]Treas. Reg. § 301.7701-3(c)(1)(iii). The Procedure and Administration regulations permit the Service to grant a reasonable extension of time for making certain elections, including the entity classification election on Form 8832. Treas. Reg. § 301.9100-1(c). Under these regulations, an extension of time to file certain elections will be granted if

**7. Elective Changes in Classification.** The Treasury regulations prescribe the deemed federal income tax consequences of the following elective changes in classification: (1) partnership to corporation; (2) corporation to partnership; (3) corporation to disregarded entity; and (4) disregarded entity to a corporation.[156]

**8. Revenue Ruling 2004-77**. In Revenue Ruling 2004-77, the Revenue Service considers the federal income tax classification of a limited partnership (LP) that consists of a limited liability company (L) as general partner and a corporation (X) as limited partner. X is the sole owner of L and L is disregarded as an entity separate from X and L's activities are treated in the same manner as a branch or division of X. The Ruling concludes that, for federal tax purposes, LP is disregarded as an entity separate from its owner, X. The Ruling states that because L is disregarded as an entity separate from X, X is treated as owning all of the interests in LP. LP is a domestic entity, with only one owner for federal tax purposes, that has not made an election to be classified as an association taxable as a corporation. Because LP has only one owner for federal tax purposes, LP cannot be classified as a partnership.

**9. Administrative Dissolution.** The Revenue Service has concluded in several relatively recent private letter rulings that if the affairs of a corporation continue after the expiration of its state charter, or the termination of its existence, it becomes an association and continues to be classified as a corporation.[157] In Private Letter Ruling 200539005 (June 17, 2005), the Revenue Service, citing *Ochs v. United States*,[158] stated that "[i]f the conduct of the affairs of a corporation continues after the expiration of its charter, or the termination of its existence, it becomes an association." The Service stated that a corporation is subject to federal corporate income tax liability as long as it continues to do business in a corporate manner, despite the fact that its recognized legal status under state law is terminated.[159] In Private Letter Ruling 200114029, the Service held that the administrative dissolution of a corporation, the subsequent reincorporation that followed and the new corporation's succession to its assets and business (1) did not affect the corporation's S corporation election; (2) did not result in a distribution for purposes of Sections 301, 311, or 336, (3) the formation of the new corporation and its succession to the administratively dissolved corporation's business was not a transaction subject to Section 351 of the Code; (4) the dissolution and subsequent reincorporation of the

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the taxpayer is able to establish that it acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government. Treas. Reg. § 301.9100-3. *See, e.g*., PLR 200318061 (May 2, 2003); PLR 200316029 (April 18, 2003); PLR 200306006 (Feb. 7, 2003). Private letter rulings are not binding as "precedent," but they often represent a substantial indication of the position of the Revenue Service on an issue.

[156]Treas. Reg. § 301.7701-3(g); *see also* Rev. Rul. 2004-59, 2004-24 IRB 1050 ("If an unincorporated state law entity that is classified as a partnership for federal tax purposes converts into a state law corporation under a state law formless conversion statute, the following is deemed to occur: the partnership contributes all its assets and liabilities to the corporation in exchange for stock in such corporation, and immediately thereafter, the partnership liquidates distributing the stock of the corporation to its partners.").

[157]*See, e.g,* PLR 200616002 (April 21, 2006); PLR 200539005 (June 17, 2005); PLR 200535017 (Sept. 2, 2005); PLR 200315020 (Apr. 11, 2003); PLR 200252033 (Dec. 27, 2002); PLR 200123058 (June 8, 2001); PLR 200114029 (Apr. 4, 2001).

[158]305 F.2d 844, 847 (Ct.Cl. 1962), *cert. denied*, 372 U.S. 968 (1963).

[159]*See also* PLR 200123058 (June 11, 2001); PLR 200114029 (Apr. 4, 2001).

corporation did not effect the bases or holding period of the shareholders' stock; and (5) the new corporation need not apply for a new employer identification number.[160]

**C. Foreign Corporation.** A foreign corporation is a corporation created or organized outside of the U.S.[161]

**D. Foreign Trust.** A foreign trust is any trust other than a U.S. trust. A U.S. trust is any trust if (i) a U.S. court is able to exercise primary jurisdiction over the administration of the trust; and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust.[162]

**E. 2008 Expatriation Legislation.** In 2008, Congress enacted new section 877A. It applies to "covered expatriates" whose "expatriation date" is on or after June 17, 2008.[163] Section 877A supersedes the existing expatriation rules. The "expatriation date" is the date an individual relinquishes U.S. citizenship or, in the case of a long-term resident, the date on which the individual ceases to be a lawful permanent resident of the United States for U.S. immigration law purposes.[164]

**1. General Operation of Section 877A and Section 2801.** Section 877A(a)(1) provides that "[a]ll property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value." Gain from the deemed sale is taken into account for the tax year of the deemed sale date without regard to other provisions of U.S. income tax law.[165] Any loss from the deemed sale generally is taken into account to the extent otherwise provided by U.S. tax income tax laws (with a limited exception for certain wash sales).[166] Thus, Section 877A subjects covered expatriates to U.S. income tax on the net unrealized gain on all of their property as if the property had been sold for its fair market value on the day before their residency termination date.[167] Gain recognized on the deemed sale is reduced, however (but not below zero), by $600,000[168] (increased for a cost of living adjustment factor for calendar years after 2008 -- $651,000 in 2012[169]). Any gains or losses subsequently

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[160]PLR 200114029 (Apr. 6, 2001).

[161]I.R.C. §§ 7701(a)(4) and (5).

[162]I.R.C. §§ 7701(a)(31), 7701(a)(30). The Small Business Job Protection Act of 1996 made several changes to the U.S. federal income tax rules applicable to foreign trusts. One significant change is the enactment of new Section 672(f). That section generally applies the grantor trust rules only to the extent such application results, directly or indirectly, in income or other amounts (if any) being currently taken into account in computing the income of a U.S. citizen or resident or a domestic corporation. Certain exceptions to this general rule are set forth in I.R.C. § 672(f)(2).

[163]Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245, 122 Stat. 1624-1650.

[164]I.R.C. § 877A(g)(3); I.R.C. § 7701(b)(6).

[165]New I.R.C. § 877A(a)(2)(A).

[166]New I.R.C. § 877A(a)(2)(B).

[167]New I.R.C. § 877A(a)(1).

[168]New I.R.C. § 877A(a)(3)(A).

[169]New I.R.C. § 877A(a)(3)(B)(i); Rev. Proc. 2011-52, § 3.27, 2011-45 I.R.B.

realized are to be adjusted for gains and losses taken into account under the deemed sale rules, without regard to the $600,000 exemption.[170]

The new legislation also imposes a transfer tax on certain transfers to U.S. persons from covered expatriates, or from their estates.[171]

**2. Property Subject to the Deemed Sale Rules of Section 877A.** Section 877A applies to most types of property interests held by the covered expatriate on the date of termination of residency, with certain exceptions.[172] Deferred compensation items, interests in nongrantor trusts, and specified tax deferred accounts are not subject to the deemed sale rule described above, but are subject to other special rules.[173]

**3. Application of Section 877A.** Section 877A applies to an individual relinquishing U.S. citizenship or to a "long-term resident" terminating U.S. residency, if such individual (1) has an average annual net income tax liability for the five preceding years ending before the date of the loss of U.S. citizenship or the residency termination that exceeds $124,000 (as adjusted for inflation[174] - $151,000 in 2012[175]); (2) has a net worth of $2 million or more on such date; or (3) fails to certify under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years or fails to submit such evidence of compliance as the Secretary may require.[176] Certain exceptions apply.[177]

A long-term resident is defined as an individual who had lawful permanent status under the U.S. immigration laws (i.e., held a greencard that has not been revoked and that has not been administratively or judicially determined to have been abandoned[178]) in at least 8 tax years during a period of 15 tax years ending in the year the greencard is relinquished.[179] An individual is considered a lawful permanent resident in a tax year if he or she is a lawful permanent resident during any portion of that year.[180] IRS Notice 2009-85[181] provides that a long-term resident ceases to be a lawful permanent resident if (1) the individual's lawful permanent resident status for U.S. immigration purposes has been revoked or has been administratively or judicially determined to have been abandoned, or if (2) the individual (a) commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country, (b) does not waive the benefits of the treaty applicable to residents of the foreign country, and (c) notifies the IRS of such treatment on Forms 8833 and 8854.

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[170]New I.R.C. § 877A(a).

[171]New I.R.C. § 2801.

[172]*See* New I.R.C. §§ 877A(a)(1), 877A(c).

[173]*See* I.R.C. §§ 877A(c), 877(d), 877(e), 877A(f).

[174]New I.R.C. § 877A(a).

[175]Rev. Proc. 2011-52, § 3.26, 2011-45 I.R.B.

[176]New I.R.C. § 877A(g)(1)(A).

[177]New I.R.C. § 877A(g)(1)(B).

[178]I.R.C. § 7701(b)(6).

[179]I.R.C. § 877A(g)(5); I.R.C. § 877(e)(2); I.R.C. § 7701(b)(6).

[180]Notice 97-19, 1997-1 C.B. 394 obsoleted in part on other grounds, Notice 2005-36, 2005-1 C.B. 1007.

[181]Notice 2009-85, 2009-45 I.R.B. 598.

## VI. U.S. FEDERAL INCOME TAXATION OF U.S. TRADE OR BUSINESS INCOME OF FOREIGN PERSONS

**A. General Pattern of Taxation of U.S. Trade or Business Income of Foreign Persons**. Nonresident aliens and foreign corporations are generally subject to U.S. federal income taxation on U.S.-source income (and certain limited types of foreign-source income) that is effectively connected with a U.S. trade or business.[182] The taxable income of a nonresident alien that is effectively connected with the conduct of a U.S. trade or business is generally taxed in the same manner and at the same rates as income of a U.S. citizen or resident alien.[183] Similarly, the taxable income of a foreign corporation that is effectively connected with a U.S. trade or business is generally taxed in the same manner and at the same rates as income of a U.S. corporation.[184]

Nonresident aliens and foreign corporations are generally allowed deductions in computing effectively connected taxable income, but only if and to the extent that the deductions are related to income that is effectively connected.[185] The proper apportionment and allocation of such deductions are determined as provided in regulations prescribed by the Treasury.[186]

**B. Taxation of U.S. Capital Gain Income.** A nonresident alien or foreign corporation's capital gain income that is effectively connected with the conduct of a U.S. trade or business is subject to U.S. federal income taxation in the same manner as the capital gain income of a U.S. resident or U.S. corporation, as the case may be. A nonresident alien or foreign corporation that earns capital gain income that is not effectively connected with the conduct of a U.S. trade or business is not subject to U.S. federal income taxation unless (1) such gain is described in I.R.C. § 871(a); (2) such gain results from the sale of a "U.S. real property interest;"[187] (3) the recipient is a nonresident alien individual who is present in the U.S. for 183 days or more during the taxable year;[188] or (4) the recipient is an individual who meets the definition of a resident alien for U.S. federal income tax purposes.[189]

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[182]I.R.C. §§871(b), 882(a), 872(a), 882(b).

[183]I.R.C. §§ 2(d), 872(a), 871(b), 873(a); *see also* Treas. Reg. §§ 1.1-1(a)(1) ("Section 1 of the Code imposes an income tax on the income of every individual who is a citizen or resident of the U.S. and, to the extent provided by Section 871(b) . . . on the income of a nonresident alien individual.").

[184]I.R.C. § 11(d), 882(b); *see also* Treas. Reg. § 1.11-1(a) ("[F]oreign corporations engaged in trade or business in the United States shall be taxable under section 11 only on their taxable income which is effectively connected with the conduct on a trade or business in the United States....").

[185]I.R.C. §§ 873(a), 882(c).

[186]I.R.C. § 882(c)(1)(A).

[187]I.R.C. § 897.

[188]I.R.C. § 871(a)(2); *but see* Joint Committee on Tax'n, "Description of the Chairman's Mark of the 'Jumpstart Our Business Strength (JOBS) Act,'"JCX-83-03 (Sept. 26, 2003) (propose to repeal Section 871(a)(2), which "can apply only in a very limited set of cases").

[189]I.R.C. § 7701(b).

**C. Branch Profits Tax Applies to Foreign Corporations Doing Business in the U.S**. Foreign corporations doing business in the U.S. are subject to the branch profits tax.[190] The branch profits tax is discussed in Part VII below.

**D. Special Withholding Rules Applicable to Partnership Effectively Connected Income.**

**1. Withholding on Partnership Effectively Connected Taxable Income**. If a foreign or domestic partnership has effectively connected taxable income allocable under section 704 to a foreign partner, then the partnership must pay a withholding tax on the effectively connected taxable income that is allocable to its foreign partners.[191] (For this purpose, a "foreign partner" generally means a nonresident alien individual, foreign corporation, foreign partnership, or foreign trust or estate.[192]) The withholding tax amount payable by the partnership is generally equal to the partner's effectively connected taxable income multiplied by the highest rate of tax in Section 11(b), in the case of a corporate partner, or Section 1, in the case of a non-corporate partner.[193]

**2. Determining Effectively-Connected Taxable Income.** The term "effectively connected taxable income" generally means the excess of effectively-connected gross income of the partnership (including income treated as effectively connected) over allowable deductions that are connected to such income, with certain prescribed adjustments.[194]

**3. Service Issues Regulations Addressing Withholding Rules Applicable to Partnership Effectively Connected Income**. On May 13, 2005, the Internal Revenue Service issued final regulations regarding the obligation of a partnership to pay a withholding tax on effectively connected taxable income allocable under Section 704 to a foreign partner.

**E. Income Tax Treaties May Modify the General Rules of Taxation**. U.S. income tax treaties often modify the general rules of taxation for nonresident aliens and foreign corporations doing business. For example, an applicable income tax treaty may limit the imposition of U.S. tax on business operations of a foreign person to cases where the business is conducted through a permanent establishment in the U.S. Tax treaties are discussed in Part XI below.

**F. Selected U.S. Reporting Issues.**

**1. U.S. Federal Income Tax Return.**

**a. Nonresident Alien.** A nonresident alien individual must file a U.S. federal income tax return (Form 1040NR) in the U.S. if any of the following conditions are met: (1) the individual had U.S.-source income (even if the income was exempt from U.S.

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[190] I.R.C. § 884(a).

[191] I.R.C. §§ 1446(a), 1446(b).

[192] I.R.C. § 1446(e).

[193] I.R.C. § 1446(b).

[194] I.R.C. § 1446(c).

income tax under an applicable treaty exemption) unless the individual's full U.S. tax was withheld at source; or (2) the individual is engaged in the conduct of a U.S. trade or business whether or not he had income from that trade or business.[195] In Notice 2005-77,[196] the Internal Revenue Service announced that it will amend the regulations to eliminate the Form 1040NR filing requirement for a nonresident alien individual who earns less than the amount of one personal exemption as United States source wages that are effectively connected with a United States trade or business (effectively connected wages) and who is required to file a United States income tax return because of those wages. All nonresident alien individuals who earn effectively connected wages are entitled to at least one personal exemption under section 151. Therefore, by amending the regulations, the new exception would treat nonresident alien individuals who earn effectively connected wages in an amount that is less than the amount of one personal exemption more similarly to United States citizens and residents who earn wages of less than the exemption amount. The exception would apply even if the nonresident alien individual also has United States source fixed or determinable annual or periodical gains, profits, or income (FDAP), provided that his United States tax liability for such income is fully satisfied by the withholding of tax at source. The amendment to the regulations, however, will not affect the filing requirements of a nonresident alien individual who seeks a refund of an overpayment of United States tax, has a United States income tax liability with respect to FDAP that is not fully satisfied by withholding at source, or who has income exempt or partially exempt by reason of an income tax convention or any section of the Code.

Regulations incorporating the guidance set forth in Notice 2005-77 will apply to tax years beginning on or after January 1, 2006. Until such regulations are issued, nonresident alien individuals may rely on Notice 2005-77.

**b. Foreign Corporation.** A foreign corporation must file a U.S. federal income tax return (Form 1120F) in the U.S. if any of the following conditions are met: (1) the corporation had U.S.-source income (even if the income was exempt from U.S. income tax under an applicable treaty exemption) unless the corporation's full U.S. tax was withheld at source; or (2) the corporation is engaged in the conduct of a U.S. trade or business whether or not it had income from that trade or business.[197]

**c. Failure to Timely File Return Results in Loss of Deductions.** Sections 874(a) and 882(c)(2) provide that nonresident aliens and foreign corporations, respectively, receive the benefit of deductions, however, "only by filing or causing to be filed with the Secretary a true and accurate return . . . including therein all the information which the Secretary may deem necessary for the calculation of such deductions . . . ."[198] If a true and accurate return is not filed, federal income tax is collected on the basis of gross income without any allocable deductions.[199]

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[195]Treas. Reg. § 1.6012-1(b).

[196]2005-46 I.R.B. 1.

[197]Treas. Reg. § 1.6012-2(g).

[198]I.R.C. §§ 874(a), 882(c)(2).

[199]Treas. Reg. §§ 1.874-1(a), 1.882-4(a)(2).

"Sections 874(a) and 882(c)(2) are draconian provisions designed to induce foreign corporations and nonresident alien individuals to file tax returns."[200] Although neither statute contains a time limit, the Treasury Regulations explicitly create a timely filing requirement.[201] Under the regulations, whether a return has been filed on a timely basis for purposes of Section 874(a) and 882(c)(2) is dependent upon whether the nonresident alien individual or foreign corporation has filed a return for the tax year immediately preceding the tax year for which deductions or credits are claimed.[202] If a return was filed for the immediately preceding tax year, or if the current tax year is the first tax year for which a return is required to be filed, the required return for the current tax year must be filed within 16 months (18 months in the case of a foreign corporation) of the due date for filing the return for the current tax year.[203] If no return for the taxable year immediately preceding the current taxable year has been filed, the required return for the current taxable year (other than the first taxable year for which a return is required to be filed) must have been filed no later than the earlier of the date which is 16 months (18 months in the case of a foreign corporation) after the due date for filing the return for the current taxable year or the date the IRS mails a notice to the taxpayer advising that the current year tax return has not been filed and that no deductions or credits may be claimed.[204] These filing deadlines may be waived if the taxpayer establishes to the satisfaction of the Service that the taxpayer, based on the facts and circumstances, acted reasonably and in good faith in failing to file a federal income tax return.[205]

**2. Internal Revenue Service - Section 6038A (Related Party Transactions - Form 5472)**. Certain foreign-owned U.S. corporations and domestic branches of foreign corporations that are engaged in a trade or business in the U.S. must file annually with the IRS a separate Form 5472, Information Return of a Foreign Owned Corporation, for each "related party" with which the reporting corporation had "reportable transactions" during its taxable year. In addition, the reporting corporation must maintain certain records relating to those transactions.[206]

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[200] *Espinosa v. Commissioner*, 107 T.C. 146, 152 (1996).

[201] Treas. Reg. § 1.874-1(b)(1)("[F]or purposes of computing the nonresident alien individual's taxable income for any taxable year, otherwise allowable deductions and credits will be allowed only if a true and accurate return for that taxable year is filed by the nonresident alien individual on a timely basis."); Treas. Reg. § 1.882-4(a)(3)("[F]or purposes of computing the foreign corporation's taxable income for any taxable year, otherwise allowable deductions . . . will be allowed only if a return for that taxable year is filed by the foreign corporation on a timely basis.").

[202] Treas. Reg. § 1.874-1(b)(1); Treas. Reg. § 1.882-4(a)(3).

[203] Treas. Reg. § 1.874-1(b)(1); Treas. Reg. § 1.882-4(a)(3).

[204] Treas. Reg. § 1.874-1(b)(1); Treas. Reg. § 1.882-4(a)(3).

[205] *See* Treas. Reg. § 1.874-1(b)(2); Treas. Reg. § 1.882-4(a)(3)(ii); *see also* Notice 2003-38, 2003-27 I.R.B. ("This compliance initiative is intended to encourage nonresident aliens and foreign corporations to file income tax returns that were not filed in a timely manner in accordance with the regulations under section 874(a) or 882(c)(2). The IRS will waive the filing deadlines set forth in Regs. 1.874-1(b)(1) and 1.882- 4(a)(3)(i) if a taxpayer files on or before September 15, 2003 all required U.S. federal income tax returns for every year for which a waiver is requested. In addition, a taxpayer must pay the reported income tax liability with each such return, must pay statutory interest and penalties as determined by the IRS (except the fraudulent failure to file penalty, as discussed below), and must cooperate with the IRS upon request in determining and satisfying its income tax liability for any taxable year for which a waiver is requested.").

[206] I.R.C. §§ 6038A, 6038C.

**3. Agricultural Foreign Investment Disclosure Act of 1978**. In response to some concern about the amount of foreign investment in U.S. property, including agricultural land, the Agricultural Foreign Investment Disclosure Act ("AFIDA") was enacted on October 14, 1978.[207] AFIDA provides that any foreign person who acquires or transfers any interest, other than a security interest, in agricultural land is required to submit a report to the Secretary of Agriculture not later than ninety (90) days after the date of such acquisition or transfer.[208] Such foreign person should complete Form FSA-153, Agricultural Foreign Investment Disclosure Act Report.[209] Form FSA-153 is required to be filed with the County Farm Service Agency office in the county of location of the acquired agricultural land.[210] A civil penalty not to exceed 25% of the fair market value of the agricultural land may be imposed for the failure to file the requisite report.[211]

The term "foreign person" includes a United States corporation in which a significant interest or substantial control is directly or indirectly held by a foreign person.[212] Regulations that have been promulgated under AFIDA provide that the term "significant interest" or "substantial control" means a ten percent (10%) or more interest in a legal entity for the purpose of obligating such legal entity to report.[213]

**4. International Investment Survey Act of 1976.** To obtain accurate and comprehensive information regarding foreign investment in the U.S., Congress passed the International Investment Survey Act of 1976 ("IISA").[214] Pursuant to the authority granted by IISA, the Department of Commerce, Bureau of Economic Analysis, has promulgated several sets of reporting requirements concerning inbound investments.[215] The primary inbound investment reports required under IISA are Forms BE-605 and BE-15. The U.S. Department of Commerce, Bureau of Economic Analysis, also has other forms that require periodic reporting by U.S. business enterprises.

Subject to certain exemptions, a Form BE-605 is required to be filed by U.S. business enterprise in which a foreign entity has a direct and/or indirect ownership interest of 10 percent of more of the voting stock (or an equivalent interest if an unincorporated business) at any time during the quarter.[216] Reports are required even though the U.S. business enterprise may have been established, acquired, liquidated, sold or inactivated during the reporting period.[217] Exemptions are available in certain cases, including where the value of total assets, sales, or gross operating revenues <u>and</u> net income (loss) for the U.S. affiliate were each equal to or less

[207]*See* 7 U.S.C. § 3501 (enacted under Pub. L. 95-460, § 2, 92 Stat. 1263 (Oct. 14, 1978); 7 C.F.R. § 781.1.

[208]7 U.S.C. § 3501a).

[209]7 C.F.R. § 781.3(a); § 781.3(b).

[210]7 C.F.R. § 781.3(a).

[211]7 U.S.C. § 3502.

[212]7 U.S.C. § 3508(3)(C); 7 C.F.R. § 781.2(g).

[213]*See* 7 C.F.R. § 781.2(k).

[214]22 U.S.C. § 3101.

[215]*See* 15 C.F.R. § 806.15.

[216]Instructions to Form BE-605 (Rev. 11/2009), at p. 1.

[217]*Id.*

than $60 million (positive or negative) for the most recent financial reporting year.[218] A U.S. affiliate claiming an exemption from filing BE-605 must complete and file the Claim for Exemption on the Form BE-605.

Subject to certain exemptions, the Form BE-15 is an annual survey used to report financial and operating data of U.S. affiliates of foreign parents.[219]

**5. International Transportation of Currency or Monetary Instruments.** The Currency and Foreign Transactions Reporting Act of 1970 ("CFTRA") was enacted in response to a growing concern about the unavailability of bank records of bank customers thought by U.S. law enforcement agencies to be engaged in criminal activities. CFTRA authorizes the Secretary of the Treasury to require reports on the international transportation and receipt of monetary instruments.[220] Pursuant to this authority, the Treasury issued regulations requiring that a form be filed reporting the international transportation and receipt of currency or monetary instruments that exceed $10,000.[221] Form 4790 is the form that should be used to report the international transportation of currency or monetary instruments. The failure to file Form 4790 can result in the imposition of civil and criminal sanctions.

Form 4790 is required to be filed at the time of entry into the U.S. or at the time of departure, mailing or shipping from the U.S. of the currency or monetary instruments in question.[222] Such reports are filed with the customs officer in charge at any customs port of entry or departure. Where a person has received a monetary instrument or currency in an aggregate amount exceeding $10,000 which has been transported, mailed or shipped to such person from outside of the U.S. with respect to which a report has not been filed, such person must file Form 4790 within fifteen (15) days after receipt of the currency or monetary instrument.

The term "monetary instrument" means (1) coin or currency of the U.S. or any other country, (2) travelers checks in any form, (3) negotiable instruments (including checks, promissory notes and money orders) in bearer form, endorsed without restriction, made out to a fictitious payee, or otherwise in such form that title thereto passes upon delivery, (4) incomplete instruments (including checks, promissory notes and money orders) that are signed but on which the name of the payee has been omitted, and (5) securities or stock in bearer form or otherwise in such form that title thereto passes upon delivery. Monetary instruments do not include (1) checks or money orders made payable to the order of a named person which have not been endorsed or which bear restrictive endorsements, (2) warehouse receipts, or (3) bills of lading.[223]

**6. Foreign bank accounts.**

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[218]*See id.* at p. 13; *see also* Bureau of Economic Analysis, *Current Reporting Requirements for Foreign Direct Investment in the United States* (January 2010) [hereinafter "BEA Reporting Requirements"], at p. 1.

[219]*See* BEA Reporting Requirements, at p. 2.

[220]*See* 31 U.S.C. §§ 5311, 5316.

[221]31 C.F.R. § 103.23.

[222]31 C.F.R. § 103.27(b)(1).

[223]*See* 31 C.F.R. § 103.11(u); General Instructions to Form 4790.

**a. Statutory and Regulatory Background.** The Bank Secrecy Act[224] authorizes the Secretary of the Treasury (Secretary), among other things, to issue regulations requiring persons to keep records and file reports that are determined to have a high degree of usefulness in criminal, tax, regulatory, and counter-terrorism matters.[225] The regulations implementing the BSA appear at 31 CFR Chapter X. The Secretary's authority to administer the BSA has been delegated to the Director of FinCEN.[226]

Under 31 U.S.C. § 5314(a), a U.S. citizen or resident, or person in, and doing business in, the United States is required to keep records and file reports, as specified by the Secretary of the Treasury, when that person enters into a transaction or maintains a relationship with a foreign financial agency. [227] For this purpose, foreign financial agency generally means a person acting for a person as a financial institution, bailee, depository trustee, or agent, or acting in a similar way related to money, credit, securities, gold, or a transaction in money, credit, securities, or gold.[228] Treasury is authorized to prescribe exemptions to the reporting requirement and to prescribe other matters the Secretary considers necessary to carry out section 5314. [229]

**b. Question Regarding Foreign Bank Accounts in Part III of Schedule B of IRS Form 1040.** Pursuant to 31 U.S.C. § 5314(a), Part III of Schedule B of IRS Form 1040 requires individuals to answer a question regarding foreign bank accounts.[230] The exact wording of the question on the 2011 Form 1040, Schedule B, is: "At any time during 2011, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country." The instructions to the 2011 Schedule B provide the following additional directive:

> **Line 7a-Question 1.** Check the "Yes" box if at any time during 2011 you had a financial interest in or signature authority over a financial account located in a foreign country. See the definitions that follow. Check the "Yes" box even if you are not required to file Form TD F 90-22.1.
>
> If "Yes," are you required to file Form TD F 90-22.1 to report that financial interest or signature authority? See Form TD F 90-22.1 and its instructions for filing requirements and exceptions to those requirements
>
> **Line 7b.** If you are required to file Form TD F 90-22.1, enter the name of the foreign country where the financial account is located

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[224]Titles I and II of Public Law 91-508, as amended, codified at 12 U.S.C. § 1829b, 12 U.S.C. § 1951-1959, and 31 U.S.C. §§ 5311-5314 and 5316-5332.

[225]31 U.S.C. § 5311.

[226]31 C.F.R. § 583 (2011).

[227]31 U.S.C. § 5314(a).

[228]*See* 31 U.S.C. 5312(a)(1).

[229]*See* 31 U.S.C. 5314(b)(1).

[230]*See* I.R.M. § 4.26.16.2.1(1) (Rev. 07-01-2008); *see generally* I.R.M. § 5.21.6 – Report of Foreign Bank and Financial Accounts (Rev. 02-17-2009); Selected Issues Relating to Tax Compliance With Respect to Offshore Accounts and Entities (JCX-65-08), July 23, 2008.

An individual who answers "yes" in response to the question asking whether the individual has an interest in or signature authority over a foreign account(s) exceeding $10,000 must then file Treasury Department Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts ("FBAR").[231] This form must be received by June 30 of the year following the year when the $10,000 threshold is met.[232] The instructions to Form TD F 90-22.1 (Rev. 1-2012) provide instructions on the place of filing. The form is not included as part of the income tax return that the individual files with the IRS and is not filed in the same office as the return.[233]

**c. Treasury Issues Final FBAR Regulations and Form TD F 90-22.1 (Rev. 1-2012).** On February 26, 2010, the Treasury Department published proposed FBAR regulations, as well as proposed revisions that clarify instructions for the FBAR (Form TD F 90-22.1).[234] On February 24, 2011, FinCen issued final regulations regarding reports of foreign financial accounts.[235] The final regulations (1) address the scope of the persons that are required to file reports of foreign financial accounts; (2) specifies the types of accounts that are reportable; and (3) provides filing relief in the form of exemptions for certain persons with signature or other authority over foreign financial accounts. The final regulations also adopt provisions intended to prevent persons subject to the rule from avoiding their reporting requirement. The final regulations are effective March 28, 2011, and apply to reports required to be filed by June 30, 2011, with respect to foreign financial accounts maintained in calendar year 2010, and for reports required to be filed with respect to all subsequent calendar years.[236] Treasury has published Form TD F-22.1 (Rev. 1-2012) reflecting the final regulations.

**(1) General Filing Requirements.** Section 1010.350 generally requires each U.S. person having a financial interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country to "report such

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[231]31 C.F.R. § 1010.350(a); *see* Instructions to 2011 Form 1040, Schedule B; Instructions to Form TD F 90-22.1 (Rev. 1-2012).

[232]31 C.F.R. § 10101.306(c); *see* Form TD F 90-22.1 (Rev. 1-2012).

[233]Instructions to Form TD F 90-22.1 (Rev. 1-2012).

[234]*See* Notice of Proposed Rulemaking, RIN 1506-AB08, [hereinafter "FBAR Preamble"], *reprinted at* 2010 TNT 39-25.

[235]Department of the Treasury, Financial Crimes Enforcement Network, 31 CFR Part 1010, RIN 1506-AB08, Amendment to the Bank Secrecy Act Regulations – Reports of Foreign Financial Accounts, *republished at* 2011 TNT 37-11.

[236]*Id.*; *but see* FinCEN Notice 2012-1, *reprinted at* 2012 TNT 31-25 (Feb. 14, 2012) ("On May 31, 2011, the Financial Crimes Enforcement Network ('FinCEN') issued Notice 2011-1 (revised on June 2, 2011), to extend to June 30, 2012, the due date for filing Form TDF 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), for certain individuals with signature authority over but no financial interest in one or more foreign financial accounts. Notice 2011-1 specifically addressed individuals whose FBAR filing requirements may be affected by the signature authority filing exceptions in 31 CFR § 1010.350(f)(2)(i)-(v). On June 17,2011, FinCEN issued Notice 2011-2 similarly extending the FBAR filing due date to June 30, 2012, for certain employees or officers of investment advisers registered with the Securities and Exchange Commission who have signature authority over but no financial interest in certain foreign financial accounts. In light of additional questions and concerns raised with respect to the exceptions addressed in Notice 2011-1 and Notice 2011-2, FinCEN is further extending the filing due date to June 30, 20 l3, for individuals whose filing due date for reporting signature authority was previously extended by Notices 2011-1 (as revised) or 2011-2. This extension applies to the reporting of signature authority held during the 2011 calendar year, as well as all years previously extended by Notice 2011-1 and 2011-2. For all other individuals with an FBAR filing obligation, the filing due date remains unchanged.").

relationship to the Commissioner of Internal Revenue for each year in which such relationship exists and . . . provide such information as shall be specified in a reporting form prescribed under 31 U.S.C. 5314 to be filed by such persons."[237] Section 1010.306(c) requires the form to be filed with respect to foreign financial accounts exceeding $10,000. The form must be filed on or before June 30 of each calendar year for accounts maintained during the previous calendar year.[238] Section 103.32 requires records of accounts to be maintained for each person having a financial interest in or signature or other authority over such account.[239] The records must be maintained for a period of five years.[240] The form used to file the report required by section 103.24 is the Report of Foreign Bank and Financial Accounts -- Form TD-F 90-22.1 (FBAR).[241] The instructions to the FBAR specify which persons must file as well as the types of accounts that must be reported.

**(2) Statutory and Regulatory Elements.**

**(a) United States Person.** "United States person" means (a) a citizen of the United States;[242] (b) a resident of the United States; and (c) an entity, including but not limited to, a corporation, partnership, trust, or limited liability company created, organized, or formed under the laws of the United States, any State, the District of Columbia, the Territories and Insular Possessions of the United States, or the Indian Tribes.[243]

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[237] 31 C.F.R. § 1010.350(a).

[238] 31 C.F.R. § 1010.306(c); *see generally* "FinCEN Announces New E-Filing System" (July 18, 2011), *reprinted at* 2011 TNT 138-38 ("The Financial Crimes Enforcement Network (FinCEN) today announced that it has developed an electronic filing system that will accept Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR). E-Filing is a quicker, cheaper, more secure, and more reliable way for individuals to file FBARs. E-Filing presents a convenient option to completing and mailing paper forms. Filers will receive an acknowledgement of each report filed."); *but see* "FinCEN Delays Mandatory E-Filing of FBARs" (Feb. 24, 2012) ("FinCEN is announcing today a general exemption from mandatory electronic filing of the Report of Foreign Bank and Financial Accounts (FBAR) until July 1, 2013."); "FinCEN Marks the End of Paper SARs and CTRs Final Reminder for Electronic Filing Requirement" (June 29, 2012), *reprinted at* 2012 TNT 127-83 ("All FinCEN forms must be electronically filed with the exception of the Currency and Monetary Instrument Report (CMIR), which is most often completed by individuals upon physically crossing the border into the United States, and FinCEN Form 8300 (Report of Cash Payments Over $10,000 Received in a Trade or Business). In addition, while FinCEN strongly encourages individuals to electronically file Reports of Foreign Bank and Financial Accounts (FBARs), it has granted a general exemption for mandatory electronic filing for the FBAR until June 30, 2013.").

[239] 31 C.F.R. § 1010.420.

[240] 31 C.F.R. § 1010.420.

[241] 31 C.F.R. § 1010.350(a).

[242] 31 C.F.R. § 1010.350(b)(1).

[243] 31 C.F.R. § 1010.350(b)(3); see also FIN-2011-G003 (Oct. 11, 2011), *reprinted at* 2012 TNT 3-18 ("As stated in the preamble to the final FBAR regulations, FinCEN does not expect officers or employees with signature or other authority to maintain records of the foreign financial accounts of their employers personally.[1] The same reasoning is applicable to former employees who had signature or other authority over, but no financial interest in, a foreign financial account with respect to his or her duties for a former employer during a reportable calendar year. Thus, FinCEN does not expect a former employee to maintain the records of the foreign financial accounts of their former employer personally. Additionally, due to proprietary and privacy concerns, FinCEN does not expect a former employer to provide information on foreign financial accounts to a former employee. Therefore, in such instances, a former employee must provide as much information as possible when filing an FBAR. At a minimum, the former employee must include the fact that the former employee had signature or other authority over a foreign financial account and must provide in Part IV, Items 34-42 information about his or her former employer for whom he or she

A resident of the United States is an individual who is a resident alien under I.R.C. § 7701(b) (modified to treat the United States as the States of the United States, the District of Columbia, the Indian lands (as that term is defined in the Indian Gaming Regulatory Act), and the Territories and Insular Possessions of the United States).[244]

**(b) Bank, Securities or Other Financial Account in a Foreign Country.** The Instructions to Form TD F 90-22.1 (Rev. 1-2012) refer to a bank, securities or other financial account in a foreign country[245] as a "foreign financial account." The Instructions provide that a foreign financial account refers to such an account located outside of the United States. For example, an account maintained with a branch of a United States bank that is physically located outside of the United States is a foreign financial account. An account maintained with a branch of a foreign bank that is physically located in the United States is not a foreign financial account.[246]

**(c) Types of Reportable Accounts.**

**i) Bank Account.** "Bank account" means a savings deposit, demand deposit, checking, or any other account maintained with a person engaged in the business of banking.[247]

**ii) Securities Account.** "Securities account" means an account with a person engaged in the business of buying, selling, holding or trading stock or other securities. [248]

**iii) Other Financial Account.** The term "other financial account" means:

**(A)** An account with a person that is in the business of accepting deposits as a financial agency; [249]

**(B)** An account that is an insurance or annuity policy with a cash value; [250]

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was acting, including the name of the former employer, as well as his or her title with the former employer in Part IV, Item 43.").

[244]31 C.F.R. § 1010.350(b)(2).

[245]The Regulations provides that a foreign country includes all geographical areas located outside of the United States. 31 C.F.R. § 1010.350(d). For this purpose, United States means the States of the United States, the District of Columbia, the Indian lands (as that term is defined in the Indian Gaming Regulatory Act), and the Territories and Insular Possessions of the United States.

[246]Instructions to Form TD F 90-22.1 (Rev. 1-2012).

[247]31 C.F.R. § 1010.350(c)(1).

[248]31 C.F.R. § 1010.350(c)(2).

[249]31 C.F.R. § 1010.350(c)(3)(i).

[250]31 C.F.R. § 1010.350(c)(3)(ii).

**(C)** An account with a person that acts as a broker or dealer for futures or options transactions in any commodity on or subject to the rules of a commodity exchange or association;[251] or

**(D)** An account with a mutual fund or similar pooled fund which issues shares available to the general public that have a regular net asset value determination and regular redemptions;[252] or

**(E)** An account with certain other investment funds.[253]

**(d) Exceptions for certain accounts.** The following accounts are not required to be reported:

**i) Governmental Entities.** An account of a department or agency of the United States, an Indian Tribe, or any State or any political subdivision of a State, or a wholly-owned entity, agency or instrumentality of any of the foregoing.[254] For purposes of Form TD F 90-22.1, this category includes a college or university that is an agency of, an instrumentality of, owned by, or operated by a governmental entity.[255] It also includes an employee retirement or welfare benefit plan of a governmental entity.[256]

**ii) Certain Entities Exercising Governmental Authority.** An account of an entity established under the laws of the United States, of an Indian Tribe, of any State, or of any political subdivision of any State, or under an intergovernmental compact between two or more States or Indian Tribes, that exercises governmental authority on behalf of the United States, an Indian Tribe, or any such State or political subdivision. For this purpose, an entity generally exercises governmental authority on behalf of the United States, an Indian Tribe, a State, or a political subdivision only if its authorities include one or more of the powers to tax, to exercise the power of eminent domain, or to exercise police powers with respect to matters within its jurisdiction.[257]

**iii) International Financial Institution if the U.S. Government is a Member.** An account of an international financial institution of which the United States government is a member.[258]

**iv) U.S. Military Banking Facility.** An account in an institution known as a "United States military banking facility" (or "United States

[251] 31 C.F.R. § 1010.350(c)(3)(iii).

[252] 31 C.F.R. § 1010.350(c)(3)(iv)(A).

[253] 31 C.F.R. § 1010.350(c)(3)(iv)(B). Treasury has reserved guidance on this section of the regulations.

[254] 31 C.F.R. § 1010.350(c)(4)(i).

[255] Instructions to Form TD F 90-22.1 (Rev. 1-2012).

[256] Instructions to Form TD F 90-22.1 (Rev. 1-2012).

[257] 31 C.F.R. § 1010.350(c)(4)(i).

[258] 31 C.F.R. § 1010.350(c)(4)(ii).

military finance facility") operated by a United States financial institution designated by the United States Government to serve United States government installations abroad even though the United States military banking facility is located in a foreign country.[259]

**v) Correspondent Accounts.** Correspondent or nostro accounts that are maintained by banks and used solely for bank-to-bank settlements.[260]

**vi) IRA Owners and Beneficiaries.** An owner or beneficiary of an IRA is not required to report a foreign financial account held in the IRA.[261]

**vii) Participants in and Beneficiaries of Tax-Qualified Retirement Plans.** A participant in or beneficiary of a retirement plan described in Internal Revenue Code section 401(a), 403(a), or 403(b) is not required to report a foreign financial account held by or on behalf of the retirement plan.[262]

**viii) Special Rule for Certain Accounts Jointly Owned by Spouses.** The spouse of an individual who files an FBAR is not required to file a separate FBAR if the following conditions are met: (1) all the financial accounts that the non-filing spouse is required to report are jointly owned with the filing spouse; (2) the filing spouse reports the jointly owned accounts on a timely filed FBAR; and (3) both spouses sign the FBAR. Otherwise, both spouses are required to file separate FBARs, and each spouse must report the entire value of the jointly owned accounts.[263]

**ix) Consolidated FBAR.** If a United States person that is an entity is named in a consolidated FBAR filed by a greater than 50 percent owner, such entity is not required to file a separate FBAR.[264]

**(e) Financial interest.** A financial interest in a bank, securities or other financial account in a foreign country means an interest described below.

**i) Owner of record or holder of legal title.** A United States person has a financial interest in each bank, securities or other financial account in a foreign country for which he is the owner of record or has legal title whether the account is maintained for his own benefit or for the benefit of others. If an account is maintained in the name of more than one person, each United States person in whose name the account is maintained has a financial interest in that account.[265]

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[259]31 C.F.R. § 1010.350(c)(4)(iii).

[260]31 C.F.R. § 1010.350(c)(4)(iv).

[261]31 C.F.R. § 1010.350(g)(4).

[262]*Ibid.*

[263]Instructions to Form TD F 90-22.1 (Rev. 1-2012).

[264]31 C.F.R. § 1010.350(g)(3); Instructions to Form TD F 90-22.1 (Rev. 1-2012).

[265]31 C.F.R. § 1010.350(e)(1).

**ii) Other financial interest.** A United States person has a financial interest in each bank, securities or other financial account in a foreign country for which the owner of record or holder of legal title is:

**(A)** A person acting as an agent, nominee, attorney or in some other capacity on behalf of the United States person with respect to the account; [266]

**(B)** A corporation in which the United States person owns directly or indirectly more than 50 percent of the voting power or the total value of the shares; [267]

**(C)** A partnership in which the United States person owns directly or indirectly more than 50 percent of the interest in profits or capital;

**(D)** A trust, if the United States person is the trust grantor and has an ownership interest in the trust for United States federal tax purposes (as determined under Sections 671 through 679 of the Code); [268]

**(E)** A trust in which the United States person either has a present beneficial interest in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income; [269] or

**(F)** Any other entity in which the United States person owns directly or indirectly more than 50 percent of the voting power, total value of the equity interest or assets, or interest in profits;[270]

**(f) Federal Tax Treatment Does Not Control Filing Requirement.** The Instructions to Form TD F 90-22.1 (Rev. 1-2012) clarify that the federal tax treatment of an entity does not determine whether the entity has an FBAR filing requirement. For example, an entity that is disregarded for federal income tax purposes must file an FBAR, if otherwise required to do so. Similarly, a trust for which the trust income, deductions, or credits are taken into account by another person for federal income tax purposes must file an FBAR, if otherwise required to do so.[271]

**(g) Signature or Other Authority.** "Signature or other authority" generally means the authority of an individual (alone or in conjunction with another) to control the disposition of money, funds or other assets held in a financial account by direct communication (whether in writing or otherwise) to the person with whom the financial

[266]31 C.F.R. § 1010.350(e)(2)(i).

[267]31 C.F.R. § 1010.350(e)(2)(ii)

[268]31 C.F.R. § 1010.350(e)(2)(iii).

[269]31 C.F.R. § 1010.350(e)(2)(iv).

[270]31 C.F.R. § 1010.350(e)(2)(ii)

[271]Instructions to Form TD F 90-22.1 (Rev. 1-2012).

account is maintained.[272] Individuals who have signature authority over, but no financial interest in, a foreign financial account are not required to report the account in the following situations:

**i)** An officer or employee of a bank that is examined by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, or the National Credit Union Administration is not required to report signature authority over a foreign financial account owned or maintained by the bank.[273]

**ii)** An officer or employee of a financial institution that is registered with and examined by the Securities and Exchange Commission or Commodity Futures Trading Commission is not required to report signature authority over a foreign financial account owned or maintained by the financial institution.[274]

**iii)** An officer or employee of an Authorized Service Provider need not report that he has signature or other authority over a foreign financial account owned or maintained by an investment company that is registered with the Securities and Exchange Commission. "Authorized Service Provider" means an entity that is registered with and examined by the Securities and Exchange Commission and that provides services to an investment company registered under the Investment Company Act of 1940.[275]

**iv)** An officer or employee of an entity with a class of equity securities listed (or American depository receipts listed) on any United States national securities exchange need not report that he has signature or other authority over a foreign financial account of such entity. An officer or employee of a United States subsidiary of a United States entity with a class of equity securities listed on a United States national securities exchange need not file a report concerning signature or other authority over a foreign financial account of the subsidiary if the United States subsidiary is included in a consolidated report of the parent filed under this section.[276]

**v)** An officer or employee of an entity that has a class of equity securities registered (or American depository receipts in respect of equity securities registered) under section 12(g) of the Securities Exchange Act need not report that he has signature or other authority over the foreign financial accounts of such entity.[277]

**(h) Special Rule for Certain Trust Beneficiaries.** A special rule applies to a trust in which a United States person has a greater than 50 percent present beneficial interest in the assets or income of the trust for the calendar year. Such a beneficiary is not required to report the trust's foreign financial accounts if the trust, trustee of

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[272] 31 C.F.R. § 1010.350(f)(1).

[273] 31 C.F.R. § 1010.350(f)(2)(i).

[274] 31 C.F.R. § 1010.350(f)(2)(ii).

[275] 31 C.F.R. § 1010.350(f)(2)(iii).

[276] 31 C.F.R. § 1010.350(f)(2)(iv).

[277] 31 C.F.R. § 1010.350(f)(2)(v).

the trust, or agent of the trust is a United States person that files a report disclosing the trust's foreign financial accounts.[278]

**(i) Special Rule for U.S. Persons with a Financial Interest in, or Signature or Other Authority Over, 25 or More Foreign Financial Accounts.** A United States person having a financial interest in, or signature of other authority over, 25 or more foreign financial accounts need only provide the number of financial accounts and certain other basic information on the report, but will be required to provide detailed information concerning each account when so requested by Treasury.[279]

**(3) Anti-Avoidance Rule.** The Regulations provide that a United States person that causes an entity, including but not limited to a corporation, partnership, or trust, to be created for a purpose of evading reporting has a financial interest in any bank, securities, or other financial account in a foreign country for which the entity is the owner of record or holder of legal title.[280]

**7. Reporting Specified Foreign Financial Assets on Form 8938.**

**a. Enacting Legislation; Effective Date.** Section 511 of the Hiring Incentives to Restore Employment Act,[281] enacted on March 18, 2010 (the ***"HIRE Act"***), amended the Internal Revenue Code by adding new section 6038D, Disclosure of Information With Respect to Foreign Financial Assets. Section 6038D applies to taxable years beginning after March 18, 2010.[282]

**b. Requirement to Report Specified Foreign Financial Assets.**

**(1) General Rule.** Under new Section 6038D and the regulations thereunder, a specified person must attach Form 8938 to that person's annual return if, during the tax year: (a) the person has an interest in one or more specified foreign financial assets; and (b) such assets have an aggregate fair market value exceeding either $50,000 on the last day of the taxable year or $75,000 at any time during the taxable year.[283]

**(2) No Form 8938 Filing Requirement if Specified Individual Is Not Required to File a Return.** A specified person is not required to file Form 8938 for any taxable year for which the specified person is not required to file an annual return with the Internal Revenue Service,[284] even if the value of the specified person's specified foreign financial assets is more than the reporting threshold.[285]

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[278]31 C.F.R. § 1010.350(g)(5).

[279]31 C.F.R. § 1010.350(g).

[280]31 C.F.R. § 1010.350(e)(3).

[281]Pub. L. No. 111-147, 124 Stat. 71.

[282]Hire Act, § 511(c).

[283]I.R.C. § 6038D(a); Temp Reg. § 1.6038D-2T(a)(1).

[284]Temp. Reg. § 1.6038D-2T(a)(7)(i).

[285]Instructions to Form 8938 (Nov. 2011).

**c. Statistory and Regulatory Elements.**

**(1) Specified Person.** The term specified person means a specified individual or a specified domestic entity.[286]

**(a) Specified Individual.**

**i) U.S. Citizens, Resident Aliens, and Certain Nonresident Aliens Electing to be Taxed as U.S. Residents.** For section 6038D purposes, a specified individual is a U.S. citizen,[287] a resident alien of the United States under the green card test or the substantial presence test of I.R.C. § 7701(b),[288] or certain nonresident aliens who have elected to be taxed as a U.S. resident.[289]

**ii) Resident Aliens Electing to be Taxed as a Resident of a Foreign Country Under a Treaty Tie-Breaker Provision.** If an individual qualifies as a resident alien under the green card test or the substantial presence test but elects to be taxed as a resident of a foreign country pursuant to a U.S. income tax treaty's residency tie-breaker rules, such individual is a specified individual for purposes of section 6038D and the regulations.[290] The Instructions to Form 8938 (November 2011) provide that the Form 8938 should be attached to Form 1040NR.

**iii) Certain Other Nonresident Aliens of the U.S. Who Are Resident in Puerto Rico or Certain U.S. Possessions.** Certain nonresident aliens who are treated as residents under other sections of the Code are specified individuals for the purposes of section 6038D and the regulations. Thus, the rules under section 6038D apply to a nonresident alien who is a bona fide resident of Puerto Rico or certain U.S. possessions in the same manner as they apply to a U.S. citizen or resident.[291]

**(b) Specified Domestic Entity.** Section 6038D(f) provides that, to the extent provided by the Secretary in regulations or other guidance, Section 6038D shall apply to any domestic entity which is formed of availed of for purposes of holding, directly or indirectly, specified foreign financial assets, in the same manner as if the entity were an individual. On December 19, 2011, Treasury issued Proposed Regulation Section 1.6038-6 setting out the conditions under which a domestic entity will be considered a "specified domestic entity."[292] The Department of the Treasury and the Internal Revenue Service anticipate that Prop. Reg. § 1.6038D-6 will be issued as a final regulation during 2012 and will apply to taxable

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[286]Temp. Reg. § 1.6038D-1T(a)(1).

[287]Temp. Reg. § 1.6038D-1T(a)(2)(i).

[288]Temp. Reg. § 1.6038D-1T(a)(2)(ii). For this purpose, resident alien status is determined pursuant to the rules of 7701(b) and Treas. Reg. §§ 301.7701(b)-1 through 301.7701(b)-9. Temp. Reg. § 1.6038D-1T(a)(3); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[289]Temp. Reg. § 1.6038D-1T(a)(2)(iii); *see* I.R.C. § 6013(g) (election to treat nonresident alien as resident of the U.S.), 6013(h) (special joint return rule for year in which nonresident alien becomes resident of the U.S.).

[290]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[291]Temp. Reg. § 1.6038D-1T(a)(2)(iv).

[292]Notice of Proposed Rulemaking, Fed. Reg. Vol. 76, No. 243, p. 78594 (Dec. 19, 2011).

years beginning after December 31, 2011.[293] The Notice of Proposed Rulemaking issuing Proposed Regulation Section 1.6038D-6 states that "[u]ntil Prop. Reg. § 1.6038D-6 is issued as a final regulation, no domestic entity is required to file Form 8938 to report specified foreign financial assets with its annual return."[294] Similarly, the Instructions to Form 8938 (Nov. 2011) state that "[u]ntil the IRS issues such [final] regulations, only individuals must file Form 8938." On January 23, 2013, the IRS issued Notice 2013-10, 2013-8 I.R.B. 503, stating as follows:

> The IRS and the Treasury Department intend that, when final regulations are issued under section 6038D, those final regulations will modify the effective/applicability date of Prop. Reg. § 1.6038D-6. Reporting by domestic entities of interests in specified foreign financial assets will not be required before the date specified by final regulations, which will not be earlier than taxable years beginning after December 31, 2012.

**(2) Determining the Reporting Threshold.**

**(a) Unmarried Specified Individual Living in the U.S.** An unmarried specified individual living in the U.S. satisfies the reporting threshold only if the total value of his or her specified foreign financial assets is more than $50,000 on the last day of the tax year or more than $75,000 on any day during the tax year.[295]

**(b) Married Specified Individuals Living in the U.S. and Filing a Joint Return.** Married specified individuals living in the U.S. and filing a joint return are not required to file Form 8938 unless the aggregate value of all of the specified foreign financial assets in which either spouse has an interest exceeds $100,000 on the last day of the taxable year or $150,000 at any time during the taxable year.[296]

**(c) Married Specified Individuals Living in the U.S. and Filing Separate Returns.** If a married specified individual lives in the U.S. and files a separate return from his or her spouse, such individual is not required to file Form 8938 unless the aggregate value of such individual specified foreign financial assets exceeds $50,000 on the last day of the taxable year or $75,000 at any time during the taxable year.[297]

**(d) Special Rule for Specified Individuals Living Abroad.** The Preamble to the Temporary Regulations provides that an individual residing outside the United States can reasonably be expected to have a greater amount of specified foreign financial assets for reasons unrelated to the policies underlying section 6038D. The regulations therefore increase the reporting threshold of section 6038D(a) in the case of a

[293]Preamble, 76 Fed. Reg. 78595 (Dec. 19, 2011).

[294]Preamble, 76 Fed. Reg. 78595 (Dec. 19, 2011).

[295]I.R.C. § 6038D(a); Temp Reg. § 1.6038D-2T(a)(1); Instructions to Form 8938 (Nov. 2011).

[296]Temp Reg. § 1.6038D-2T(a)(2).

[297]Instructions to Form 8938 (Nov. 2011).

specified individual whose tax home is in a foreign country and who meets either a foreign residency or foreign physical presence test (referred to as a ***"qualified individual"***).[298]

**i) Specified Individual That Does Not File a Joint Return.** A specified individual who is a qualified individual that does not file a joint return is not required to file Form 8938 unless the aggregate value of the specified foreign financial assets in which the specified individual has an interest exceeds $200,000 on the last day of the taxable year or $300,000 at any time during the taxable year.[299]

**ii) Certain Married Specified Individuals Filing a Joint Return with One or Both Spouses Living Abroad.** If married specified individuals file a joint annual return and either spouse is a qualified individual, the regulations provide that they are not required to file Form 8938 unless the aggregate value of all of the specified foreign financial assets in which either spouse has an interest exceeds $400,000 on the last day of the taxable year or $600,000 at any time during the taxable year.[300]

**(e) Jointly-Owned Assets.**

**i) Married Individual Filing a Joint Return.** Married specified individuals who file a joint annual return include the value of a specified foreign financial asset that they jointly own together or a specified foreign financial asset held by a child for which they have made an election under section 1(g)(7) of the Code only once in determining whether the aggregate value of all of the specified foreign financial assets in which either married specified individual has an interest exceeds the appropriate reporting threshold.[301]

**ii) Married Individuals Filing Separately.** If a married specified individual files a separate annual return and his or her spouse is a specified individual, the married specified individual includes one-half of the value of a specified foreign financial asset that the married specified individual jointly owns with his or her spouse in determining whether the married specified individual has an interest in specified foreign financial assets the aggregate value of which exceeds the reporting threshold.[302]

**iii) Joint Ownership With a Spouse Who is Not a Specified Individual or Someone Other Than a Spouse.** A joint interest in a specified foreign financial asset is subject to reporting under Section 6038D by each specified person that is a joint owner of the asset.[303] In general, each joint owner who is a specified individual must include the full value of the jointly owned asset (and not the value of the specified person's interest) for purposes of determining whether the aggregate value of all specified foreign financial assets in which the joint owner has an interest exceeds the reporting thresholds.[304]

[298]*See* I.R.C. § 911(d)(1).

[299]Temp Reg. § 1.6038D-2T(a)(3); Instructions to Form 8938 (Nov. 2011).

[300]Temp. Reg. § 1.6038D-2T(a)(4); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[301]Temp. Reg. § 1.6038D-2T(c)(1)(i).

[302]Temp. Reg. § 1.6038D-2T(c)(1)(ii).

[303]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011); *see* Temp. Reg. § 1.6038D-2T(c)(1)(i).

[304]Temp. Reg. § 1.6038D-2T(c)(1)(i).

Thus, if a specified individual jointly owns an asset with a spouse who is not a specified individual or someone other than a spouse, such specified individual must include the full value of the jointly owned asset (and not just his or her interest) for purposes of determining whether the aggregate value of all specified foreign financial assets in which the joint owner has an interest exceeds the reporting thresholds.[305]

**(f) Special Valuation Rule for Interest in a Foreign Trust.** For purposes of determining the aggregate value of specified foreign financial assets in which a specified person has an interest, if the specified person does not know or have reason to know based on readily accessible information the fair market value of the person's interest in a foreign trust during the taxable year, the value to be included in determining the aggregate value of the specified foreign financial assets is the maximum value (discussed below) of the specified person's interest in the foreign trust.[306]

**(g) Special Valuation Rule for Interests in Foreign Estates, Pension Plans, and Deferred Compensation Plans.** For purposes of determining the aggregate value of specified foreign financial assets in which a specified person has an interest, if the specified person does not know or have reason to know based on readily accessible information the fair market value of the person's interest in a foreign estate, foreign pension plan, or foreign deferred compensation plan during the taxable year, the value to be included in determining the aggregate value of the specified foreign financial assets is the fair market value, determined as of the last day of the taxable year, of the currency and other property distributed during the taxable year to the specified person as a beneficiary or participant.[307]

**(3) Specified Foreign Financial Assets.** For purposes of section 6038D, specified foreign financial assets include financial accounts maintained by foreign financial institutions, as well as certain other foreign financial assets or instruments.[308] An asset or instrument may be a specified foreign financial asset subject to reporting under section 6038D and the regulations even if the asset or instrument does not have a positive value.[309]

**(a) Financial Accounts Maintained by a Foreign Financial Institution.**

**i) General Rule.** A specified foreign financial asset generally includes any financial account maintained by a foreign financial institution.[310]

**(A) Financial Account.** Generally, for purposes of section 6038D, a financial account is (A) any depository or custodial account maintained by a foreign financial institution; and (B) any equity or debt interest in a foreign

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[305]Instructions to Form 8938 (Nov. 8938).

[306]Temp. Reg. § 1.6038D-5T(f)(2)(ii).

[307]Temp. Reg. § 1.6038D-5T(f)(3)(ii).

[308]I.R.C. § 6038D(b); Temp. Reg. § 1.6038D-3T(a); Temp. Reg. § 1.6038D-3T(b).

[309]Temp. Reg. § 1.6038D-2T(a)(5).

[310]Temp. Reg. § 1.6038D-3T(a)(1).

financial institution (other than interests which are regularly traded on an established securities market).[311]

**(B) Foreign Financial Institution.** A foreign financial institution is a financial institution that is a foreign entity[312] and that meets one or more of the following requirements:

i. Accepts deposits in the ordinary course of a banking or similar business;

ii. Holds financial assets for the account of others as a substantial portion of its business; or

iii. Is engaged, or holds itself out as being engaged, primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities.[313]

The Instructions to Form 8938 (Nov. 2011) state that "[a] foreign financial institution includes investment vehicles such as foreign mutual funds, foreign hedge funds, and foreign private equity funds."

For purposes of Section 6038D, a specified foreign financial asset includes a financial account maintained by a financial institution organized under the laws of a U.S. possession.[314]

**(C) Treatment of Assets Held in a Foreign Financial Account.** An asset held in a financial account maintained by a foreign financial institution is not required to be reported on Form 8938 separately from the reported financial account in which the asset is held.[315] The value of an asset held in a financial account maintained by a foreign financial institution is included in determining the maximum value of that account.[316]

**ii) Excepted Financial Accounts.** The following are not specified financial assets:

**(A) Accounts Maintained by U.S. Payors.** A financial account maintained by a U.S. payor as defined in § 1.6049-5(c)(5)(i)

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[311]Temp. Reg. § 1.6038D-1T(a)(7) (defining financial account by reference to I.R.C. § 1471(d)(2) and the regulations); *see* I.R.C. § 1471(d)(2); Instructions to Form 8938 (Nov. 2011).

[312]Temp. Reg. § 1.6038D-1T(a)(9) (defining foreign financial institution by reference to I.R.C. § 1471(d)(4) and the regulations); *see* I.R.C. § 1471(d)(4).

[313]Temp. Reg. § 1.6038D-1T(a)(8) (defining financial institution by reference to I.R.C. § 1471(d)(5) and the regulations); *see* I.R.C. § 1471(d)(5).

[314]Temp. Reg. § 1.6038D-3T(a)(2).

[315]Temp. Reg. § 1.6038D-3T(a)(1).

[316]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

(including assets held in such an account).[317] For example, a specified person is not required to report a financial account maintained by a U.S. branch of a foreign financial institution described in § 1.1441-1(b)(2)(iv).[318]

**(B) Mark to Market Election.** A financial account if the specified person uses mark-to-market accounting under section 475 for all of the holdings in the account.[319]

**(b) Other Specified Foreign Financial Assets.** A specified foreign financial asset includes any asset that is held for investment outside of an account maintained by a financial institution and is: (a) stock or securities issued by a person other than a U.S. person; [320] (b) any interest in a foreign entity ,[321] which is defined as any entity which is not a U.S. person;[322] and (c) a financial instrument or contract issued by a person other than a U.S. person or that has a counterparty that is a person other than a U.S. person. [323] The Preamble to the Temporary Regulations states that "[t]hese three categories are broad and overlap in certain cases such that an asset not held in a financial account may be within more than one of the statutory categories of section 6038D(b)(2).

**i) Examples of Other Specified Foreign Financial Assets.** The regulations provide that examples of assets other than financial accounts that may be considered other specified foreign financial assets if they are held for investment include, but are not limited to:

**(A)** Stock issued by a foreign corporation;[324]

**(B)** A capital or profits interest in a foreign partnership;[325]

**(C)** A note, bond, debenture, or other form of indebtedness issued by a foreign person;[326]

**(D)** An interest in a foreign trust; [327]

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[317]Temp. Reg. § 1.6038D-3T(a)(3)(i).

[318]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[319]Temp. Reg. § 1.6038D-3T(a)(3)(ii).

[320]I.R.C. § 6038D(b)(2)(A); Temp. Reg. § 1.6038D-3T(b)(1)(i).

[321]I.R.C. § 6038D(b)(2)(C); Temp. Reg. § 1.6038D-3T(b)(1)(iii).

[322]Temp. Reg. § 1.6038D-1T(a)(10) (defining "foreign entity" by reference to I.R.C. § 1473(5)); *see* I.R.C. § 1473(5).

[323]I.R.C. § 6038D(b)(2)(B); Temp. Reg. § 1.6038D-3T(b)(1)(ii).

[324]Temp. Reg. § 1.6038D-3T(d)(1).

[325]Temp. Reg. § 1.6038D-3T(d)(2).

[326]Temp. Reg. § 1.6038D-3T(d)(3).

[327]Temp. Reg. § 1.6038D-3T(d)(4).

**(E)** An interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement with a foreign counterparty;[328] and

**(F)** Any option or other derivative instrument with respect to any of the items listed as examples in this paragraph or with respect to any currency or commodity that is entered into with a foreign counterparty or issuer.[329]

**ii) Held for Investment.** An asset not held in an account maintained by a financial institution is held for investment for purposes of section 6038D and the regulations if the asset is not used or held for use in the specified person's trade or business.[330] For this purpose, an asset is used in, or held for use in, the conduct of a trade or business and not held for investment if the asset is:

**(A)** Held for the principal purpose of promoting the present conduct of a trade or business;[331]

**(B)** Acquired and held in the ordinary course of a trade or business, as, for example, in the case of an account or note receivable arising from that trade or business;[332] or

**(C)** Otherwise held in a direct relationship to the trade or business.[333] In determining whether an asset is held in a direct relationship to the conduct of a trade or business by a specified person, principal consideration will be given to whether the asset is needed in the trade or business of the specified person. An asset will be considered needed in a trade or business, for this purpose, only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset will be considered as needed in the trade or business if, for example, the asset is held to meet the operating expenses of the trade or business. Conversely, an asset will be considered as not needed in the trade or business if, for example, the asset is held for the purpose of providing for future diversification into a new trade or business, future plant replacement, or future business contingencies. Stock is never considered used or held for use in a trade or business for purposes of applying this test.[334]

An asset will be treated as held in a direct relationship to the conduct of a trade or business of a specified person if (a) the asset was acquired with funds generated by the trade or business of the specified person or the affiliated group of the specified person, if any; (b) the income from the asset is retained or reinvested in the trade or business; and (c) personnel who

[328]Temp. Reg. § 1.6038D-3T(d)(5).

[329]Temp. Reg. § 1.6038D-3T(d)(6).

[330]Temp. Reg. § 1.6038D-3T(b)(3).

[331]Temp. Reg. § 1.6038D-3T(b)(4)(i).

[332]Temp. Reg. § 1.6038D-3T(b)(4)(ii).

[333]Temp. Reg. § 1.6038D-3T(b)(4)(iii).

[334]Temp. Reg. § 1.6038D-3T(b)(5)(i).

are actively involved in the conduct of the trade or business exercise significant management and control over the investment of such asset.[335]

**iii) Assets Not Considered Specified Foreign Financial Assets.** The following assets are not specified foreign financial assets --

**(A)** An asset for which a specified person uses mark-to-market accounting under section 475;[336] and

**(B)** An interest in a social security, social insurance, or other similar program of a foreign government.[337]

**(4) Interest in a Specified Foreign Financial Asset.**

**(a) General Rule.** For section 6038D purposes, a specified person is generally considered to have an interest in a specified foreign financial asset if any income, gains, losses, deductions, credits, gross proceeds, or distributions attributable to the holding or disposition of the specified foreign financial asset are or would be required to be reported, included, or otherwise reflected on the specified person's annual return filed with the Internal Revenue Service (even if no income, gains, losses, deductions, credits, gross proceeds, or distributions are attributable to the asset for a particular taxable year).[338]

**(b) Special Rule For Parents Making Election Under Code Section 1(g)(7).** For purposes of section 6038D and the regulations, a parent that makes an election under section 1(g)(7) to include certain unearned income of a child in the parent's gross income required to be reported for the taxable year has an interest in any specified foreign financial asset held by the child.[339]

**(c) Treatment of Specified Financial Assets Held by Entities.**

**i) General Rule.** A specified person is generally not treated as having an interest in any specified foreign financial assets held by a partnership, corporation, trust, or estate solely as a result of the specified person's status as a partner, shareholder, or beneficiary.[340] This general rule is subject to certain exceptions for disregarded entities and grantor trusts as discussed below.

**ii) Exception for Disregarded Entity.** A specified person that is the owner of an entity disregarded as an entity separate from its owner (as provided in § 301.7701-2(c)(2)(i) of this chapter) (disregarded entity) is treated as having an interest in any specified foreign financial assets held by the disregarded entity.

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[335]Temp. Reg. § 1.6038D-3T(b)(5)(ii).

[336]Temp. Reg. § 1.6038D-3T(b)(2).

[337]Instructions to Form 8938 (Rev. Nov. 2011).

[338]Temp. Reg. § 1.6038D-2T(b)(1).

[339]Temp. Reg. § 1.6038D-2T(b)(2).

[340]Temp. Reg. § 1.6038D-2T(b)(3).

**iii) Exception for Specified Persons Treated as Owners of a Trust.** A specified person that is treated as the owner of a trust or any portion of a trust under sections 671 through 679 is generally treated as having an interest in any specified foreign financial assets held by the trust or by the portion of the trust that the specified person owns.[341] A specified person, however, that is treated as an owner of a domestic liquidating trust created pursuant to a court order issued in a bankruptcy under Chapter 7 or a confirmed plan under Chapter 11 of the Bankruptcy Code, a domestic widely held fixed investment trust, or any portion of such a trust under sections 671 through 679 is not required to file Form 8938 to report any specified foreign financial asset held by the trust.

**(d) Special Rule for Foreign Estates and Foreign Trusts.** A beneficial interest in a foreign trust or a foreign estate is not a specified foreign financial asset of a specified person unless the specified person knows or has reason to know based on readily accessible information of the interest. Receipt of a distribution from the foreign trust or foreign estate is deemed for this purpose to be actual knowledge of the interest.[342]

**d. Reporting on Form 8938.**

**(1) Required Information.** A specified person required to report on Form 8938 must provide the following information with regard to each specified foreign financial asset:

**(a)** In the case of a financial account maintained by a foreign financial institution, the name and address of the foreign financial institution and the account number of the account;[343]

**(b)** In the case of stock or a security, the name and address of the issuer, and information that identifies the class or issue of which the stock or security is a part;[344]

**(c)** In the case of a financial instrument or contract, information that identifies the financial instrument or contract, including the names and addresses of all issuers and counterparties;[345]

**(d)** In the case of an interest in a foreign entity, information that identifies the interest, including the name and address of the entity;[346]

**(e)** The maximum value of the specified foreign financial asset during the portion of the taxable year in which the specified person has an interest in the asset;[347]

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[341]Temp. Reg. § 1.6038D-2T(b)(3).

[342]Temp. Reg. § 1.6038D-3T(c).

[343]I.R.C. § 6038D(c)(1); Temp. Reg. § 1.6038D-4T(a)(1).

[344]I.R.C. § 6038D(c)(1); Temp. Reg. § 1.6038D-4T(a)(2).

[345]I.R.C. § 6038D(c)(1); Temp. Reg. § 1.6038D-4T(a)(3).

[346]I.R.C. § 6038D(c)(1); Temp. Reg. § 1.6038D-4T(a)(4).

**(f)** In the case of a financial account that is a depository or custodial account, whether such financial account was opened or closed during the taxable year;[348]

**(g)** The date, if any, on which the specified foreign financial asset, other than a financial account that is a depository or custodial account, was either acquired or disposed of (or both) during the taxable year;[349]

**(h)** The amount of any income, gain, loss, deduction, or credit recognized for the taxable year with respect to the reported specified foreign financial asset, and the schedule, form, or return filed with the Internal Revenue Service on which the income, gain, loss, deduction, or credit, if any, is reported or included by the specified person;[350]

**(i)** The foreign currency exchange rate and, if the source of such rate is other than as described in § 1.6038D-5T(d)(1), the source of the rate used to determine the specified foreign financial asset's U.S. dollar value, including maximum value;[351] and

**(j)** For a specified foreign financial asset excepted from reporting on Form 8938 under § 1.6038D-7T(a), the specified person must report the number of each type of form on which the asset is reported directly (for example, Form 3520, "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts," Form 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner," Form 5471, "Information Return of U.S. Persons With Respect To Certain Foreign Corporations," Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund," Form 8865, "Return of U.S. Persons With Respect To Certain Foreign Partnerships," or Form 8891, "U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans.")[352]

**(2) Reporting Period.**

**(a) Reporting Period for a Specified Individual.** The Form 8938 reporting period is the taxable year for a specified individual who is a U.S. citizen, a resident alien, or a bona fide resident of a U.S. possession for the entire taxable year.[353] The reporting period for an individual who is a U.S. citizen or resident alien for less than the entire taxable year is the portion of the taxable year for which the specified individual is a U.S. citizen or resident alien.[354]

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[347]I.R.C. § 6038D(c)(1); Temp. Reg. § 1.6038D-4T(a)(5).

[348]I.R.C. § 6038D(c)(1); Temp. Reg. § 1.6038D-4T(a)(6).

[349]I.R.C. § 6038D(c)(1); Temp. Reg. § 1.6038D-4T(a)(7).

[350]I.R.C. § 6038D(c)(1); Temp. Reg. § 1.6038D-4T(a)(8).

[351]I.R.C. § 6038D(c)(1); Temp. Reg. § 1.6038D-4T(a)(9).

[352]I.R.C. § 6038D(c)(1); Temp. Reg. § 1.6038D-4T(a)(10).

[353]Temp. Reg. § 1.6038D-2T(a)(9); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[354]Temp. Reg. § 1.6038D-2T(a)(9); 76 Fed. Reg. 78554 (Dec. 19, 2011).

**(b) Reporting Period for a Specified Domestic Entity.** The Form 8938 reporting period for a specified domestic entity is the entity's taxable year.[355]

**(3) Treatment of Married Individuals.**

**(a) Married Specified Individuals Filing a Joint Return - Single Form 8938.** Married specified individuals who file a joint annual return for the taxable year must fulfill their reporting requirements under Section 6038D by filing a single Form 8938.[356] The single Form 8938 must report all of the specified foreign financial assets in which either married specified individual has an interest.[357] A specified foreign financial asset that is jointly owned by married specified individuals or a specified foreign financial asset held by a child for which the married specified individuals have made an election under section 1(g)(7) is reported only once on the single Form 8938.[358]

**(b) Married Individuals Filing Separately.** A married specified individual who files a separate annual return for the taxable year must fulfill the reporting requirements under section 6038D by filing a separate Form 8938 that reports all of the specified foreign financial assets in which the married specified individual has an interest, including assets jointly owned with the married specified individual's spouse.[359]

**(c) Example.** Assume two married specified individuals, H and W, jointly own a specified foreign financial asset with a value of $90,000 at all times during the taxable year. H separately has an interest in a specified foreign financial asset with a value of $10,000 at all times during the taxable year. W separately has an interest in a specified foreign financial asset with a value of $1,000 at all times during the taxable year.[360] The filing requirements are as follows:

**i) Married Specified Individuals Filing Separate Returns.** If H and W file separate annual returns, the aggregate value of the specified foreign financial assets in which H has an interest at the end of the taxable year is $55,000, comprising one-half of the value of the jointly owned asset, $45,000, and the value of H's separately owned specified foreign financial asset, $10,000. The aggregate value of the specified foreign financial assets in which W has an interest at the end of the taxable year is $46,000, comprising one-half of the value of the jointly owned asset, $45,000, and the value of W's separately owned specified foreign financial asset, $1,000. H must file Form 8938 with his annual return for the taxable year because the aggregate value of the specified foreign financial assets in which H has an interest exceeds the applicable reporting threshold ($50,000). H must report the maximum value of the entire jointly owned asset, $90,000, and the maximum value of the separately owned asset, $10,000. The aggregate value of the specified foreign financial

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[355]Temp. Reg. § 1.6038D-2T(a)(9); 76 Fed. Reg. 78554 (Dec. 19, 2011).

[356]Temp. Reg. § 1.6038D-2T(c)(2)(i).

[357]Temp. Reg. § 1.6038D-2T(c)(2)(i).

[358]Temp. Reg. § 1.6038D-2T(c)(2)(i).

[359]Temp. Reg. § 1.6038D-2T(c)(2)(ii).

[360]*See* Temp. Reg. § 1.6038D-2T(d).

assets in which W has an interest, $46,000, does not exceed the applicable reporting threshold. W is not required to file Form 8938 with her separate annual return.[361]

**ii) Married Specified Individuals Filing a Joint Return.** If H and W file a joint annual return, they must file a single Form 8938 with their joint annual return for the taxable year because the aggregate value of all of the specified foreign financial assets in which either H and W have an interest ($90,000 (included only once), $10,000, and $1000, or $101,000) exceeds the applicable reporting threshold ($100,000). The single Form 8938 must report the maximum value of the jointly owned specified foreign financial asset, $90,000, and the maximum value of the specified foreign financial assets separately owned by H and W, $10,000 and $1,000, respectively.[362]

**(4) Treatment of Certain Assets Excepted from Reporting on Form 8938.**

**(a) Treatment of Certain Assets Reported on Other Forms.** As discussed below, certain specified foreign financial assets are excepted from the reporting obligations imposed under section 6038D. A specified person required to file Form 8938 with the Internal Revenue Service is not required to report a specified foreign financial asset on Form 8938 if the asset is reported or reflected on a Form 3520 (in the case of a specified person who is the beneficiary of a foreign trust), Form 5471, Form 8621, Form 8865, or Form 8891 timely filed with the Internal Revenue Service by the specified person for the taxable year,[363] and the Form 8938 indicates the filing of the form on which the asset is reported.[364] In addition, the value of specified foreign financial assets that qualify for this exception is included for purposes of determining whether the aggregate value of specified foreign financial assets in which a specified individual has an interest exceeds the applicable reporting threshold.[365]

**(b) Treatment of Certain Grantor Trusts.**

**i) Foreign Grantor Trusts.** A specified person required to file Form 8938 that is treated as an owner of a foreign trust or any portion of such a trust under sections 671 through 679 is not required to report any specified foreign financial asset held by the trust on Form 8938 provided (1) the specified person reports the trust on a Form 3520 timely filed with the Internal Revenue Service for the taxable year, (2) the trust timely files Form 3520-A with the Internal Revenue Service for the taxable year, and (3) the Form 8938 filed by the specified person for the taxable year indicates the filing of the Form 3520 and the Form 3520-A.[366]

**ii) Widely Held Fixed Investment Trusts and Certain Liquidating Trusts.** Another category of assets excepted from reporting are assets

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[361] Temp. Reg. § 1.6038D-2T(d).

[362] Temp. Reg. § 1.6038D-2T(d).

[363] *See* Temp. Reg. § 1.6038D-7T(a)(1)(i).

[364] *See* Temp. Reg. § 1.6038D-7T(a)(1)(ii); *see* Form 8938, Part IV.

[365] Temp. Reg. § 1.6038D-2T(a)(6).

[366] Temp. Reg. § 1.6038D-7T(a)(2).

considered owned by a specified person that is treated as the owner of certain widely-held fixed investment trusts and certain liquidating trusts.[367] Additionally, certain assets held by a specified individual who is a bona fide resident of a U.S. possession are also excepted from reporting.[368] Specified foreign financial assets that qualify for either of these two exceptions are not included for purposes of determining whether the aggregate value of specified foreign financial assets in which a specified person has an interest exceeds the applicable reporting threshold.[369]

**e. Valuation of Assets.**

**(1) Fair Market Value Standard.** The value of a specified foreign financial asset must be determined both for purposes of determining if the aggregate value of the specified foreign financial assets in which a specified person holds an interest exceeds the reporting thresholds and for purposes of reporting the maximum value of a specified foreign financial asset on Form 8938.[370] The value of a specified foreign financial asset for both of these purposes generally is the asset's fair market value.[371]

**(a) Maximum Value.** The maximum value of a specified foreign financial asset means a reasonable estimate of the asset's highest fair market value during the taxable year.[372]

**(b) U.S. Dollars.** For purpose of determining the aggregate value of specified foreign financial assets in which a specified person has an interest and determining the maximum value of a specified foreign financial asset, the value of a specified foreign financial asset denominated in a foreign currency during the taxable year must be determined in the foreign currency and then converted to U.S. dollars.[373]

**(c) Assets With No Positive Value.** If the maximum value of a specified foreign financial asset is less than zero, the value of the specified foreign financial asset is treated as zero for the purposes of determining the aggregate value of specified foreign financial assets in which a specified person has an interest and determining the maximum value of a specified foreign financial asset required to be reported on Form 8938.[374]

**(d) Foreign Currency Conversion**. If a specified foreign financial asset is denominated in a foreign currency, the value of the asset for purposes of determining both the aggregate value of specified foreign financial assets in which a specified person holds an interest and the maximum value of the specified foreign financial asset is first determined in the foreign currency prior to conversion into U.S. dollars (that is, independently of

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[367] *See* Temp. Reg. § 1.6038D-7T(b).

[368] *See* Temp. Reg. § 1.6038D-7T(c).

[369] Temp. Reg. § 1.6038D-2T(a)(6).

[370] Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[371] Temp. Reg. 1.6038D-5T(a).

[372] Temp. Reg. § 1.6038D-5T(b)(1).

[373] Temp. Reg. § 1.6038D-5T(b)(2).

[374] Temp. Reg. § 1.6038D-5T(b)(3).

exchange rate fluctuations during the year).[375] The asset's foreign currency value is then converted into U.S. dollars at the taxable year-end spot rate for converting the foreign currency into U.S. dollars (that is, the rate to purchase U.S. dollars).[376] The U.S. Treasury Department's Financial Management Service foreign currency exchange rate is to be used to convert the value of a specified foreign financial asset into U.S. dollars.[377] If no U.S. Treasury Department Financial Management Service foreign currency exchange rate is available, another publicly available foreign currency exchange rate may be used to determine an asset's maximum value, but the use of such rate must be disclosed on Form 8938.[378]

**(2) Valuing Financial Accounts.** The maximum value of a financial account means a reasonable estimate of the maximum value of the holdings of the financial account at any time during the taxable year.[379] A specified person may rely upon periodic account statements provided at least annually for reporting a financial account's maximum value absent actual knowledge or reason to know based on readily accessible information that the statements do not reflect a reasonable estimate of the maximum account value during the taxable year.[380] The value of an asset held in a financial account maintained by a foreign financial institution is included in determining the value of that financial account.[381]

**(3) Valuing Other Specified Foreign Financial Assets.**

**(a) General Rule.** For purposes of determining the maximum value of a specified foreign financial asset other than a financial account maintained with a foreign financial institution, a specified person may generally treat the asset's fair market value on the last day during the taxable year on which the specified person has an interest in the asset as the maximum value of the asset.[382] The specified person may not use this valuation approach if the specified person has actual knowledge or reason to know based on readily accessible information that the fair market value determined as of such date does not reflect a reasonable estimate of the maximum value of the asset during the year (for example, because there is a reason to know that the asset's value declined significantly during the year).[383] The Preamble provides that a specified person may determine the fair market value of a specified foreign financial asset based on information publicly available from reliable financial information sources or from other verifiable sources.[384] The Preamble also states that, even if there is no information from reliable financial information sources regarding the fair market

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[375]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011); *see* Temp. Reg. § 1.6038D-5T(b)(2).

[376]Temp. Reg. § 1.6038D-5T(c)(3); Temp. Reg. § 1.6038D-5T(c)(4).

[377]Temp. Reg. § 1.6038D-5T(c)(1).

[378]Temp. Reg. § 1.6038D-5T(c)(2).

[379]Temp. Reg. § 1.6038D-5T(b)(1); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[380]Temp. Reg. § 1.6038D-5T(d).

[381]Temp. Reg. § 1.6038D-5T(e).

[382]Temp. Reg. § 1.6038D-5T(f)(1).

[383]Temp. Reg. § 1.6038D-5T(f)(1); Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[384]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

value of a reported asset, the regulations do not require a specified person to obtain an appraisal by a third party in order to reasonably estimate the asset's fair market value.[385]

**(b) Special Valuation Rules for Interests in Foreign Trusts.** If a specified person is a beneficiary of a foreign trust, the maximum value of the specified person's interest in the trust is the sum of:

**i)** The fair market value, determined as of the last day of the taxable year, of all of the currency or other property distributed from the foreign trust during the taxable year to the specified person; and

**ii)** The value as of the last day of the taxable year of the specified person's right as a beneficiary to receive mandatory distributions from the foreign trust as determined under section 7520.[386]

**(4) Special Valuation Rule for Interests in Foreign Estates, Pension Plans, and Deferred Compensation Plans.** The maximum value of a specified person's interest in a foreign estate, foreign pension plan, or a foreign deferred compensation plan is the fair market value, determined as of the last day of the taxable year, of the specified person's beneficial interest in the assets of the foreign estate, foreign pension plan, or foreign deferred compensation plan.[387] If the specified person does not know or have reason to know based on readily accessible information such fair market value, the maximum value to be reported is the fair market value, determined as of the last day of the taxable year, of the currency and other property distributed during the taxable year to the specified person as a beneficiary or participant.[388]

**(5) Special Rules for Jointly owned Interests.** The Instructions to Form 8938 (Rev. Nov. 2011) contains special rules for jointly-owned interests.

**f. Penalties for Failure to Disclose.**

**(1) General Rule.** If a specified person fails to file a Form 8938 that includes the required information with respect to any taxable year at the time and in the manner described in section 6038D and the regulations thereunder, a penalty of $10,000 will apply to that specified person.[389] If any such failure continues for more than 90 days after the day on which the Commissioner or his delegate mails a notice of the failure to the specified person required to file the Form 8938, the specified person is subject to an additional penalty of $10,000 for each 30-day period (or fraction thereof) during which the failure continues after the

[385]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

[386]Temp. Reg. § 1.6038D-5T(f)(2)(i).

[387]Temp. Reg. § 1.6038D-5T(f)(3)(i).

[388]Temp. Reg. § 1.6038D-5T(f)(3)(i).

[389]I.R.C. § 6038D(d)(1); Temp. Reg. § 1.6038D-8T(a).

90-day period has expired.[390] The additional (or continuation) penalty is limited to a maximum of $50,000 for each such failure.[391]

**(2) Married Individuals Filing a Joint Annual Return.** Married specified individuals who file a joint annual return and fail to file a required Form 8938 that includes the required information with respect to any taxable year at the time and in the manner described in section 6038D and the regulations thereunder are subject to penalties under as if the married specified individuals are a single specified person.[392] The liability of married specified individuals who file a joint annual return with respect to penalties under this section is joint and several.[393]

**(3) Presumption of Aggregate Value.** For the purpose of assessing the penalties for failure to disclose, if the Revenue Service determines that a specified person has an interest in one or more specified foreign financial assets, and the specified person has not provided sufficient information to demonstrate the aggregate value of the assets upon request by the Secretary, then the aggregate value of the assets is treated as being in excess of the applicable reporting threshold.[394]

**(4) Reasonable Cause Exception.** If a specified person shows that the failure to report the required information is due to reasonable cause and not due to willful neglect, no penalty will be imposed.[395] To show that the failure to report is due to reasonable cause and not due to willful neglect, the specified person must make an affirmative showing of all the facts alleged as reasonable cause for the failure to report.[396] The determination of whether a failure to disclose a specified foreign financial asset on Form 8938 was due to reasonable cause and not due to willful neglect is made on a case-by-case basis, taking into account all pertinent facts and circumstances. For this purpose, the fact that a foreign jurisdiction would impose a civil or criminal penalty on the specified person (or any other person) for disclosing the required information is not reasonable cause.[397]

**g. Coordination with Form TD F 90-22.1.** The Preamble to the Temporary Regulations provides that, if required, both Forms TD F 90-22.1 and 8938 must be filed. The Preamble provides that "different policy considerations apply to Form 8938 and FBAR reporting. These are reflected in the different categories of persons required to file Form 8938 and the FBAR, the different filing thresholds for Form 8938 and FBAR reporting, and the different assets (and accompanying information) required to be reported on each form. Although certain information may be reported on both Form 8938 and the FBAR, the information required by the forms is not identical in all cases, and reflects the different rules, key definitions (for

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[390] I.R.C. § 6038D(d)(2); Temp. Reg. § 1.6038D-8T(c).

[391] I.R.C. § 6038D(e); Temp. Reg. § 1.6038D-8T(c).

[392] Temp. Reg. § 1.6038D-8T(b).

[393] Temp. Reg. § 1.6038D-8T(b).

[394] I.R.C. § 6038D(e); Temp. Reg. § 1.6038D-8T(d).

[395] I.R.C. § 6038D(g); Temp. Reg. § 1.6038D-8T(e)(1).

[396] Temp. Reg. § 1.6038D-8T(e)(2).

[397] I.R.C. § 6038D(g); Temp. Reg. § 1.6038D-8T(e)(3).

example, 'financial account'), and reporting requirements applicable to Form 8938 and FBAR reporting."[398]

[398]Preamble, 76 Fed. Reg. 78554 (Dec. 19, 2011).

## VII. THE BRANCH PROFITS TAX

**A. Application and Tax Rate.** In addition to the regular corporate income tax imposed on foreign corporations doing business in the U.S., the U.S. imposes a flat 30-percent branch profits tax (or such lesser rate as is imposed by an applicable income tax treaty) on the "dividend equivalent amount" of a foreign corporation doing business in the U.S.[399] The "dividend equivalent amount" generally is the U.S. branch's earnings and profits effectively connected with a U.S. trade or business[400] ***with*** certain adjustments.

**1. Items of Income Excluded from Branch Tax Computation of Effectively-Connected Earnings and Profits.** The following earnings and profits attributable to income effectively connected with a U.S. trade or business are excluded from the imposition of branch profits tax:

**a.** Certain foreign transportation earnings;[401]

**b.** Earnings derived from the sale of any interest in U.S. real property holding corporations;[402]

**c.** Earnings derived by certain corporations organized in a U.S. possession;[403] and

**d.** Earnings derived by certain captive insurance companies.[404]

**2. Adjustments to Reflect Changes in U.S. Net Equity.** In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (i.e., the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business).[405] The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities).[406] The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.[407]

**B. Branch-Level Interest Tax.** Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a U.S. corporation and therefore is subject to U.S.

[399]I.R.C. § 884(a); Treas. Reg. § 1.884-1(a).

[400]I.R.C. §884(b); Treas. Reg. § 1.884-1(b)(1).

[401]I.R.C. § 884(d)(2)(A); Treas. Reg. § 1.884-1(f)(2)(i).

[402]I.R.C. § 884(d)(2)(C); Treas. Reg. § 1.884-1(f)(2)(iii).

[403]I.R.C. § 884(d)(2)(E); Treas. Reg. § 1.884-1(f)(2)(vi).

[404]I.R.C. § 884(d)(2)(D); Treas. Reg. § 1.884-1(f)(2)(iv).

[405]I.R.C. § 884(b); Treas. Reg. § 1.884-1(b)(2).

[406]I.R.C. §§ 884(b)(1), 884(c); Treas. Reg. § 1.884-1(b)(2).

[407]I.R.C. §§ 884(b)(2), 884(c); Treas. Reg. § 1.884-1(b)(3).

withholding tax (if the interest is paid to a foreign person).[408] Certain "excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and therefore is subject to U.S. 30-percent withholding tax.[409] For this purpose, excess interest is the excess of the interest deduction allocated or apportioned with respect to the U.S. trade or business over the amount of interest paid by such trade or business.[410]

**C. Anti-Treaty Shopping Provision Under Branch Profits Tax**. Special anti-treaty shopping rules apply for purposes of the branch profits tax. In order to take advantage of a treaty provision reducing or eliminating the branch profits tax, the foreign corporation must be a "qualified resident" of the treaty country.[411] A "qualified resident" means, with respect to any foreign country, any foreign corporation which is a resident of such foreign country unless:

**1.** 50-percent or more (by value) of the stock of such foreign corporation is owned by individuals who are not residents of such foreign country and who are not U.S. citizens or resident aliens;[412] or

**2.** 50-percent or more of the foreign corporation's income is used (directly or indirectly) to meet liabilities to persons who are not residents of such foreign country or U.S. citizens or resident aliens.[413]

Certain additional rules apply to dividends paid by foreign corporations that qualify for a reduced branch profits tax rate under an income tax treaty.[414]

**D. Exception for Termination of U.S. Branch.** A foreign corporation will not be subject to the branch profits tax in the year in which a foreign corporation completely terminates all of its U.S. trade or business.[415] A foreign corporation's previously taxed accumulated effectively connected earnings and profits are extinguished as a result of a complete termination of all of the U.S. trade or business of a foreign corporation.[416]

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[408] I.R.C. § 884(f)(1)(A); Treas. Reg. § 1.884-4(a)(1).

[409] I.R.C. § 884(f)(1)(B); Treas. Reg. § 1.884-4(a)(2).

[410] I.R.C. §§ 884(f)(1)(B), 884(f)(2); Treas. Reg. § 1.884-4(a)(2)(i).

[411] I.R.C. § 884(e)(1); Treas. Reg. § 1.884-5.

[412] I.R.C. § 884(e)(4)(A)(i); Treas. Reg. § 1.884-5.

[413] I.R.C. § 884(e)(4)(A)(ii); Treas. Reg. § 1.884-5.

[414] *See* I.R.C. § 884(e)(3)(B).

[415] Temp. Reg. § 1.884-2T(a).

[416] *See also* Announcement 94-42, 1994-12 I.R.B. 8 ("A foreign corporation will use Form 8848 if it has completely terminated all of its U.S. trade or business during the tax year . . . .").

# VIII. U.S. INCOME TAXATION OF U.S. SOURCE FIXED DETERMINABLE ANNUAL OR PERIODICAL INCOME

## A. General Patterns of Taxation of Fixed Determinable, Annual or Periodical Income.

**1. Effectively Connected Fixed Determinable, Annual or Periodical Income**. If effectively connected with a U.S. trade or business, U.S. source fixed determinable, annual or periodical ("FDAP") income (for example, interest, dividends, rents, royalties) earned by a nonresident alien or foreign corporation is subject to tax, with appropriate deductions, at ordinary rates.[417] Generally, no withholding is required for any income that is effectively connected with the conduct of a U.S. trade or business (other than compensation for personal services).[418] In order to avoid withholding, persons conducting U.S. trades or businesses are required to file certain prescribed forms with withholding agents for each tax year for which such persons will be entitled to the income, and before payment of the income in respect of which it applies.

**2. Non-Effectively Connected FDAP Income.** Nonresident aliens and foreign corporations are subject to a 30% tax (or such lesser rate as is determined by an applicable income tax treaty) on most items of U.S. source FDAP income that are not effectively connected with the conduct of a trade or business in the U.S.[419] FDAP income includes:

> "interest (other than original issue discount as defined in Section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income . . . ***but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.***"[420]

The 30% tax liability is generally collected by way of withholding at source.[421]

## B. Special Issues Relating to Non-Effectively Connected FDAP Income.

**1. Treatment of Original Issue Discount.** As a general rule, nonresident aliens and foreign corporations are subject to a 30% tax on U.S.-source interest that is not effectively connected with the conduct of a U.S. trade or business.[422] Original issue discount is

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[417]I.R.C. §§ 871(a), 871(b), 881(a), 882(a)(1).

[418]I.R.C. § 1441(c)(1).

[419]I.R.C. §§ 871(a) and 881(a); *see also Central de Gas de Chihuahua v. Commissioner*, 102 T.C. 515, 517 (1994) (no actual payment required under I.R.C. § 882 and allocation of rent under I.R.C. § 482 provides a sufficient basis for imposing the 30% tax).

[420]I.R.C. §§ 871(a)(1)(A) and 881(a)(1).

[421]I.R.C. § 1441(a) (withholding rules for payments to non-resident alien individuals and foreign partnerships); I.R.C. § 1442(a) (withholding rules for payments to foreign corporations).

[422]I.R.C. §§ 871(a)(1)(A), 881(a)(1).

excluded from this general rule.[423] "Original issue discount" (or "OID") is generally defined as the excess (if any) of the stated redemption price at maturity of an obligation, over the issue price of the obligation.[424]

Although original issue discount is excluded from the 30% tax on U.S.-source interest, special rules apply with respect to certain amounts received with respect to original issue discount obligations, but only to the extent the amounts received are not effectively connected with the conduct of a U.S. trade or business.[425] An "original issue discount obligation" is generally any evidence of indebtedness having OID.[426]

**a. Treatment of Domestic Holders of OID Instruments.** As a general rule, domestic holders of OID instruments are required to include in income an amount equal to the sum of the daily portions of the OID for each day during the tax year in which such holder held such instrument, and the inclusion increases basis.[427] Congress did not intend this increase in basis to apply to untaxed foreign investors, however.[428] The basis of the OID instrument for the purpose of computing gain does not increase during the period the foreign investor holds it unless the U.S. taxed the investor on the OID.

**b. Payments on Original Issue Discount Obligation.** In the case of a payment on an "original issue discount obligation," nonresident aliens and foreign corporations are subject to a 30% tax on the amount of original issue discount accruing while such obligation was held by the nonresident alien individual or foreign corporation.[429] The 30% tax, however, applies only to the extent that:

**(1)** The tax does not exceed the amount of the payment on the original issue discount obligation (less withholding tax imposed on the payment);[430] and

**(2)** The discount has not previously been taken into account under this provision.[431]

**c. Payments Received from Sale or Exchange of Original Issue Discount Obligations.** In the case of the sale or exchange of an "original issue discount obligation," nonresident aliens and foreign corporations are subject to a 30% tax on the amount of the original issue discount accruing while such obligation was held by the nonresident alien or foreign corporation.[432] The 30% tax, however, applies only to the original issue discount that

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[423]I.R.C. §§ 871(a)(1)(A), 881(a)(1).

[424]I.R.C. § 1273(a)(1).

[425]I.R.C. §§ 871(a)(1)(C), 881(a)(3).

[426]I.R.C. §§ 871(g)(1)(A), 881(e).

[427]I.R.C. §§ 1272(a)(1), 1272(d)(2).

[428]Staff of the Joint Comm. On Taxation, 98th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1984*, 402 403 (1984).

[429]I.R.C. §§ 871(a)(1)(C)(ii), 881(a)(3)(B).

[430]I.R.C. §§ 871(a)(1)(C)(ii), 881(a)(3)(B).

[431]I.R.C. §§ 871(a)(1)(C)(ii), 881(a)(3)(B).

[432]I.R.C. §§ 871(a)(1)(C)(i), 881(a)(3)(A).

accrued while the obligation was held by the nonresident alien or foreign corporation and only to the extent such discount was not taken into account in prior payments.[433]

**d. Exclusions from Definition of "Original Issue Discount Obligation."** There are two special exclusions from the definition of the term "original issue discount obligation":

**(1) Short-Term Obligations.** The term does not include any obligation payable 183 days or less from the date of original issue.[434]

**(2) Tax-Exempt Obligations.** The term does not include any obligation that produces certain tax-exempt income.[435]

**2. Special Treatment of Interest on Deposits.** Interest on deposits with banks and savings institutions is exempt from U.S. income taxation if the interest is not effectively connected with the conduct of a U.S. trade or business.[436]

**3. Exception for "Portfolio Interest."**

**a. Treatment of Portfolio Interest.** U.S.-source "portfolio interest" received by a nonresident alien is not subject to the general 30% flat tax.[437] The same rule applies to portfolio interest received by a foreign corporation.[438]

**b. Definition of "Portfolio Interest."** The term "portfolio interest" means non-exempt U.S. source interest (including original issue discount) which would otherwise be subject to the general 30% flat tax;[439] and which is paid to a nonresident alien or foreign corporation on an obligation which meets either (1) a bearer obligation test or (2) a registered obligation test. As part of the 2010 Hiring Incentives to Restore Employment Act,[440] Congress repealed the bearer obligation test for obligations issued after the date which is 2 years after March 18, 2010.[441]

**(1) Bearer Obligation Test.** The bearer obligation test is met if the obligation is not in registered form (i.e., bearer obligation) and the obligation meets certain

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[433] I.R.C. §§ 871(a)(1)(C)(i), 881(a)(3)(A).

[434] I.R.C. § 871(g)(1)(B)(i).

[435] I.R.C. § 871(g)(1)(B)(ii).

[436] I.R.C. §§ 871(i)(1), 871(i)(2)(A), 871(i)(3).

[437] I.R.C. § 871(h)(1); *see* Treas. Reg. § 1.871-14(a).

[438] I.R.C. § 881(c)(1); Treas. Reg. § 1.871-14(b).

[439] I.R.C. § 871(h)(2).

[440] Pub. L. No. 111-144, § 502(b)(1) 124 Stat. 42.

[441] See Notice 2012-20, 2012-13 I.R.B. 574 ("This notice provides guidance related to the repeal of section 163(f)(2)(B) of the Internal Revenue Code (Code) and related provisions enacted by section 502 of the Hiring Incentives to Restore Employment Act of 2010, Pub. L. 111-147 (the HIRE Act).").

prescribed conditions to ensure that such obligation is sold (or resold in connection with original issue) only to a person who is not a U.S. person.[442]

**(2) Registered Obligation Test.** An obligation meets the registered obligation test if the obligation is in registered form[443] and either (i) the obligation is one with respect to which the U.S. person who would otherwise be required to withhold tax receives a statement that the beneficial owner of the obligation is not a U.S. person;[444] or (ii) the obligation is targeted to foreign markets and the interest on such obligation is paid through financial institutions outside the United States.[445]

**c. Exceptions and Special Rules.** The term "portfolio interest" does not include the following:

**(1)** Interest that is effectively connected with the conduct by the foreign recipient of a U.S. trade or business;[446]

**(2)** Interest on obligations issued on or before July 18, 1984;[447]

**(3)** Interest received by:

**(a)** A 10% or greater than 10% foreign shareholder of a U.S. corporate borrower;[448] or

**(b)** A person owning 10% or more of the capital or profits of a U.S. partnership borrower;[449]

**(4)** Interest received by a related controlled foreign corporation;[450]

**(5)** Interest (other than interest on an obligation of the U.S.) received by foreign banks on obligations issued in the ordinary course of business;[451] and

**(6)** Contingent interest.[452]

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[442]I.R.C. §§ 871(h)(2)(A), 881(c)(2)(A), 163(f)(2)(B); *see* Treas. Reg. § 1.871-14(b)(1).

[443]I.R.C. §§ 871(h)(2)(B), 881(c)(2)(B); *see* Treas. Reg. § 1.871-14(c)(1)(i).

[444]I.R.C. §§ 871(h)(2)(B), 881(c)(2)(B); *see* Treas. Reg. § 1.871-14(c)(1)(ii)(C).

[445]*See* Treas. Reg. § 1.871-14(e)(1).

[446]I.R.C. § 871(h)(2); Treas. Reg. § 1.871-14(a).

[447]Treas. Reg. § 1.871-14(b)(1).

[448]I.R.C. § 871(h)(3)(B)(i).

[449]I.R.C. § 871(h)(3)(B)(ii).

[450]I.R.C. § 881(c)(3).

[451]I.R.C. § 881(c)(3).

[452]I.R.C. § 871(h)(4).

**4. Special Rule for Dividends from 80/20 Corporations.** A portion of the dividends paid by a U.S. corporation meeting the 80% foreign business requirement (of I.R.C. § 861(c)(1)) is not subject to the 30% gross tax.[453] The percentage of the dividends that are free of the 30% tax is determined as follows:

$$\frac{\text{Foreign source gross income of the U.S. corporation for the three prior years}}{\text{Total gross income of the U.S. corporation for the three prior years}}$$

A corporation generally meets the 80% foreign business requirement if, for the three prior tax years, at least 80% of the domestic corporation's gross income was (i) from a foreign source; and (ii) attributable to the active conduct of a trade or business in a foreign country.[454]

**C. Other Items of Income Subject to 30% Flat Tax.**

**1. Certain Timber and Iron Ore Gains.** Nonresident aliens and foreign corporations are subject to a 30% tax on gains derived from the disposal of timber, coal or domestic iron ore with a retained economic interest.[455]

**2. Gains from Sale or Exchange of Certain Intangible Property**. The 30% gross basis tax is imposed on gains derived by nonresident aliens and foreign corporations from the sale of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property, or of any interest in any such property, to the extent such gains are from payments which are contingent on the productivity, use, or disposition of the property or interest sold or exchanged.[456] The tax applies only to the extent the amount received is not effectively connected with the conduct of a U.S. trade or business.

**D. Withholding of Tax on FDAP Income of Nonresident Aliens and Foreign Corporations.**

**1. Withholding Agents Required to Withhold 30% Tax.** All persons (referred to as "withholding agents") having the control, receipt, custody, disposal, or payment of U.S.-sourced FDAP income of any nonresident alien or foreign partnership must deduct and withhold a 30% tax (or lesser rate imposed by an applicable income tax treaty[457]).[458] The same obligation applies to withholding agents with respect to U.S.-source FDAP income of a foreign corporation.[459]

**a. Withholding Obligation Applies to Payment of FDAP Income in Series of Repeated Payments or in a Single Lump Sum.** The U.S. Treasury regulations provide that the term "fixed or determinable annual or periodical" income is merely descriptive

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[453] I.R.C. §§ 871(i)(2)(B), 881(d).

[454] I.R.C. § 861(c)(1).

[455] I.R.C. §§ 871(a)(1)(B), 881(a)(2).

[456] I.R.C. §§ 871(a)(1)(D), 881(a)(4).

[457] *See* Treas. Reg. § 1.1441-6.

[458] I.R.C. § 1441(a).

[459] I.R.C. § 1442(a).

of the character of a class of income. If an item of income is FDAP, it is "immaterial" whether payment of that item is made in a series of repeated payments or in a single lump sum.[460]

**(1) Description of Fixed or Determinable Annual or Periodical Income.** Under the Treasury regulations, income is "fixed" when it is to be paid in amounts definitely predetermined. Income is "determinable" whenever there is a basis of calculation by which the amount to be paid may be ascertained at a later time. The income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals. The fact that a payment is not made annually or periodically does not, however, necessarily prevent its being FDAP income. The fact that the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not make the payments any the less determinable or periodical.[461]

**(2) Sales Income Is Not FDAP.** The Regulations provide that income derived from the sale in the U.S. of real or personal property (with certain limited exceptions) is not FDAP income.[462]

**2. Treatment of Domestic Partnerships with Nonresident Aliens and Foreign Corporations as Partners.**

**a. Withholding on Payments to Domestic Partnership with Foreign Partners.** The regulations clarify that a payment to a person that the withholding agent may treat as a domestic partnership is treated as a payment to a U.S. payee.[463] Therefore, if a U.S. withholding agent can reliably associate a Form W-9 provided by a U.S. partnership, the withholding agent may treat the payment as made to a U.S. payee and the payment is not subject to withholding under Section 1441 even though it may have partners that are foreign persons.

**b. Withholding by U.S. Partnerships.** Domestic partnerships are required to withholding on U.S.-source non-effectively connected FDAP income that is included in the distributive share of a member of such partnership who is a foreign person.[464] A domestic partnership is required to withhold when any distributions that include amounts subject to

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[460]Treas. Reg. § 1.1441-2(b)(1)(ii); *see also* Treas. Reg. § 1.1441-2(b)(1) ("For purposes of chapter 3 of the Code and the regulations thereunder, fixed or determinable annual or periodical income is all income included in gross income under section 61 (including original issue discount), except for the items specified in (b)(2) of this section."). The general "theme" of the regulations is that "[a] withholding agent must withhold 30-percent of any payment of an amount subject to withholding made to a payee that is a foreign person unless it can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a beneficial owner that is a U.S. person or as made to a beneficial owner that is a foreign person entitled to reduced withholding." Treas. Reg. § 1.1441-1(b)(1). Generally, the determination by a withholding agent of the U.S. or foreign status of a payee and of its other relevant characteristics (e.g., as a beneficial owner or intermediary, or as an individual, corporation, or flow-through entity) is made on the basis of a withholding certificate that is one of the Forms W-8 or a Form 8233 (indicating foreign status of the payee or beneficial owner) or a Form W-9 (indicating U.S. status of the payee). Treas. Reg. § 1.1441-1(b)(2)(i).

[461]Treas. Reg. § 1.1441-2(b).

[462]Treas. Reg. § 1.1441-2(b)(2)(i).

[463]Treas. Reg. § 1.1441-5(b)(1).

[464]I.R.C. § 1441(b) (flush language); Treas. Reg. § 1.1441-5(b)(2)(i).

withholding (including guaranteed payments made by a U.S. partnership) are made.[465] To the extent a foreign partner's distributive share of income subject to withholding has not actually been distributed to the foreign partner, the U.S. partnership is required to withhold on the foreign partner's distributive share of the income on the earlier of the date that the Schedule K-1 is mailed or otherwise provided to the partner or the due date for furnishing the Schedule K-1.[466] If a partnership properly withholds on a foreign partner's undistributed share of U.S. source FDAP income, no withholding is required when the income is subsequently distributed.[467]

**3. Treatment of Foreign Partnerships.** A payment made to a foreign partnership may be treated as a payment made to the partners (if certain conditions are met) rather than to the partnership and the withholding agents must follow certain prescribed withholding procedures to determine the status of the payee partners.[468] A withholding agent, however may treat a payment to a foreign partnership as made to the partnership (rather than to its partners) if, with respect to the partnership, certain requirements set forth in the regulations are met.[469]

**4. Corporate Distributions.**

**a. Dividend Distributions.** The withholding rules also apply to U.S.-source dividend income of nonresident aliens and foreign corporations, respectively. [470]

**b. Other Distributions.** A corporation making a distribution with respect to its stock is required to withhold on the entire amount of the distribution, unless it elects to reduce the amount of withholding.[471] The amounts with respect to which a distributing corporation may elect to reduce the withholding include the following:

**(1)** A distributing corporation may elect to not withhold on a distribution to the extent it represents a nontaxable distribution payable in stock or stock rights;

**(2)** A distributing corporation may elect to not withhold on a distribution to the extent it represents a distribution in part or full payment for stock;

**(3)** A distributing corporation may elect to not withhold on a distribution (actual or deemed) to the extent it is not paid out of accumulated earnings and profits or current earnings and profits, based on a reasonable estimate (determined pursuant to a procedure in the regulations).[472] A distributing corporation, however, that is a withholding agent with respect to a distribution and that determines at the end of the tax year in which the

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[465] Treas. Reg. § 1.1441-5(b)(2)(i).
[466] Treas. Reg. § 1.1441-5(b)(2)(i).
[467] Treas. Reg. § 1.1441-5(b)(2)(v).
[468] Treas. Reg. § 1.1441-5(c)(1).
[469] Treas. Reg. § 1.1441-5(c)(1)(ii).
[470] *See* Treas. Reg. § 1.1441-3(c)(1).
[471] Treas. Reg. § 1.1441-3(c)(1).
[472] Treas. Reg. § 1.1441-3(c)(2)(i)(C).

distribution is made that it underwithheld on the distribution is liable for the amount underwithheld.[473]

5. **Exceptions and Exemptions from Withholding; Special Rules.**

a. **Foreign Source Income.** Items of foreign-source income of a nonresident alien are not subject to withholding under Section 1441 or 1442.[474]

b. **Income Effectively Connected with the Conduct of a U.S. Trade or Business.** No withholding is required in the case of any item of income (other than certain compensation for personal services) which is effectively connected with the conduct of a trade or business and which is included in the gross income of the recipient as trade or business income.[475] In order to avoid withholding, persons conducting U.S. trades or businesses are required to file a prescribed form (Form W-8ECI) with withholding agents for each tax year for which such persons will be entitled to the income, and before payment of the income in respect of which it applies.[476]

c. **Treatment of Compensation for Services.**

(1) **Services Performed by a Foreign Partnership or a Foreign Corporation.** Subject to application of a *de minimis* rule in Section 864(b)(1), a foreign partnership or foreign corporation that performs services in the U.S. is generally treated as engaged in the conduct of a U.S. trade or business and any income arising therefrom is treated as effectively connected income.[477] No withholding is required with respect to income for services performed by a foreign partnership or a foreign corporation (other than a foreign corporation which has certain income derived from a personal service contract).[478]

(2) **Services Performed by an Individual.** Compensation for personal services performed by a nonresident alien within the U.S. is generally subject to withholding, unless that compensation is specifically exempted from withholding (e.g., by treaty) or is subject to graduated withholding applicable to employees.[479]

6. **Liability for Withholding Tax.** Every withholding agent is personally liable for such tax and is indemnified against the claims and demands of any person for the amount of any payments made to the Government.[480]

7. **Reporting Requirements.**

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[473] Treas. Reg. § 1.1441-3(c)(2)(ii)(B).

[474] Treas. Reg. § 1.1441-1(b)(4)(v).

[475] I.R.C. § 1441(c)(1); Treas. Reg. § 1.1441-4(a)(1).

[476] Treas. Reg. § 1.1441-4(a)(2).

[477] I.R.C. § 864(b).

[478] Treas. Reg. § 1.1441-4(a)(1); *see* Treas. Reg. § 1.1441-4(a)(2)(i) (addresses withholding agent's reliance on a claim of effectively connected income).

[479] Treas. Reg. § 1.1441-4(b)(1).

[480] I.R.C. § 1461.

**a. Form 1042.** Every withholding agent is generally required to file Form 1042 on or before March 15 reporting the tax required to be withheld during the preceding calendar year. Even if no tax was withheld by the withholding agent, Form 1042 is nevertheless required to be filed if the withholding agent was required to prepare a Form 1042S with respect to any payments made during the year.[481] Withholding agents are required to transmit with the Form 1042 all Forms 1042S prepared during the previous year.[482]

**b. Form 1042S.** Every withholding agent is required to prepare before March 15 a 1042S showing all income items paid during the preceding calendar year to nonresident aliens, foreign partnerships, nonresident alien or foreign fiduciaries of a trust or estate, or foreign corporations if such items consist of amounts subject to withholding.[483] A copy of the Form 1042S must be provided to the recipient.[484]

**8. Withholding Tax as Credit to Recipient of Income.** The entire amount of income from which tax is required to be withheld must be included in gross income on the "return required to be made by the recipient," without deduction for the withheld amount, but the tax so withheld is allowed as a credit against the total income tax computed in the taxpayer's return.[485]

**E. Obtaining Reduced Treaty Withholding Rates.** The Treasury Regulations provide that the general withholding rate of 30 percent must be reduced as may be provided by an income tax treaty with any country. The regulations prescribe the method for securing the reduced withholding rate.[486]

**F. Reporting of Bank Deposit Interest.** Sections 1.6049-4(b)(5) and 1.6049-8 of the Income Tax Regulations, as revised by TD 9584, require the reporting of certain deposit interest paid to nonresident alien individuals on or after January 1, 2013.[487] The regulations provide that in the case of reportable interest aggregating $10 or more paid to a nonresident alien individual (as defined in section 7701(b)(1)(B) of the Internal Revenue Code), the payor shall make an information return on Form 1042-S for the calendar year in which the interest is paid.

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[481] Treas. Reg. § 1.1461-1(b)(1); *see also Northern Indiana Pub. Serv. Co. v. Commissioner*, 101 T.C. 294 (1993) (special 6-year statute of limitations contained in I.R.C. § 6501(e)(1) applies where there is an omission of gross income paid to nonresident aliens that exceeds 25% of the amount shown on Form 1042); GCM 39,888 (April 20, 1995) (substantial understatement penalty applies to Form 1042).

[482] Treas. Reg. § 1.1461-1(c)(1).

[483] Treas. Reg. § 1.1461-1(c)(2).

[484] Treas. Reg. § 1.1461-1(c)(1)(i).

[485] I.R.C. § 1462.

[486] Treas. Reg. § 1.1441-6(a); *but see* I.R.C. § 894(c) enacted in 1997 (foreign person is entitled to reduced withholding under a treaty with a foreign country on an item of income derived through an entity that is a partnership (or is otherwise treated as transparent) for U.S. tax purposes only if such item is treated for purposes of the tax laws of such country as an item of income of such person); *see also* Treas. Reg. § 1.894-1(d)(i) ("The tax imposed by sections 871(a), 881(a), 1443, 1461, and 4948(a) on an item of income received by an entity, wherever organized, that is fiscally transparent under the laws of the United States and/or any other jurisdiction with respect to an item of income shall be eligible for reduction under the terms of an income tax treaty to which the United States is a party only if the item of income is derived by a resident of the applicable treaty jurisdiction.").

[487] Treas. Reg. § 1.6049-4(b)(5)(ii); Treas. Reg. § 1.6049-8(a).

Reportable interest is interest on deposits with banks, certain savings institutions and certain amounts held by insurance companies under agreements to pay interest thereon[488] and that (1) relates to a deposit maintained at an office within the United States, and (2) is paid to a nonresident alien individual who is a resident of a country identified, in an applicable revenue procedure as of December 31 prior to the calendar year in which the interest is paid, as a country with which the United States has in effect an income tax or other convention or bilateral agreement relating to the exchange of information pursuant to which United States agrees to provide, as well as receive, information and under which the competent authority is the Secretary of the Treasury or his delegate.[489]

The Service has issued Rev. Proc. 2012-24[490] to list the countries with which the United States has in effect an income tax or other convention or bilateral agreement relating to the exchange of information pursuant to which the United States agrees to provide, as well as receive, information and under which the competent authority is the Secretary of the Treasury or his delegate. Rev. Proc. 2012-24 states that "[a]s discussed in the preamble to the regulations, even when such an agreement exists, the Internal Revenue Service is not compelled to exchange information, including information collected pursuant to the regulations, if there is concern regarding the use of the information or other factors exist that would make exchange inappropriate." Rev. Proc. 2012-24 also identifies the countries with which the Treasury Department and the IRS have determined that it is appropriate to have an automatic exchange relationship with respect to the information collected under the regulations. Canada is the only country listed in Rev. Proc. 2012-24.

**G. Expansion of Information Reporting Requirements on Foreign Financial Institutions.**

**1. March 18, 2010: HIRE Act Adds New Chapter 4.** On March 18, 2010, the Hiring Incentives to Restore Employment Act of 2010[491] (the "HIRE Act") was enacted into law. The HIRE Act added a new Chapter 4 (new sections 1471–1474) to Subtitle A of the Internal Revenue Code. These sections expand the information reporting requirements imposed on foreign financial institutions (as defined in Section 1471(d)(4) ("FFIs") with respect to certain United States accounts (as defined in section 1471(d)(1)) ("U.S. accounts").[492] Chapter 4 requires withholding agents to withhold 30 percent of certain payments to an FFI unless the FFI has entered into an agreement with the IRS to, among other things, report certain information with respect to U.S. accounts.[493] Chapter 4 also imposes on withholding agents certain withholding, documentation, and reporting requirements with respect to certain payments made to certain other foreign entities. Chapter 4 also imposes withholding, documentation, and reporting requirements with respect to certain payments made to certain foreign entities.[494]

[488]I.R.C. § 871(a)(2)(A).

[489]Treas. Reg. § 1.6049-8.

[490]2012-20 I.R.B. 913.

[491]Pub. L. No. 111-147. 124 Stat.71.

[492]*See generally* I.R.C. Sec. 1471.

[493]I.R.C. Sec. 1471(a).

[494]See I.R.C. Sec. 1472(b).

**2. February 8, 2012: U.S. Treasury Department and IRS Publish Proposed Regulations Under Chapter 4.** On February 8, 2012, the Treasury Department and the IRS published proposed regulations under chapter 4 in the Federal Register (REG-121647-10, 77 Fed. Reg. 9022).

**3. February 8, 2012: Treasury Announces Intergovernmental Framework for FATCA Implementation.** On February 8, 2012, the U.S. Treasury Department issued a "Joint Statement from the United States, France, Germany, Italy, Spain and the United Kingdom Regarding an Intergovernmental Approach to Improving International Tax Compliance and Implementing FATCA" ("Joint Statement").[495] The Joint Statement states as follows:

> **A. General Considerations**
>
> 1. Building on their longstanding and close relationship with respect to mutual assistance in tax matters, the United States, France, Germany, Italy, Spain and the United Kingdom wish to intensify their co-operation in combating international tax evasion.
>
> 2. On 18 March 2010 the United States enacted provisions commonly referred to as the Foreign Account Tax Compliance Act (FATCA), which introduce reporting requirements for foreign financial institutions (FFIs) with respect to certain accounts. France, Germany, Italy, Spain and the United Kingdom are supportive of the underlying goals of FATCA. FATCA, however, has raised a number of issues, including that FFIs established in these countries may not be able to comply with the reporting, withholding and account closure requirements because of legal restrictions.
>
> 3. An intergovernmental approach to FATCA implementation would address these legal impediments to compliance, simplify practical implementation, and reduce FFI costs.
>
> 4. Because the policy objective of FATCA is to achieve reporting, not to collect withholding tax, the United States is open to adopting an intergovernmental approach to implement FATCA and improve international tax compliance.
>
> 5. In this regard the United States is willing to reciprocate in collecting and exchanging on an automatic basis information on accounts held in US financial institutions by residents of France, Germany, Italy, Spain and the United Kingdom. The approach under discussion, therefore, would enhance compliance and facilitate enforcement to the benefit of all parties.
>
> 6. The United States, France, Germany, Italy, Spain and the United Kingdom are cognizant of the need to keep compliance costs as low as possible

[495] *See* "Treasury Announces Intergovernmental Framework for FATCA, 2012 TNT 27-28. Since the date Treasury made this announcement, other countries have issued similar joint statements with Treasury.

for financial institutions and other stakeholders and are committed to working together over the longer term towards achieving common reporting and due diligence standards.

7. In light of these considerations, the United States, France, Germany, Italy, Spain and the United Kingdom have agreed to explore a common approach to FATCA implementation through domestic reporting and reciprocal automatic exchange and based on existing bilateral tax treaties.

**B. Possible Framework for Intergovernmental Approach**

1. The United States and a partner country (FATCA partner) would enter into an agreement pursuant to which, subject to certain terms and conditions, the FATCA partner would agree to:

> *a. Pursue the necessary implementing legislation to require FFIs in its jurisdiction to collect and report to the authorities of the FATCA partner the required information;*
>
> *b. Enable FFIs established in the FATCA partner (other than FFIs that are excepted pursuant to the agreement or in U.S. guidance) to apply the necessary diligence to identify US accounts; and*
>
> *c. Transfer to the United States, on an automatic basis, the information reported by the FFIs.*

2. In consideration of the foregoing, the United States would agree to:

> *a. Eliminate the obligation of each FFI established in the FATCA partner to enter into a separate comprehensive FFI agreement directly with the IRS, provided that each FFI is registered with the IRS or is excepted from registration pursuant to the agreement or IRS guidance;*
>
> *b. Allow FFIs established in the FATCA partner to comply with their reporting obligations under FATCA by reporting information to the FATCA partner rather than reporting it directly to the IRS;*
>
> *c. Eliminate U.S. withholding under FATCA on payments to FFIs established in the FATCA partner (i.e., by identifying all FFIs in the FATCA partner as participating FFIs or deemed-compliant FFIs, as appropriate);*

*d. Identify in the agreement specific categories of FFIs established in the FATCA partner that would be treated, consistent with IRS guidelines, as deemed compliant or presenting a low risk of tax evasion;*

*e. Commit to reciprocity with respect to collecting and reporting on an automatic basis to the authorities of the FATCA partner information on the U.S. accounts of residents of the FATCA partner.*

3. In addition, as a result of the agreement with the FATCA partner described above, FFIs established in the FATCA partner would not be required to:

*a. Terminate the account of a recalcitrant account holder;*

*b. Impose passthru payment withholding on payments to recalcitrant account holders;*

*c. Impose passthru payment withholding on payments to other FFIs organized in the FATCA treaty partner or in another jurisdiction with which the United States has a FATCA implementation agreement.*

4. The United States, France, Germany, Italy, Spain and the United Kingdom would:

*a. Commit to develop a practical and effective alternative approach to achieve the policy objectives of passthru payment withholding that minimizes burden.*

*b. Commit to working with other FATCA partners, the OECD, and where appropriate the EU, on adapting FATCA in the medium term to a common model for automatic exchange of information, including the development of reporting and due diligence standards.*

**4. May 15, 2012: IRS Holds Public Hearing on Proposed Regulations.** On May 15, 2012, the IRS held a public hearing on the proposed regulations.[496]

**5. July 26, 2012: U.S. Treasury Department Releases First Model For Bilateral Agreements with Other Jurisdictions.** On July 26, 2012, the Treasury Department released a model for bilateral agreements ("Model 1") with other jurisdictions (in both reciprocal[497] and nonreciprocal versions[498]) under which FFIs would satisfy their chapter 4

[496]*See* "Unofficial Transcript Available of IRS Hearing on FATCA," 2012 TNT 95-28.

[497]*See* "FATCA Reciprocal Model Agreement Available," 2012 TNT 145-28.

requirements by reporting information about U.S. accounts to their respective tax authorities, followed by the automatic exchange of that information on a government-to-government basis with the United States. The model agreement outlines time frames for FFIs in partner jurisdictions to complete the necessary due diligence to identify U.S. accounts.

**6. September 14, 2012: U.S./U.K. Announce Signing of Bilateral Agreement for Implementation of FATCA.** On September 14, 2012 the U.S. and U.K. announced the signing of a bilateral agreement for the implementation of FATCA.[499] The U.S./U.K is based on the Model 1 template.[500]

**7. October 24, 2012: IRS Announces Modification of Certain FATCA Timelines.** On October 24, 2012, the IRS announced (i) certain timelines for withholding agents and FFIs to complete due diligence and other requirements and (ii) certain additional guidance concerning gross proceeds withholding and the status of certain instruments as grandfathered obligations under sections 1471 through 1474 of the Internal Revenue Code (Code).[501]

**8. November 8, 2012: Treasury Announces Cooperation with Other Countries to Implement FATCA.** On November 8, 2012, the U.S. Treasury Department "announced that it is engaged with more than 50 countries and jurisdictions around the world to improve international tax compliance and implement the information reporting and withholding tax provisions commonly known as the Foreign Account Tax Compliance Act (FATCA)."[502]

**9. November 14, 2012: Treasury Releases a Second Model Intergovernmental Agreement for Implementation of FATCA.** On November 14, 2012, the Treasury Department released a second model agreement ("Model 2"), under which financial institutions in the partner jurisdiction would report specified information directly to the IRS, supplemented by government-to-government exchange of information on request.[503]

**10. November 15, 2012: U.S. and Denmark Sign FATCA Agreement.** On November 15, 2012, the U.S. and Denmark announced the execution of a bilateral agreement for the implementation of FATCA.[504] The agreement with Denmark is based on the Model 1 template.[505]

**11. November 19, 2012: U.S. and Mexico Sign FATCA Agreement.** On November 19, 2012, the U.S. and Mexico announced the execution of a bilateral agreement for

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[498]*See* "FATCA Nonreciprocal Model Agreement Available," 2012 TNT 145-29.

[499]*See* "Treasury Announces Bilateral Agreement with United Kingdom to Combat Tax Evasion," 2012 TNT 180-74; "U.K. Treasury Announces FATCA Agreement," 2012 TNT 180-75.

[500]*See* "First FATCA Intergovernmental Agreement Signed with U.K.," 2012 TNT 180-4.

[501]Ann. 2012-42, 2012 TNT 207-9.

[502]"Treasury Announces Cooperation with Other Countries to Implement FATCA," 2012 TNT 218-23.

[503]*See* "Treasury Releases FATCA Model II Agreement," 2012 TNT 222-1; Model 2 Template, "Treasury Releases Model II Agreement to Implement FATCA," 2012 TNT 222-15.

[504]*See* "Denmark-U.S. FATCA Agreement is Available," 2012 TNT 224-25.

[505]*See* "U.S., Denmark Sign FATCA Agreement," 2012 TNT 224-3.

the implementation of FATCA.[506] The agreement with Mexico is based on the Model 1 template.[507]

**12. January 28, 2013: IRS Issues Final FATCA Regulation.** On January 13, 2013, the IRS issued final regulation under Section 1471 through 1474 of the Code. [508]

# IX. SPECIAL TAX CONSIDERATIONS PERTAINING TO OWNERSHIP AND DISPOSITION OF U.S. REAL ESTATE BY FOREIGN PERSONS

## A. Background and General Pattern of Taxation.

**1. Background.** Special U.S. tax rules apply to gains of foreign persons attributable to dispositions of interests in U.S. real property. The rules governing the imposition and collection of tax on such dispositions are contained in a series of provisions that were enacted in 1980 and that are collectively referred to as the Foreign Investment in Real Property Tax Act ("FIRPTA"). Prior to the enactment of the FIRPTA provisions, foreign persons could invest in U.S. real property without being subject to U.S. tax on the eventual disposition of such property.

**2. General Pattern of Taxation.** The U.S. income tax rules which apply to income derived by a foreign person from U.S. real property are essentially the same as the normal rules which apply to income derived by a foreign person from U.S. sources. Accordingly, foreign persons owning U.S. real estate are generally subject to U.S. taxation either on a gross basis on noneffectively connected income or on a net basis if they have effectively connected income.

**B. Election to Treat All Income from U.S. Real Estate as U.S. Trade or Business Income**. A foreign person may elect to treat all income from U.S. real property interests as income which is effectively connected with the conduct of a trade or business in the U.S. (the "Code net election"). The Code and treaty provisions which contain such an election provide that the election applies to all U.S. real property and all income from such property.[509] The Code net election (and frequently the treaty net elections) applies not only to rental income but also to royalties from mines, wells and other natural deposits as well as to gains from certain sales of timber, coal or iron ore.[510] The Code net election may not be made by a foreign person in a taxable year in which such foreign person has no income from U.S. real property, or from any interest in such property, which is subject to the 30-percent withholding tax.[511] The Code net

[506]*See* "Mexico-U.S. FATCA Agreement is Available," 2012 TNT 229-43.

[507]*See* "U.S., Mexico Sign FATCA Agreement," 2012 TNT 229-4.

[508] T.D. 9610, 2013-15 IR.B. 765, *reprinted at* 2013 TNT 13-6.

[509]*See* I.R.C. §§ 871(d)(1), 882(d)(1).

[510]I.R.C. §§ 871(d)(1)(A), 882(d)(1)(A).

[511]Treas. Reg. § 1.871-10(a); *see* Rev. Rul. 91-7, 1991-1 C.B. 110 ("A nonresident alien individual or foreign corporation may not make an election under section 266 of the Code to capitalize real estate taxes, mortgage interest, and other carrying charges attributable to unimproved and unproductive U.S. real property if, during the taxable year in which such expenses are incurred, such expenses are not allowable deductions under section 873(a) or 882(c).").

election does not result in a foreign person being considered engaged in a U.S. trade or business; rather, only the income (and deductions) from the U.S. real property is treated as income which is effectively connected with the conduct of a trade or business within the United States.[512] Once made, the Code net election is irrevocable unless the IRS consents to a revocation of the election.[513]

**C. Treatment of Dispositions of U.S. Real Property Interests by Foreign Persons**. Gain or loss of a foreign person from the disposition of a U.S. real property interest is deemed to be effectively connected with the conduct of a U.S. trade or business.[514] Losses of nonresident alien individuals are taken into account under these provisions only to the extent that such losses would be taken into account under Code section 165(c), (which limits loss deductions to business losses, losses on transactions entered into for profit, and certain casualty or theft losses).[515] In the case of nonresident alien individuals, the alternative minimum tax applies to the lesser of the individual's alternative minimum taxable income or the individual's net real property gains.[516]

**1. Definition of "U.S. Real Property Interest."** The term "U.S. real property interests" ("USRPI") means (i) any interest in real property (including an interest in a mine, well, or other natural deposit) located in the U.S. or the Virgin Islands, or (ii) any interest (other than any interest solely as a creditor) in a domestic corporation, unless the taxpayer establishes that the corporation was not a U.S. real property holding corporation ("USRPHC") at any time during the shorter of (i) the period during which the taxpayer held such interest, or (ii) the five-year period ending on the date of the disposition of the interest.[517]

**a. Definition of "Real Property" and "Interest in Real Property."** The term "real property" includes land and unsevered natural products of the land, improvements and personal property associated with the use of real property.[518] The term "interest in real property" includes (i) a fee ownership, co-ownership or leasehold interest in real property;[519] (ii) options to acquire land or improvement thereon and options to acquire leaseholds;[520] (iii) partial interests in real property, such as life estates, remainders, and reversions;[521] and (iv) any direct or

[512] Treas. Reg. § 1.871-10(e)(1).

[513] I.R.C. §§ 871(d)(3), 882(d)(2); Treas. Reg. § 1-1871-10(d)(2)(iii); Treas. Reg. § 1.882-2(a).

[514] I.R.C. § 897.

[515] I.R.C. § 897(b).

[516] I.R.C. § 897(a)(2)(A).

[517] I.R.C. § 897(c)(1)(A)(ii). A special rule applies to publicly-traded USRPHC stock. USRPHC stock of a class that is regularly traded on an established securities market is treated as a U.S. real property interest only in the case of a foreign person that, at some time during the five-year prescribed testing period, held more than 5 percent of that class of stock. I.R.C. § 897(c)(3).

[518] Treas. Reg. § 1.897-1(b)(1).

[519] Treas. Reg. § 1.897-1(d)(2)(i).

[520] *See* Treas. Reg. § 1.897-1(d)(2)(i); Treas. Reg. § 1.897-1(d)(2)(ii)(B).

[521] Treas. Reg. § 1.897-1(d)(2)(i).

indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, U.S. real property.[522]

**b. Definition of U.S. Real Property Holding Corporation.** A corporation is a U.S. real property holding corporation ("USRPHC") if the fair market value of its USRPIs equals or exceeds fifty percent of the sum of the fair market values of its:

**(1)** USRPIs;

**(2)** Interests in foreign real property; and

**(3)** Any other assets which are used or held for use in a trade or business.[523]

For purposes of this asset test, a corporation that is a partner in a partnership or a beneficiary of an estate or trust generally takes into account its proportionate share of all assets of such partnership, estate or trust.[524] Look-through rules also apply to a controlling interest (50 percent or more of the fair market value of all classes of stock) held by a corporation in another corporation, whether foreign or domestic.[525]

USRPHC status is important for determining whether gain from the disposition by a foreign person of an interest in a domestic corporation is taxable. Such status is also important for purposes of the withholding requirements of Section 1445.

If a corporation qualifies as a USRPHC, then any interest in it is treated as a USRPI for a period of five years from that date, unless such corporation disposes of all of its USRPIs in taxable dispositions.[526] The fair market value of a corporation's USRPIs is presumed to be less than fifty percent of the fair market value of the assets described above if the total book value of such USRPIs is twenty-five percent or less of the book value of the aggregate of the corporation's assets.[527]

**c. Treatment of Interests in Partnerships Owning U.S. Real Property Interests.** Gain recognized by a foreign person on the disposition of an interest in a partnership, trust, or estate generally is subject to tax under Section 897 to the extent that the gain is attributable to any appreciation in the value of any U.S. real property interests of the entity.[528] Under the Treasury Regulations, an interest in a partnership in which, directly or indirectly, fifty percent or more of the value of the gross assets consist of USRPIs, and ninety percent or more of the value of the gross assets consist of USRPIs plus any cash or cash

[522]Treas. Reg. § 1.897-1(d)(2)(i).

[523]I.R.C. § 897(c)(2).

[524]I.R.C. § 897(c)(4)(B).

[525]I.R.C. § 897(c)(5).

[526]Treas. Reg. § 1.897-2(b); Treas. Reg. § 1.897-2(f).

[527]Treas. Reg. § 1.897-2(b)(2); *see* Treas. Reg. § 1.897-1(o) for methods of determining the fair market value of assets.

[528]I.R.C. § 897(g).

equivalents is treated entirely as a USRPI for purposes of the withholding provisions of Section 1445.[529] On the other hand, such interest is treated as a USRPI for purposes of determining the gain from the disposition of a USRPI only to the extent that the gain on the disposition is attributable to USRPIs.[530] Thus, the disposition of any portion of a partnership interest is subject to partial taxation under Section 897(a) and full withholding under Section 1445(a).

**2. Application of Nonrecognition Provisions.** For purposes of Section 897, nonrecognition provisions apply under Section 897 only in the case of an exchange of a U.S. real property interest for an interest the sale of which would be taxable under the Code.[531] This rule is designed to prevent a foreign person from escaping U.S. tax by exchanging a taxable asset for a nontaxable asset in an exchange which would otherwise qualify for nonrecognition treatment under the Code.[532] Moreover, gain generally is recognized by a foreign person under Section 897 on the transfer of a U.S. real property interest to a foreign corporation if the transfer is made as paid-in surplus or as contribution to capital.[533]

**3. Section 897(i) Election.** If a foreign corporation that holds a U.S. real property interest is entitled to nondiscriminatory treatment with respect to such interest under an applicable treaty, the foreign corporation may elect to be treated as a U.S. corporation for purposes of the FIRPTA provisions.[534] This election may be made only if all shareholders of the corporation consent to the election and specifically agree that any gain upon the disposition of the interest that would be taken into account under Section 897 will be taxable even if such taxation would be contrary to a treaty.[535] This election to be treated as a domestic corporation is the exclusive remedy for any person claiming treaty protection against discriminatory treatment as a result of the FIRPTA provisions. [536]

### D. Withholding on Disposition of U.S. Real Property Interests.

**1. General Withholding Requirement.** In general, a transferee, foreign or domestic, of a foreign person's USRPI is required to deduct and withhold a tax equal to 10% of the amount realized on the disposition.[537] The "amount realized" is the sum of (i) the cash paid or to be paid, (ii) the fair market value of other property transferred, or to be transferred, and (iii) the outstanding amount of any liability assumed by the transferee or to which the USRPI is subject immediately before and after the transfer.[538]

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[529]Treas. Reg. § 1.897-7T.

[530]I.R.C. § 897(g).

[531]I.R.C. § 897(e)(1).

[532]Staff of the Joint Comm. on Taxation, 104$^{th}$ Cong., 2d Sess., *Impact on International Competitiveness of Replacing the Federal Income Tax* (JCS-5-96) (1996).

[533]I.R.C. § 897(j).

[534]I.R.C. § 897(i).

[535]I.R.C. § 897(i)(3)(A).

[536]I.R.C. § 897(i)(4).

[537]I.R.C. § 1445(a).

[538]Treas. Reg. § 1.1445-1(g)(5).

2. **Reporting and Payment Requirement.** A transferee of a USRPI is required to report and send to the IRS any taxes withheld by the 20th day after the date of transfer.[539] If (i) an application for a Withholding Certificate was sent to the IRS on or before the date of transfer by the transferor or transferee, and (ii) the principal purpose of filing the application for Withholding Certificate was not for the purpose of delaying payment to the IRS, then the transferee must still withhold tax but need not remit withheld taxes to the IRS until the 20th day after the IRS' final determination regarding the application for withholding certificate.[540]

3. **Liability of Transferee.** A transferee may be held personally liable for the failure to comply with the withholding provisions.[541] If a transferee is required to deduct and withhold tax under section 1445 but fails to do so, and the transferor's tax liability with respect to the transfer was satisfied (or was established to be zero) by (1) the transferor's filing of an income tax return (and payment of any tax due) with respect to the transfer, or (2) the issuance of a withholding certificate by the Internal Revenue Service establishing that the transferor's maximum tax liability is zero, then the regulations provide that the tax required to be withheld under section 1445 will not be collected from the transferee.[542] The regulations provide, however, that the transferee will be held liable for interest (for the period prescribed in the regulations).[543]

**E. Exemptions and Special Rules.**

1. **Purchase of Residence for $300,000 or Less.** If a transferee is acquiring a residence for use as a residence, and the amount realized by the transferor is $300,000 or less, then no withholding is required.[544]

2. **Notice of Nonrecognition.** No withholding is required if the transferor provides notice to the transferee that a nonrecognition provision exempts the gain or loss on the transfer. The notice must be given to the IRS by the 20th day after the date of transfer.[545]

3. **Stock Regularly Traded on Established Securities Market.** No withholding is required if the disposition is of a share of a class of stock that is regularly traded on an established securities market.[546]

4. **Non-USRPHC Affidavit.** No withholding is required if the transferor provides to the transferee a statement that the interest is not a USRPI.[547]

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[539] Treas. Reg. § 1.1445-1(c)(1).

[540] Treas. Reg. § 1.1445-1(c)(2)(i)(B).

[541] I.R.C. §§ 1461, 6672; Treas. Reg. § 1.1445-1(e).

[542] Treas. Reg. § 1.1445-1(e)(3)(ii).

[543] Treas. Reg. § 1.1445-1(e)(3)(iii).

[544] I.R.C. § 1445(b)(5).

[545] Treas. Reg. § 1.1445-2(d).

[546] I.R.C. § 1445(b)(6).

[547] I.R.C. §§ 1445(b)(3), 1445(b)(7).

**5. Nonforeign Affidavit.** No withholding is required if the transferor provides to the transferee an affidavit stating, under penalties of perjury, the transferor's U.S. taxpayer identification number and that the transferor is not a foreign person.[548]

On August 5, 2003, the Service issued new Treas. Reg. § 1.1445-2(b)(2)(iii), which provides that a disregarded entity may not certify that it is the transferor of a U.S. real property interest as the disregarded entity is not the transferor for U.S. tax purposes. Rather, the owner of the disregarded entity is treated as the transferor and must provide a certificate of non-foreign status to avoid withholding under Section 1445. Any domestic entity must include in its certification of non-foreign status with respect to the transfer of U.S. real estate a certification that it is not a disregarded entity.

**6. Options, Installment Sales and Foreclosures**. Special rules are provided in the Regulations for options,[549] installment sales[550] and foreclosures.[551]

**7. Withholding Certificates.** Withholding under Section 1445(a) may be reduced or eliminated pursuant to a withholding certificate issued by the Service in accordance with the rules of Treas. Reg. § 1.1445-3(a).

**F. Withholding Rules for Corporations, Partnerships, Trusts or Estates**. The U.S. generally requires domestic partnerships, domestic trusts, and domestic estates to withhold an amount equal to 35% (or to the extent provided in regulations 15%) of the gain realized from sales of U.S. real property interests that are allocable to foreign persons.[552] A 35% withholding tax is imposed on certain distributions by foreign corporations.[553] A 10% withholding tax is imposed on distributions by certain domestic corporations to foreign shareholders.[554]

**G. Service Issues Final Regulations Requiring Foreign Transferors to Provide Taxpayer Identification Numbers**. On August 5, 2003, the Internal Revenue Service issued final regulations that require foreign transferors of U.S. real property interests (and transferees where applicable) to provide their taxpayer identifying numbers (TINs) on withholding tax returns, applications for withholding certificates, and other notices and elections under sections 897 and 1445 and the regulations thereunder.[555] This requirement is effective for dispositions occurring after November 3, 2003.[556]

[548]I.R.C. §§ 1445(b)(2), 1445(b)(7).

[549]*See* Treas. Reg. § 1445-1(b)(3).

[550]*See* Treas. Reg. § 1.1445-2(d)(4); Rev. Proc. 2000-35, 2002-2 C.B. 211.

[551]*See* Treas. Reg. § 1.1445-2(d)(3).

[552]I.R.C. § 1445(e)(1).

[553]I.R.C. § 1445(e)(2).

[554]I.R.C. § 1445(e)(3).

[555]T.D. 90822003-2 C.B. 807; *see, e.g.*, Treas. Reg. § 1.1445-1(c)(1).

[556]*Ibid.*

# X. SELECTED U.S. PAYROLL TAX ISSUES RELATING TO NONRESIDENT ALIENS

## A. FICA.

**1. General Statutory Authority for FICA Tax Liability.** A tax is imposed on both employers[557] and employees[558] under the Federal Insurance Contributions Act ("FICA") for social security (old-age, survivors and disability insurance - "OASDI") and hospital insurance purposes. The FICA tax rate and maximum wage base subject to tax for 2013 are as follows:

| Tax Rate | Maximum Earnings Base | Maximum Tax on Employee | Maximum Tax on Employer |
|---|---|---|---|
| For 2013, employee OASDI rate is 6.2%; employer OASDI rate is 6.2%[559] | $113,700[560] | $7,049.40 | $7,049.40 |
| 1.45%(HI) | No limit | No limit | No limit |

For tax years beginning after December 31, 2012, the Code imposes on every taxpayer (other than a corporation, estate or trust) a tax equal to .9% of wages which are in excess of (1) in the case of a joint return, $250,000; (2) in the case of a married taxpayer filing a separate return, ½ of the dollar amount determined under (1); and (3) in any other case, $200,000.[561]

The term "wages" with certain enumerated exceptions, generally means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.[562] The term "employment" generally includes any service, of whatever

[557] *See* I.R.C. § 3111.

[558] *See* I.R.C. § 3101.

[559] I.R.C. § 3101(a); P.L. 111-312, §§ 601(a)(2), 601(c) (as amended by P.L. 112-96, § 1001(a)).

[560] IRS Notice 1036 (Rev. Jan. 2013); IRS Publication 15 (Jan. 10, 2013).

[561] I.R.C. § 3101(b)(2).

[562] I.R.C. § 3121(a).

nature, by an employee for his employer, irrespective of the citizenship or residence of either, within the United States.[563]

**2. Imposition of FICA Taxes on Wages Paid by U.S. and Foreign Persons.**

**a. Wages Paid by U.S. Person/Employer.** FICA taxes must generally be withheld on wages paid by a U.S. person/employer to a nonresident alien employee for work performed within the U.S. In addition, the employer is generally subject to FICA taxes for the wages paid.[564]

**b. Wages Paid by Foreign Person/Employer.** FICA taxes must generally be withheld on wages paid by a foreign person/employer to a nonresident alien employee for work performed within the U.S. In addition, the foreign person/employer is generally subject to FICA taxes for the wages paid.[565]

**3. Exception to Liability for Persons in Certain Visa Categories**. Exceptions to the general liability rules apply to persons in the U.S. under certain visa categories, including A (employees of foreign governments)[566], F (student)[567], G (certain employees of international organizations)[568], J (exchange visitors)[569], M (nonacademic students)[570] and Q (international cultural exchange visitors)[571] visas. Notably, services performed by a nonresident alien individual who is temporarily present in the U.S. under F, J, M or Q visa status are exempted from the FICA requirement if the services are performed to carry out the purpose for which the individual was admitted to the U.S.[572]

**4. Impact of Totalization Agreements.** A nonresident alien's liability for FICA taxes may be modified by an applicable totalization agreement between the U.S. and the country in which the individual is a resident.

**B. FUTA.**

**1. General Statutory Authority for FUTA Tax Liability**. A tax is also imposed on employers under the Federal Unemployment Tax Act.[573] The tax rate is equal to 6.2-percent (through 2010 and the first 6 months of calendar year 2011; changing to 6.0 percent in

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[563]I.R.C. § 3121(b).

[564]Rev. Rul. 92-106, 1992-2 C.B. 258, 260.

[565]*Ibid.*

[566]I.R.C. § 3121(b)(11).

[567]I.R.C. § 3121(b)(19).

[568]I.R.C. § 3121(b)(15).

[569]I.R.C. § 3121(b)(19).

[570]I.R.C. § 3121(b)(19).

[571]I.R.C. § 3121(b)(19).

[572]I.R.C. § 3121(b)(19); *see* Treas. Reg. § 31.3121(b)(19)-1(a)(1).

[573]I.R.C. § 3301.

the case of the remainder of calendar year 2011 and each calendar year thereafter[574]) of the taxable wages paid by the employer during the calendar year.[575] The FUTA tax applies to the first $7,000 in wages paid to each employee annually.[576] An employer generally may deduct FUTA taxes and the employer's share of FICA taxes as an ordinary and necessary business expense (assuming the payment of such taxes meets the ordinary and necessary business expense tests).[577]

"Wages," with certain exceptions, is all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.[578] "Employment" includes any service, of whatever nature, performed by an employee for his employer, irrespective of the citizenship or residence of either, within the U.S.[579]

**2. Imposition of FICA Taxes on Wages Paid by U.S. and Foreign Persons.**

**a. Wages Paid by U.S. Person/Employer.** A U.S. person/employer must generally pay FUTA taxes on wages paid to a nonresident alien employee for work performed within the U.S.[580]

**b. Wages Paid by Foreign Person/Employer.** A foreign person/employer must generally pay FUTA taxes on wages paid to a nonresident alien employee for work performed within the U.S[581]

**3. Exceptions to Liability for Persons in Certain Visa Categories**. Exceptions to the general liability rules apply to persons in the U.S. under certain visa categories. Notably, services performed by a nonresident alien individual who is temporarily present in the U.S. under F, J, M or Q visa status are exempted from the FUTA requirement if the services are performed to carry out the purpose for which the individual was admitted to the U.S.[582]

**C. Self-Employment Tax.** Self-employment income derived by a nonresident alien individual is not subject to the self-employment tax (SECA).[583]

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[574]I.R.C. § 3301(2) (as amended by P.L. 111-92, § 10(a).

[575]I.R.C. § 3301.

[576]*See* I.R.C. § 3306(b).

[577]*See* I.R.C. § 162(a); *Eastman Kodak Co. v. U.S.*, 534 F.2d 252 (Ct. Cl. 1976); Rev. Rul. 96-51, 1996-2 C.B. 36, *modified by* Rev. Rul. 2007-12, 2007-1 C.B. 685; Rev. Rul. 86-14, 1986-1 CB 304.

[578]I.R.C. § 3306(b).

[579]I.R.C. § 3306(c).

[580]Rev. Rul. 92-106, 1992-2 C.B. at 260.

[581]*Ibid.*

[582]I.R.C. § 3306(c)(19).

[583]I.R.C. § 1402(b); Treas. Reg. § 1.1402(b)-1(d).

## XI. TAX TREATIES

**A. Functions of Tax Treaties.** In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. Tax treaties generally have three main functions:

**1.** Avoiding the double taxation of income, property or property transfers, by allocating or limiting the right of the source or the residence country to tax income or property;

**2.** Avoiding discriminatory tax treatment of residents of the Contracting States; and

**3.** Permitting reciprocal administrative assistance in the prevention of tax avoidance and tax evasion.

**B. Persons Covered.** The persons generally covered by a tax treaty are the residents or entities of the treaty countries.

**C. Issues Covered.** Income tax treaties often cover the following issues:

**1.** The trade or business of a nonresident is not taxable unless such trade or business is conducted through or effectively connected with a permanent establishment.

**2.** Passive income is generally taxed at a reduced rate or, in certain cases, such income may be totally exempt.

**3.** Income derived from the performance of personal services is generally more favorably treated. For instance, certain treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that country unless their contacts exceed certain specified minimums (for example, presence for a set number of days or earnings of over a certain amount).[584]

**4.** The branch tax rate may be reduced or eliminated altogether.

**5.** Double taxation is avoided through the allowance of foreign tax credits, foreign country exemptions or reduced rates of tax, and competent authority provisions.

**D. Other Matters Often Covered in Income Tax Treaties**. Other matters often covered in an income tax treaty include:

[584]Staff of Joint Comm. on Taxation, 103rd Cong., 1st Sess., *Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States and Mexico*, at 37 [hereinafter "Joint Committee Treaty Report"].

**1.** Eliminating double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to primary taxing jurisdiction as a resident by each of the two countries.[585]

**2.** Providing for exemption of income from shipping and air transport operations.

**3.** Addressing the tax treatment of visiting artists and athletes.

**4.** Providing special source rules.

**5.** Providing that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that which it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against enterprises owned by residents of the other country.[586]

**6.** Providing for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. [587]

**7.** Prohibiting treaty shopping by limiting treaty benefits to bonafide residents of the two countries.[588]

**E. Disclosure Requirement.** Taxpayers who take the position that a U.S. treaty overrides or otherwise modifies an Internal Revenue law and thereby effects a tax reduction are required to disclose the position on statements attached to their returns.[589] This requirement applies to positions based upon any U.S. treaty, including an income tax treaty, an estate and gift tax treaty, and a friendship, commerce and navigation treaty.[590] Taxpayers who are not otherwise required to file a U.S. tax return must, nevertheless, file a return to make the required disclosure under Section 6114.[591] If reporting is required under Section 6114, Treasury Regulation Section 301.6114-1(d) lists the information required to be provided as an attachment to the return. The IRS has developed Form 8833 for use by taxpayers to make the treaty-based return position disclosure required by Section 6114.[592] A taxpayer who fails in a material way to disclose one or more treaty-based return positions as required by Section 6114, is subject to a separate penalty for each failure in the amount of $1,000 ($10,000 in the case of a C

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[585] *Joint Committee Treaty Report* at 36-37.

[586] *Joint Committee Treaty Report* at 38.

[587] *Joint Committee Treaty Report* at 37.

[588] *Joint Committee Treaty Report* at 38.

[589] I.R.C. § 6114.

[590] Treas. Reg. § 301.6114-1(a)(1)(i).

[591] Treas. Reg. § 301.6114-1(a)(ii).

[592] Ann. 93-63, 1993-16 I.R.B. 11.

corporation).[593] The penalty may be waived by the I.R.S. if the taxpayer's failure to disclose was not due to willful neglect.[594]

### F. Relationship of Treaties to Internal U.S. Law.

**1. How are Treaties Adopted?** In the U.S., the procedure involved in adopting a treaty is different from that involved in passing a Federal statute. Treaties must be negotiated between the Executive branch and a foreign government, consented to by two-thirds vote of the Senate, and ratified by the President.[595] Federal statutes, on the other hand, must be passed by both Houses of Congress and signed by the President, or passed over the President's veto by two-thirds vote of both Houses.[596]

**2. U.S. Constitution.** Article 6, clause 2 of the U.S. Constitution provides that the "Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land . . . . "

**3. Provisions of Internal Revenue Code Affecting Interrelationship between Treaties and Internal U.S. Law**. Under Section 894(a) of the Code, the provisions of the Code are required to be applied to any taxpayer with "due regard" to any treaty obligation of the U.S. which applies to the taxpayer. Section 7852(d)(1) of the Code provides that, for purposes of determining the relationship between a provision of a treaty and any tax law of the U.S., "neither the treaty nor the law shall have preferential status by reason of its being a treaty or law." Congress added the quoted language to 7582(d) in 1988 to clarify that Section 7852(d) does not prevent application of the general rule providing that the later in time of a statute or treaty controls.[597]

### G. Authority of the Commissioner to Recharacterize Transactions Involving Treaty Shopping.

**1. I.R.C. § 7701(l).** On August 10, 1993, Congress enacted section 7701(l) of the Internal Revenue Code (the "Code"), which authorizes Treasury to "prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where [Treasury] determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title." Pursuant to this authority, Treasury issued final regulations, effective September 11, 1995, permitting "the district director to disregard, for purposes of sections 871, 881, 1441 and 1442, the participation of one or more persons in a conduit financing arrangement."[598]

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[593] I.R.C. § 6712; Treas. Reg. § 301.6712-1(a).

[594] I.R.C. § 6712; Treas. Reg. § 301.6712-1(b).

[595] U.S. Const., art. 2, § 2(2).

[596] U.S. Const., art. 1, § 7(2); Staff of the Joint Comm. on Taxation, 101st Cong., 2d Sess., *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90) (1990).

[597] Staff of the Joint Comm. On Taxation, 100th Cong., 2d Sess., *Description of the Technical Corrections Act of 1988 (H.R. 4333 and S. 2238) (JCS-10-88) (1988).*

[598] T.D. 8611, 1995-37 I.R.B. 20, 21, *corrected by* 1995-2 C.B. 286 and *corrected by* 1998 W.L. 840741.

The final regulations under Section 7701(l) provide rules that permit the IRS district director to disregard the participation of one or more intermediate entities in a financing arrangement where such entities are acting as conduit entities.[599] Although the regulations were issued under Section 881, "any reference to tax imposed under section 881 includes, except as otherwise provided and as the context may require, a reference to tax imposed under section 871 or 884(f)(1)(A) or required to be withheld under section 1441 or 1442."[600]

Under the regulations, "financing arrangement" generally means a series of transactions by which:

**a.** One person (the "financing entity") advances money or other property, or grants rights to use property;

**b.** Another person (the "financed entity) receives money or other property, or rights to use property;

**c.** The advance and receipt are effected through one or more other persons (the "intermediate entities"); and

**d.** There are financing transactions (e.g., debt)[601] linking the financing entity, each of the intermediate entities, and the financed entity.[602]

If the IRS disregards a conduit entity in a financing arrangement, the financing arrangement is recharacterized as a transaction directly between the remaining parties to the financing arrangement (in most cases, the financed entity and the financing entity).[603]

An intermediate entity will be a conduit entity only if:

The participation of the intermediate entity in the financing arrangement reduces the U.S. withholding tax that otherwise would have been imposed;[604] and

**e.** The participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan; and

**f.** Either:

**(1)** The intermediate entity is related to the financing entity or the financed entity; or

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[599]Treas. Reg. § 1.881-3(a)(1).

[600]Treas. Reg. § 1.881-3(a)(1).

[601]Treas. Reg. § 1.881-3(a)(2)(ii).

[602]Treas. Reg. § 1.881-3(a)(2)(i)(A).

[603]Treas. Reg. § 1.881-3(a)(3)(ii)(A).

[604]*See* Treas. Reg. § 1.881-3(e), Examples 9 & 10 (no conduit entity if no reduction in U.S. withholding tax).

**(2)** The intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity.[605]

**2. Judicial Doctrines.** The IRS may also attack a treaty structure using judicially-developed doctrines. The courts have stated that the incidence of taxation depends upon the substance of a transaction as a whole.[606] In certain treaty-related cases, the courts have recharacterized transactions in order to impose tax consistent with this principle. For example, where three parties have engaged in a chain of transactions, the courts have at times ignored the "middle" party as a mere "conduit," and imposed tax as if a single transaction had been carried out between the parties at the ends of the chain.[607]

In *Aiken Industries, Inc. v. Commissioner*,[608] the Tax Court recharacterized an interest payment by a U.S. person on its note held by a related treaty-country resident, which in turn had a precisely matching obligation to a related non-treaty country resident, as a payment directly by the U.S. person to the non-treaty country resident. The transaction in its recharacterized form resulted in a loss of the treaty protection that would otherwise have applied on the payment of interest by the U.S. person to the treaty-country resident, and thus caused the interest payment to give rise to 30-percent U.S. tax.

In *Northern Indiana Public Service Company v. Commissioner*,[609] the Seventh Circuit Court of Appeals "glean[ed]" the following from *Aiken Industries* and similar cases: "Transactions involving a foreign corporation are to be disregarded for lack of meaningful economic activity if the corporation is merely transitory, engaging in absolutely no business activity for profit -- in other words, it is a 'mere skeleton' . . . Transactions will also be disregarded if the foreign corporation lacks dominion and control over the interest payments it collects."

**3. Limitation of Benefits Provisions in Income Tax Treaties**. The benefits available under an applicable income tax treaty may be limited by a Limitation on Benefits provision in the treaty itself. "The United States views an income tax treaty as a vehicle for providing treaty benefits to residents of the two Contracting States. This statement begs the question of who is to be treated as a resident of a Contracting State for the purpose of being granted treaty benefits . . . The United States holds strongly to the view that tax treaties should include provisions that specifically prevent misuse of treaties by residents of third countries. Consequently, all recent U.S. income tax treaties contain comprehensive Limitation on Benefits provisions."[610]

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[605]Treas. Reg. § 1.881-3(a)(4)(i).

[606]*See, e.g., Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

[607]*See, e.g.*, *Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925, *acq. on another issue*, 1972-2 C.B. 1; *see also* H.R. Conf. Rep. No. 213, 103rd Cong., 1st Sess., 655 (1993), 1993-3 C.B. 657.

[608]56 T.C. 925 (1971), *acq. on another issue*, 1972-2 C.B. 1.

[609]115 F.3d 506 (7th Cir. 1997), *aff'g* 105 T.C. 341 (1995).

[610]U.S. Treas. Dep't, "Technical Explanation of the United States Model Income Tax Convention of September 20, 1996," at p. 88.

A Limitation of Benefits provision "assures that source basis tax benefits granted by a Contracting State pursuant to the Convention are limited to the intended beneficiaries -- residents of the other Contracting State who have a substantial presence in, or business nexus with, that State. Absent this Article, if a resident of a third State were to organize a corporation in a contracting State for the purpose of deriving treaty-benefited income from the other Contracting State, the entity would generally be entitled to benefits as a resident of a Contracting State, subject to any limitations imposed by the domestic law of the source State (e.g., business purpose, substance-over-form, step transaction or conduit principles)."[611]

[611]U.S. Treas. Dep't, Technical Explanation of the Convention and Protocol Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Signed at Washington on September 18, 1992, 1994-2 C.B. 489.

## XII. U.S. ESTATE AND GIFT TAX CONSIDERATIONS FOR NONRESIDENT ALIENS

**A. General Rule Applicable to Nonresident Aliens for Purposes of U.S. Federal Estate and Gift Taxation**. For U.S. federal estate and gift tax purposes, nonresident aliens are subject to U.S. federal estate and gift tax on their "property situated in the U.S."[612]

**B. Residency for U.S. Estate and Gift Tax Purposes.** The residency test for federal estate and gift tax purposes is different than the residency test for federal income tax purposes. For U.S. estate and gift tax purposes, a U.S. resident is an individual who was domiciled in the U.S. at the time of his death or gift, whichever is applicable.[613] A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of moving. Residence without the requisite present intention to remain indefinitely will not sufficiently constitute a domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.[614] An individual may be a "resident" for income tax purposes but not for estate and gift tax purposes. Also, U.S. estate tax treaties may affect the determination of whether an alien is domiciled in the U.S. for U.S. estate tax purposes.

**C. Overview of U.S. Estate Tax Rules Applicable to Nonresident Aliens.**

**1. Determining the Gross Estate.** For U.S. estate tax purposes, the gross estate of a nonresident alien consists of all U.S. situs property in which the alien decedent had an interest at the time of his death.[615]

**a. Property Situated in the U.S.** Property situated in the U.S. includes (but is not limited to) the following:

**(1)** U.S. real estate;[616]

**(2)** Tangible personal property located in the U.S.;[617]

**(3)** Stock in a U.S. corporation;[618] and

**(4)** Certain debt obligations of a U.S. person.[619]

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[612] I.R.C. §§ 2101(a), 2103, 2501(a)(1), 2511.

[613] Treas. Reg. § 20.0-1(b)(1); Treas. Reg. § 25.2501-1(b).

[614] Treas. Reg. § 20.0-1(b)(1); Treas. Reg. § 25.2501-1(b)..

[615] I.R.C. § 2103.

[616] Treas. Reg. § 20.2104-1(a)(1).

[617] Treas. Reg. § 20.2104-1(a)(2).

[618] I.R.C. § 2104(a); Treas. Reg. § 20.2104-1(a)(5).

[619] I.R.C. § 2104(c).

The treatment of a partnership interest in a U.S. partnership is unclear. Existing authority suggests that an interest in a U.S. partnership carrying on business in the U.S. with U.S.-situs assets should be includable in the gross estate of a nonresident alien.[620]

**b. Property Not Situated in the U.S.** Property that is not situated in the U.S. includes (but is not limited to) the following:

**(1)** Foreign real estate;[621]

**(2)** Tangible personal property located outside the U.S.;[622]

**(3)** Proceeds of life insurance on the life of a nonresident alien;[623]

**(4)** Deposits, including certificates of deposit, in U.S. banks and U.S. savings institutions unless the interest earned on such deposits is effectively connected with the conduct of a U.S. trade or business in the U.S., or unless the nonresident alien is considered a U.S. resident for income tax purposes;[624]

**(5)** Stock issued by a foreign corporation;[625]

**(6)** A debt instrument issued by a U.S. person if the interest generated by such instrument constitutes "portfolio interest" (except for certain contingent portfolio interest);[626] and

**(7)** Short-term original issue debt obligations, if any interest thereon (were such interest received by the decedent at the time of his death) would not be effectively connected with the conduct of a U.S. trade or business.[627]

**2. Estate Tax Rates.** The estate tax rates applicable to U.S. citizens and residents are also applicable to taxable estates of nonresident aliens.[628]

**3. Estate Tax Credit.** A nonresident alien's estate is allowed a unified credit of $13,000.[629]

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[620]*See* Rev. Rul. 55-701, 1955-2 C.B. 836; *see generally* 2 RUFUS RHOADES & MARSHALL J. LANGER, U.S. INTERNATIONAL TAXATION AND TAX TREATIES, §33.02[2][a][vi] (2010) (analyzing whether partnership interest is includable in the U.S. gross estate); Martin, "Why Section 2104 Must Address When Partnership Interests Owned by Foreign Investors Are (And Are Not) Subject to United States Estate Tax," 2003 TNT 94-127 (May 13, 2003).

[621]Treas. Reg. § 20.2105-1(a)(1).

[622]Treas. Reg. § 20.2105-1(a)(2).

[623]I.R.C. § 2105(a).

[624]I.R.C. §§ 2105(b), 871(i)(3).

[625]Treas. Reg. § 20.2105-1(f).

[626]I.R.C. § 2105(b)(3).

[627]I.R.C. § 2105(b)(4).

[628]I.R.C. § 2101.

**D. Overview of U.S. Gift Tax Rules Applicable to Nonresident Aliens.** A U.S. imposes a tax on taxable gifts by any individual, resident or nonresident, but in the case of nonresident aliens, the statute applies only to taxable gifts of property situated in the U.S.[630] An exception applies for certain transfers of intangible property.[631]

**E. U.S. Estate and Gift Tax Treaties.** There are also a number of estate and gift tax treaties that reduce or eliminate the otherwise applicable U.S. estate or gift tax. These treaties provide uniform rules on residency, location of property, and exemptions from home country tax with respect to certain types of property.

[629] I.R.C. § 2102(c)(1).

[630] I.R.C. § 2501(a)(1); *see* I.R.C. § 2511.

[631] *See* I.R.C. 2501(a)(2).

## XIII. THIN CAPITALIZATION ISSUES

**A. Advances Between Related Companies Are Closely Scrutinized.** Advances between a parent corporation and a subsidiary or other affiliate are closely scrutinized by the Service and the courts "because the control element suggests the opportunity to contrive a fictional debt."[632] Although the existence of a bona fide debt is not precluded merely because the debtor and creditor are related parties,[633] the courts recognize that the form of "the transaction and the labels parties place on the transaction may not have as much significance when the corporation is closely held because the parties can mold the transaction at their will."[634]

**B. Judicial Analysis of Debt-Equity Cases.** No single uniform approach has been adopted by the courts in analyzing whether particular advances constitute debt or equity, and the results of each case usually depend upon the individual facts and circumstances involved.[635] The courts have enumerated several factors to be considered in resolving a debt-equity issue. The courts decide how much weight to give to each of these factors based on the facts and circumstances of each case.[636] The identified factors are neither equally significant nor is any single factor determinative or relevant in each case.[637] The Tax Court has stated that the determinative question, to which an evaluation of the various independent factors should ultimately point, is whether there was a "genuine intention to create a debt, with a reasonable expectation of repayment, and . . . [whether] that intention comport[s] with the economic reality of creating a debtor-creditor relationship."[638]

The U.S. Court of Appeals for the Fifth Circuit has identified 13 nonexclusive factors to be considered in deciding whether advances are debt or equity.[639] Those factors are:

**1.** The name given to the certificate evidencing the advance. The name given to the certificates evidencing the advances suggests whether advances are debt or equity.[640]

**2.** The presence or absence of a fixed maturity date. The presence of a fixed maturity date can indicate that an advance is debt.[641] The absence of a fixed maturity date

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[632]*See Matter of Uneco, Inc. v. United States*, 532 F.2d 1204, 1207 (8th Cir. 1976) (quoting *Cayuna Realty Co. v. United States*, 382 F.2d 298, 300-01 (Ct. Cl. 1967)); *P.M. Fin. Corp. v. Commissioner*, 302 F.2d 786, 789 (3d Cir. 1962); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); *Calumet Indus. Inc. v. Commissioner*, 95 T.C. 257, 286 (1990); *Malone & Hyde, Inc. v. Commissioner*, 49 T.C. 575, 578 (1968).

[633]*Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956), *rev'g*, 21 T.C. 513 (1954), *acqu.*, 1968-2 C.B.1.

[634]*Calumet Indus. Inc. v. Commissioner*, 95 T.C. 257, 286 (1990).

[635]*Litton Business Systems v. Commissioner*, 61 T.C. 367, 376 (1973), *acqu.* 1974-2 C.B.1.

[636]*Estate of Mixon v. United States,* 464 F.2d 394 (5th Cir. 1972); *see John Kelley Co. v. Commissioner*, 326 U.S. 521, 530 (1946).

[637]*Estate of Mixon v. United States,* 464 F.2d at 402 (5th Cir. 1972); *Calumet*, 95 T.C. at 285.

[638]*Nestle Holdings, Inc. v. Commissioner*, 70 T.C.M. (CCH) 682, 700 (1995), (*quoting Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367, 377 (1973)), *vacated and remanded on another issue,* 152 F.3d 83 (2d Cir. 1998).

[639]*Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972). The Ninth Circuit has identified eleven factors. *See Hardman v. U.S.*, 827 F.2d 1409, 1412 (9th Cir. 1987); *Bauer v. Comm'r*, 748 F.2d 1365 (9th Cir. 1984); *cf*. F.S.A. 199922012 (June 4, 1999).

[640]*Estate of Mixon v. United States*, 464 F.2d at 402-403.

[641]*Id.* at 404.

indicates that "repayment was in some way tied to the fortunes of the business, indicative of an equity advance."[642] The right to enforce maturity dates may be meaningless, however, if the parties do not expect the recipient to repay.[643] Postponing maturity dates for prolonged periods suggests that the nominal lender does not intend to require repayment and that the transfers are equity.[644] A reasonable expectation of repayment by the provider of an advance when the advance is made suggests that the advance is debt.[645]

**3.** The source of repayments of advances (i.e., whether the recipient of the funds can repay the advance with reasonably anticipated cash-flow or liquid assets). An advance is more likely to be equity if the recipient does not have liquid assets or reasonably anticipated cash-flow from which to repay.[646]

**4.** Whether the provider of the funds has the right to enforce payment of principal and interest. A definite obligation to repay an advance suggests that the advance is a loan.[647]

**5.** Whether the provider of the advance gains an increased right to participate in management. If, as a result of an advance of funds, the provider of the funds has an increased right to participate in the management of the recipient, then it is acting more like a shareholder than a creditor.[648]

**6.** The status of the contribution in relation to regular creditors. Whether an advance is equal or subordinate to the claims of regular corporate creditors affects whether the taxpayer was dealing as a shareholder or creditor.[649] Failure to demand timely repayment effectively subordinates intercompany debt to the rights of other creditors who receive payment in the interim.[650]

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[642] *Estate of Mixon*, 464 F.2d at 404.

[643] *Foresun, Inc. v. Commissioner*, 41 T.C. 706, 717 (1964), *aff'd in part, modified in part and remanded* 348 F.2d 1006, 1009 (6th Cir. 1965); *see Slappey Drive Indus. Park v. United States*, 561 F.2d 572, 583 n.18 (5th Cir. 1977); *Harlan v. United States*, 409 F.2d 904, 907 n.4 (5th Cir. 1969).

[644] *Slappey Drive Indus. Park v. United States,* 561 F.2d at 583; *Harlan v. United States,* 409 F.2d at 909; *Foresun, Inc. v. Commissioner,* 41 T.C. at 706, *aff'd as to this issue*, 348 F.2d at 1009.

[645] *Gilbert v. Commissioner*, 248 F.2d 399, 406 (2d Cir. 1957), *remanding* 15 T.C.M. (CCH) 688 (694); *C.M. Gooch Lumber Sales Co. v. Commissioner,* 49 T.C. 649, 656 (1968); *Nestle Holdings, Inc. v. Commissioner*, 70 T.C.M. (CCH) 682 (1995), *vacated and remanded on another issue,* 152 F.3d 83 (1998).

[646] *Estate of Mixon v. United States,* 464 F.2d at 405; *Segel v. Commissioner*, 89 T.C. 816, 830-831 (1987); *Laidlaw Transportation, Inc. v. Commissioner*, 75 T.C.M. (CCH) 2598, 2622 (1998).

[647] *Estate of Mixon v. United States*, 464 F.2d at 405; *see Campbell v. Carter Found. Prod. Co.*, 322 F.2d 827, 832 (5th Cir. 1963).

[648] *Estate of Mixon v. United States,* 464 F.2d at 406; *American Offshore, Inc. v. Commissioner*, 97 T.C. 579, 603 (1991).

[649] *Estate of Mixon v. United States,* 464 F.2d at 406; *American Offshore, Inc. v. Commissioner*, 97 T.C. at 603.

[650] *American Offshore, Inc.*, 97 T.C. at 603; *Inductotherm Indus., Inc. v. Commissioner*, 48 T.C.M. (CCH) 167 (1984), *aff'd without published opinion* 770 F.2d 1071 (3rd Cir. 1985).

**7.** Intent of the parties. The intent of the parties is important in deciding whether payments are debt or equity.[651] More weight, however, is given to objective facts than to stated intent.[652]

**8.** Whether the recipient of the advance is adequately capitalized Courts generally consider a borrower's debt-to-equity ratio and other financial data in deciding if it is thinly capitalized. Inadequate capitalization strongly suggests that an advance is equity if: (a) the debt to equity ratio was initially high, (b) the parties realized that it would likely go higher, and (c) the recipient of the funds used a substantial part of the funds to buy capital assets and to meet expenses needed to begin operations.[653]

**9.** Identity of interest between the creditor and the shareholder. If advances by shareholder are proportionate to their stock ownership, the advances are more likely to be equity.[654] On the other hand, a sharply disproportionate ratio between a stockholder's percentage stock holdings and debt is strongly indicative that the debt is bona fide.[655]

**10.** Source of interest payments (i.e., whether the recipient of the funds pays interest from earnings). Payment of interest by the recipient of an advance suggests that a transfer is debt.[656] The failure to insist on interest payments indicates that the payors are not expecting substantial interest income, but are more interested in the future earnings of the corporation or the increased market value of their interest.[657]

**11.** The ability of the corporation to obtain loans from outside lending institutions. If a corporation can borrow money from outside sources when it receives a transfer of funds, the transfer is more likely to be debt.[658]

**12.** The extent to which the recipient used the advance to buy capital assets. A corporation's use of cash advances to acquire capital assets suggests that an advance is equity.[659] Use of an advance by an ongoing business to expand its operations, for example, by acquiring an existing business, suggests that the advance is equity.[660]

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[651] *Estate of Mixon v. United States*, 464 F.2d at 407.

[652] *In re Lane*, 742 F.2d 1311 (11th Cir. 1984); *Estate of Mixon v. United States*, 464 F.2d at 397.

[653] *Estate of Mixon v. United States*, 464 F.2d at 408; *Tyler v. Tomlinson*, 414 F.2d 844, 848 (5th Cir. 1969); *United States v. Henderson*, 375 F.2d 36, 40 (5th Cir. 1967); *American Offshore, Inc. v. Commissioner*, 97 T.C. 579, 604 (1991).

[654] *Slappey Drive Indus.* Park, 561 F.2d at 583; *Estate of Mixon v. United States,* 464 F.2d at 409; *Tyler v. Tomlinson*, 414 F.2d at 850; *Tomlinson v. 1661 Corp.*, 377 F.2d 291, 297 (5th Cir. 1967); *American Offshore, Inc. v. Commissioner*, 97 T.C. at 604; *Leach Corp. v. Commissioner*, 30 T.C. 563, 579 (1958), *acq*. 1959-2 C.B. 3.

[655] *American Offshore, Inc. v. Commissioner*, 97 T.C. at 604.

[656] *Estate of Mixon v. United States,* 464 F.2d at 409; *American Offshore, Inc. v. Commissioner*, 97 T.C. 605.

[657] *American Offshore Inc. v. Commissioner*, 97 T.C. at 605.

[658] *Estate of Mixon v. United States,* 464 F.2d at 410; *Tomlinson v. 1661 Corp.,* 377 F.2d at 299; *American Offshore, Inc. v. Commissioner*, 97 T.C. at 605.

[659] *Slappey Drive Indus. Park v. United States*, 561 F.2d at 583; *Estate of Mixon v. United States*, 464 F.2d at 410.

[660] *Plantation Patterns, Inc. v. United States*, 462 F.2d 712, 722 (5th Cir. 1972); *Tyler v. Tomlinson,* 414 F.2d at 848-849.

**13.** Whether the recipient repaid the funds on the due date. The failure of a corporation to repay principal amounts on the due date indicates that advances were equity.[661]

**C. Laidlaw Transportation, Inc. v. Commissioner**. In *Laidlaw Transportation, Inc. v. Commissioner*, 75 T.C.M. (CCH) 2598 (1998), Laidlaw Transportation, Ltd., a Canadian corporation, owned all of the stock of Laidlaw Transportation Inc ("LTI").[662] LTI and its U.S. subsidiaries received nearly a billion dollars from 1984 to 1988 from a related Dutch corporation ("LIIBV").[663] During the same period, LTI transferred $133 million in interest payments to LIIBV.[664] The Commissioner challenged the substance of the advances to LTI arguing that the advances constituted equity.[665] The Tax Court determined that the advances were equity and disallowed an interest deduction.[666] The Tax Court determined that the transactions at issue were not at arm's length as evidenced by the existence of a common chair, directors, officers and core management team, and the fact that there were related entities with interlocking directorates.[667]

Factors weighing in favor of debt included: (1) characterization of the advances as debt.[668] Factors weighing in favor of equity included (1) the Dutch lender did not intend to enforce the loan maturity dates;[669] (2) the taxpayers' liquid assets and reasonably anticipated cash flow were insufficient to pay the interest or the principal balance on the loans from LIIBV;[670] (3) although LIIBV had a right to enforce payment of principal and interest, LIIBV and the taxpayers' did not enforce any of the loan agreements;[671] (4) LIIBV's postponement of repayments from the taxpayers effectively subordinated the purported debt to LIIBV and this effective subordination made the obligations to repay LIIBV inferior to the claims of the taxpayers' regular corporate creditors;[672] (5) LIIBV and the taxpayers did not intend the advances to be treated as loans because LIIBV made large advances, extended the terms for payment, did not seek security in the written agreements, and represented to Canadian tax officials that the loans are "in the nature of capital contributions;"[673] (6) the taxpayers' were

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[661]*Estate of Mixon v. United States,* 464 F.2d at 410*; see Slappey Drive Indus. Park v. United States,* 561 F.2d at 582; s*ee also Texas Farm Bureau v. United States*, 725 F.2d 307, 311 (5th Cir. 1984); *Plantation Patterns Inc. v. Commissioner*, 462 F.2d 712, 718-719 (5th Cir. 1972), *aff'g.* 29 T.C. M. (CCH) 817 (1970); *Tyler v. Tomlinson*, 414 F.2d at 848-850; *Berkowitz v. United States*, 411 F.2d 818, 821 (5th Cir. 1969); *American Offshore, Inc. v. Commissioner*, 97 T.C. 606; *Laidlaw Transportation Inc. v. Commissioner*, 75 T.C.M. (CCH) 2598. 2623; *Nestle Holdings, Inc. v. Commissioner*, 70 T.C.M. at 700; *Lansall Company v. United States*, 512 F.Supp. 1178, 1180 (S.D.N.Y. 1981).

[662]*Laidlaw Transportation, Inc. v. Commissioner,* 75 T.C.M. (CCH) at 2599-2600.

[663]*Id.* at 2598.

[664]*Ibid.*

[665]*Id* at 2599.

[666]*Id*. at 2624.

[667]*Id*. at 2616.

[668]*Id.* at 2617.

[669]*Id.* at 2617-2618.

[670]*Id*. at 2618.

[671]*Id.* at 2619.

[672]*Laidlaw Transportation, Inc. v. Commissioner,* 75 T.C.M. (CCH) at 2619-2620.

[673]*Id*. at 2620.

thinly capitalized;[674] (7) the taxpayers postponed interest payments, used debt to finance interest payments, and continued to increase their indebtedness;[675] (8) the taxpayers could not have borrowed nearly a billion dollars on the same terms as those made by LIIBV;[676] (9) the taxpayers used most of the advances from LIIBV to expand their operations, especially by acquiring other companies, and told the Canadian tax authorities that advances through LIIBV were capital investments which formed a part of the subsidiaries' permanent capital;[677] (10) LIIBV repeatedly deferred and extended the vast majority of principal payments;[678] (11) LIIBV's directors did not expect to be repaid or intend to request repayment.[679]

Factors that were neutral were (1) the documents evidencing the advances did not give LIIBV any right to participate in the management of the borrowers or the guarantors, but this would have been unnecessary because LTL and its core management team already controlled LIIBV;[680] (2) the fact that LIIBV did not directly own any stock in the taxpayers;[681] (3) the fact that LIIBV transferred cash to the taxpayers in exchange for debt;[682] and (4) the taxpayers had not stated right to convert the creditor's loans to stock.[683]

The Court determined that the factors that relate to the form of the transaction support treating the LIIBV advances to the taxpayers as debt. The factors relating to substance support treating the LIIBV advances as equity. The Court stated that the substance of the transactions is revealed in the lack of arm's length dealing between LIIBV and the taxpayers, the circular flow of funds, and the conduct of the parties by changing the terms of the agreements when needed to avoid deadlines.[684]

In holding for the Commissioner, the Tax Court noted that the advances were structured in a manner that ultimately created a "double deduction" to the Canadian parent on a global basis.[685] The Canadian parent borrowed funds from an independent lender and transferred these funds, as capital contributions, to a wholly-owned Netherlands subsidiary. The Netherlands subsidiary in turn loaned those funds, with stated interest, to U.S. sister companies that were also wholly-owned by the Canadian parent. Under this structure, the Canadian parent deducted interest on its loan with the outside lender, and the U.S. subsidiaries deducted interest on its borrowings from the Netherlands subsidiary.[686]

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[674] *Id*. at 2620-2621.

[675] *Id.* at 2622.

[676] *Id*. at 2623.

[677] *Ibid.*

[678] *Ibid.*

[679] *Id*. at 2624.

[680] *Id*. at 2619.

[681] *Id*. at 2621-2622.

[682] *Id*. at 2624.

[683] *Ibid.*

[684] *Ibid.*

[685] *Id*. at 2602.

[686] *Ibid.*

**D. Nestle Holdings, Inc. v. Commissioner**. In *Nestle Holdings, Inc. v. Commissioner*, 70 T.C.M. (CCH) 682 (1995), aff'd 152 F.3d 83 (2d Cir. 1998), Nestle Holdings, Inc. ("Nestle") was a first-tier subsidiary of Nestle S.A. ("NSA"), a publicly-held corporation headquartered in Switzerland.[687] The dispute arose from a tender offer by Nestle for the stock of Carnation Company.[688] Nestle's initial plan was to finance its acquisition of Carnation with a capital contribution of $ 525 million from NSA and a $2.5 billion loan from outside sources.[689] Ultimately, this plan was revised, and the acquisition was financed in 1985 by commercial loans of $1.6 billion and related-party loans of $1.325 billion.[690] NSA provided some of these related-party loans but made no capital contributions to Nestle. The tender offer succeeded and, in January 1985, Carnation became a consolidated subsidiary of Nestle.[691] After the acquisition, Nestle made requisite interest and principal payments to the related parties and deducted the interest payments as expenses on its tax returns.[692]

The Service disallowed the interest deduction claimed by Nestle contending that NSA intended to make a capital contribution to Nestle but characterized its investment as debt so as to obtain tax benefits.[693] The Tax Court rejected the Service's arguments and held that the advances constituted debt.[694]

The Tax Court found that NSA and Nestle had a genuine intention that the advances create a debt obligation. The revised financing structure that did not include a capital contribution was the result of additional time for planning and was supported by valid business reasons. The Court also found substantial objective evidence of an intent to create a debtor-creditor relationship and evidence negating a capital contribution intent. Because of the anticipated fall of the dollar against the Swiss franc and the hedging policy of NSA, NSA had business reasons for not making an equity investment in Nestle.[695]

The Court also found that Nestle anticipated that the combined Nestle-Carnation entities would have a high level of cash and investments on hand that could be used to pay down debt; that divestiture of assets would be used to pay debt; and also the cash flow from the combined entities would be adequate for debt service. The advances in this case contained interest and payment provisions, and timely principal and interest payments were made. Moreover, the advances were made as part of an acquisition of a complete, existing enterprise that had valuable assets and an established market position.[696]

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[687] *Id*. at 685.
[688] *Id*. at 688.
[689] *Id*. at 689.
[690] *Id*. at 689-690.
[691] *Id*. at 688.
[692] *Id*. at 693-94.
[693] *Id*. at 700.
[694] *Id*. at 705.
[695] *Id*. at 701.
[696] *Ibid.*

The Court also determined that Nestle, as a separate entity, could have obtained the full amount from some combination of private lenders and commercial banking sources. The Court held that the terms of the related-party advances cannot be characterized as a patent distortion of what would normally have been available to a taxpayer as independent-debt financing.[697]

The Court also relied heavily on Nestle making a net reduction of related party debt beginning in 1985 in addition to making timely interest payment.[698] The Court also found that there was no evidence that the Nestle's debt/equity or leverage ratios were out of line with other companies.

### E. Plantation Patterns Doctrine.

**1. What is the Plantation Patterns Doctrine?** The *Plantation Patterns* doctrine is a judicially-developed doctrine that treats a guarantor as the true obligor for U.S. federal income tax purposes.[699] Thus, in cases where a subsidiary's debt is guaranteed by a parent corporation, the U.S. Internal Revenue Service may (in an examination) review the loan arrangement to determine whether the loan of the third-party creditor represents, in substance, a primary debt obligation of the parent corporation guarantor instead of a primary debt obligation of the subsidiary. In such a case, the loan to the debtor is deemed under the *Plantation Patterns* doctrine to be a loan made directly to the guarantor that is, in turn, contributed by the guarantor as equity to the nominal debtor. Payments by the subsidiary corporation on the guaranteed obligation are treated for federal income tax purposes as dividends to the guarantor/parent, and the guarantor/parent in turn is treated as having made the interest payments on its obligation to the creditor.[700]

**2. When Do The Courts Generally Apply the Plantation Patterns Doctrine?** The *Plantation Patterns* doctrine arose from a case in which a newly-formed corporation with nominal capitalization ("Newco") purchased all the stock of another corporation ("Oldco"). Newco paid for the Oldco stock by making a small down payment and issuing promissory notes for the balance. The notes were guaranteed by Newco's individual shareholder. The guarantees were necessary because of the low down payment and because the debt had to be unsecured to enable the new corporation to obtain financing for its operations.

In reviewing the notes issued by Newco, the Revenue Service concluded that the notes were in substance indirect capital contributions by the shareholder to the corporation. The Revenue Service disallowed interest deductions claimed by the thinly-capitalized Newco corporation and treated interest payments as nondeductible dividends to the shareholder. In upholding the Revenue Service's determination, the U.S. Tax Court and the Court of Appeals relied heavily on two salient facts: (1) that the corporation which issued the notes was thinly capitalized; and (2) that the notes had more equity characteristics than debt.

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[697] *Id*. at 702-703.

[698] *Id*. at 704.

[699] *See Plantation Patterns, Inc. v. Commissioner*, 29 T.C.M. 817 (CCH) (1970), *aff'd*, 462 F.2d 712 (5th Cir. 1972).

[700] *See, e.g., Plantation Patterns, Inc.*, 462 F.2d at 716.

U.S. courts have continued to apply the reasoning of *Plantation Patterns* in appropriate circumstances. Application of the doctrine is most often a concern where the nominal debtor is thinly capitalized and cannot obtain outside financing without a guarantee.[701]

[701] *See In re Lane v. United States,* 742 F.2d 1311 (11th Cir. 1984) (funds guaranteed by primary shareholder held debt to guarantor, followed by guarantor's capital contributions to three "S" corporations where corporations were thinly capitalized and continually operated at a loss); *Stoneking v. Commissioner,* 50 T.C.M. (CCH) 1305 (1985) (guaranteed debt held capital contribution by guarantor to closely-held, thinly-capitalized corporation that could not obtain outside financing); Rev. Rul. 79-4, 1979-1 C.B. 150 (loan to corporation considered loan to individual sole-shareholder guarantor, followed by guarantor's capital contribution to corporation where corporation inadequately capitalized); *cf.* 1997 F.S.A. LEXIS 149 (June 20, 1997) ("The facts before us are clearly distinguishable from the facts before the court in Plantation Patterns. Here, the facts clearly indicate that . . . was not thinly capitalized."); 1995 F.S.A. LEXIS 142 (June 5, 1995) ("In determining that the guaranteed debt was, in substance, debt of the shareholder, the Plantation Patterns court focused on the financial health of the purported debtor corporation, believing that New Plantation was not adequately capitalized.").

## XIV. LIMITATION ON EARNINGS STRIPPING.

### A. Background.

1. **Section 163(j) Enacted in 1989**. Section 163(j) was added to the Internal Revenue Code in 1989[702] to prevent erosion of the U.S. tax base by means of excessive deductions for interest paid by a taxable corporation to a tax exempt (or partially tax-exempt) related person.[703] (The payment of excessive deductible interest that is tax exempt (or partially tax exempt) in the hands of a related person is referred to as "earnings stripping."[704]) Section 163(j), as originally enacted, addresses the use of earnings stripping for interest paid by a U.S. corporation (with a debt-equity ratio of in excess of 1.5 to 1) to a foreign related party, by limiting the amount of deductible interest in a year to no more than 50 percent of an adjusted taxable income amount.[705]

2. **Issuance of Proposed Regulations in 1991**. In 1991, Treasury issued proposed regulations under Section 163(j).[706] The regulations have never been finalized.

3. **Amendment to Section 163(j) in 1993**. In 1993, Congress amended Section 163(j) by adding an additional limitation on the deductibility of interest on certain loans from unrelated lenders.[707] Under the 1993 Amendment, interest paid on a loan from an unrelated party generally is treated under the earnings stripping rules in the same manner as interest paid to a related person with respect to which no U.S. tax is imposed if no gross-basis U.S. income tax is imposed on the interest (whether or not the interest recipient is subject to net-basis U.S. income tax with respect to that interest), a related person guaranteed the loan, and the related person is either exempt from U.S. Federal income tax or is a foreign person.[708] Exceptions apply where the taxpayer controls the guarantor, and in cases, identified by regulation, where the interest on the indebtedness would have been subject to net basis tax if the interest had been paid to the guarantor.[709]

4. **Amendment to Section 163(j) in 2000**. In 2000, Congress amended Section 163(j) by adding a provision providing that interest paid by a taxable REIT subsidiary to the related REIT is subject to the earnings stripping rules of Section 163(j).[710] Thus, the taxable REIT subsidiary cannot deduct interest in any year that would exceed 50% of the subsidiary's adjusted gross income.[711] This amendment is effective for taxable years beginning after December 31, 2000. This amendment is not addressed in this outline.

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[702] The Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, 103 Stat. 2106,

[703] H.R. Rep. No. 247, 101st Cong., 1st Sess. 1240-1250 (1989), *reprinted in* 1989 U.S.C.C.A.N. 2710-2720.

[704] Congressional Committee Reports; Notice of Proposed Rulemaking INTL-0870-89 (June 12, 1991).

[705] H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 63-71 (1989), *reprinted in* 1989 U.S.C.C.A.N. 3018.

[706] Notice of Proposed Rulemaking INTL-0870-89 (June 12, 1991).

[707] H.R. Conf. Rep. No. 213, 103rd Cong., 1st Sess. 631 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1320.

[708] I.R.C. § 163(j)(3)(B), 163(j)(6)(D)(i); H.R. Conf. Rep. No. 213, *supra* at n. 475.

[709] I.R.C. § 163(j)(6)(D)(ii); H.R. Conf. Rep. No. 213, *supra* at n. 475.

[710] I.R.C. § 163(j)(3)(C); S. Rep. No. 201, 106th Cong., 1st Sess. (1999).

[711] I.R.C. § 163(j)(3)(C); *see* S. Rep. No. 201, 106th Cong., 1st Sess., 59-60, H.R. Conf. Rep. No. 478 at 178.

**B. General Operation of Section 163(j).** Section 163(j) will apply to a U.S. corporation for a tax year only if three elements are present: (1) the debt-to-equity ratio of the company at the close of the year exceeds 1.5 to 1;[712] (2) the company pays or accrues "disqualified interest" during the tax year;[713] and (3) the total "net interest expense" of the company exceeds 50% of its "adjusted taxable income" plus any "excess interest limitation carryforward" to such year.[714]

**1. Debt-to-Equity Ratio Exceeds 1.5 to 1**. Section 163(j) applies only if the company's debt-to-equity ratio at the close of the tax year exceeds 1.5 to 1.[715] Under Section 163(j), a company's debt-to-equity ratio is the ratio of total debt of the company to the equity of the company.[716]

**a. Definition of Total Debt.** The proposed regulations define the debt of a corporation generally as its liabilities determined according to generally applicable tax principles.[717] "Short-term liabilities," however, are excluded from characterization as debt.[718]

**b. Definition of Equity.** Equity is the sum of money plus the adjusted tax basis of other assets less total debt (but not below zero).[719] The proposed regulations provide that the amount of a taxpayer's equity is reduced (but not below zero) by the amount of short-term liabilities excluded from characterization as debt.[720]

**2. Company Pays or Accrues "Disqualified Interest" During Tax Year**. Section 163(j) applies only if the U.S. company pays or accrues disqualified interest during the tax year.

**a. Definition of "Disqualified Interest."** "Disqualified interest" is defined as:

**(1)** Any interest paid or accrued by the taxpayer (directly or indirectly) to a related person if no U.S. tax is imposed with respect to such interest;[721] and

**(2)** Any interest paid or accrued by the taxpayer with respect to any indebtedness to a person who is not a related person (for example, a U.S. bank) if:

**(a)** There is a guarantee of such indebtedness by a foreign related person,[722] and

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712 I.R.C. § 163(j)(2)(A)(ii).

713 I.R.C. § 163(j)(1)(A).

714 I.R.C. §§ 163(j)(2)(A)(i), 163(j)(2)(B)(i).

715 I.R.C. § 163(j)(2)(A)(ii); *cf.* Prop. Reg. § 1.163(j)-1(b).

716 I.R.C. § 163(j)(2)(C); *cf.* Prop. Reg. § 1.163(j)-3(a).

717 Prop. Reg. § 1.163(j)-3(b)(1).

718 Prop. Reg. § 1.163(j)-3(b)(2).

719 I.R.C. § 163(j)(2)(C); *Cf.* Prop. Reg. § 1.163(j)-3(c)(1).

720 Prop. Reg. § 1.163(j)-3(c)(3).

721 I.R.C. § 163(j)(3)(A).

**(b)** No gross basis U.S. tax (i.e., a withholding tax) is imposed with respect to such interest.[723]

In the case of a guarantee by a foreign related person of a U.S. corporate indebtedness to a U.S. bank, any interest paid or accrued with respect to such indebtedness would be disqualified interest because no U.S. withholding tax is imposed on interest payments to the U.S. bank. (The bank is subject to tax on a net basis with respect to interest payments received.)[724]

**b. Definition of "Related Person."** Generally, for purposes of Section 163(j), a recipient is treated as related to the payor of the interest if the recipient and payor would be treated as related under the rules of Section 267(b) or subject to the controlled partnership rules of Section 707(b)(1).[725] Special rules apply to interest paid to partnerships.[726]

**3. "Net Interest Expense" of Company Exceeds 50% of "Adjusted Taxable Income" Plus "Excess Interest Limitation Carryforward."** Section 163(j) applies to a U.S. company only if the net interest expense of the company exceeds (such excess hereinafter referred to as "excess interest expense") the sum of (i) 50% of its adjusted taxable income, and (ii) any "excess interest limitation carryforward."[727]

**a. Definition of "Net Interest Expense."** The net interest expense of the company is the excess of interest paid or accrued by the company for the tax year, over interest income of the company for the tax year.[728]

**b. Definition of Adjusted Taxable Income.** Generally, "adjusted taxable income" is taxable income computed without regard to any deduction for net interest expense, net operating losses, or any deductions allowable for depreciation, amortization, or depletion.[729]

**c. Excess Interest Limitation Carryforward.** The excess interest limitation carryforward is generated in any year in which 50% of the company's adjusted taxable income exceeds its net interest expense.[730] In such a case, the company is treated as having excess limitation for that year and that excess limitation may be carried forward for three years.[731] The amount of carryforwards taken into account for a year succeeding the excess

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[722]I.R.C. § 163(j)(3)(B)(i).

[723]I.R.C. § 163(j)(4)(B)(ii).

[724]*See* H.R. Rep. No. 111, 103rd Cong., 1st Sess. 680-687 (1993), *reprinted in* 1993 U.S.C.C.A.N. 911-918.

[725]I.R.C. § 163(j)(4)(A).

[726]I.R.C. § 163(j)(4)(B)(i).

[727]I.R.C. §§ 163(j)(2)(A)(i), 163(j)(2)(B)(i).

[728]I.R.C. § 163(j)(6)(B).

[729]I.R.C. § 163(j)(6)(A).

[730]I.R.C. § 163(j)(2)(B)(iii)(I).

[731]I.R.C. § 163(j)(2)(B)(ii);*Cf.* Prop. Reg. § 1.163(j)-2(c).

limitation year, however, cannot exceed the excess interest expense for that succeeding year (determined without regard to carryforwards from taxable years that had excess limitation).[732]

**d. All Members of "Affiliated Group" Are Treated as One Taxpayer.** For purposes of applying Section 163(j), all members of the same affiliated group are treated as one taxpayer.[733] Section 163(j) does not address how the statute should be applied in an affiliated group context; however, the IRS has issued proposed regulations with respect to the application of Section 163(j) to members of an affiliated group.[734] Prop. Reg. Section 1.63(j)-5(b) addresses the application of the rules of Section 163(j) to consolidated groups. Prop. Reg. Section 1.163(j)-5(c) provides comparable rules applicable to other affiliated groups.[735]

**4. If Section 163(j) Applies to a Corporation, What Are the Consequences?** If all of the elements of Section 163(j) are met and Section 163(j) applies, the amount disallowed will be the lesser of the corporation's "excess interest expense" or its "disqualified interest" expense.[736] Disallowed interest expense may be carried forward and can be deducted in future years to the extent of "excess limitation" in the carryover year.[737] As a result, Section 163(j) does not necessarily cause a permanent loss of the deduction for disallowed interest expense. Rather, it defers the deduction to a later time when the taxpayer has sufficient taxable income to allow the disallowed interest to be deducted.

## C. Examples.

**1. Example 1**. Assume that for 1990 a corporation has $150 of adjusted taxable income and $60 of net interest expense. Assume that for 1991 the corporation has $100 of adjusted taxable income and again $60 of net interest expense. Assume that for 1992 the corporation again has $100 of adjusted taxable income and $60 of net interest expense.

**a. Consequences in 1990.** The corporation is not subject to disallowance of interest deductions for 1990 under Section 163(j). Moreover, it has excess limitation for 1990 of $15 (i.e., 50% of adjusted taxable income (50% of $150 = $75), over net interest expense ($60).[738]

**b. Consequences in 1991.** For 1991, the sum of 50% of adjusted taxable income ($50), plus the excess limitation carryforward from 1990 that may be taken into account for 1991, equals $60 (i.e., $50 (representing 50% of adjusted taxable income) plus $10 (only $10 of excess limitation carryforward is utilized because net interest expense is $60)).

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[732] I.R.C. § 163(j)(2)(B)(ii).

[733] I.R.C. § 163(j)(6)(C).

[734] *See* Prop. Reg. § 1.163(j)-5.

[735] Notice of Proposed Rulemaking, Reg-2090S9-89 [originally issued as INTL-0870-89] published June 13, 1991 (CCH 49,161).

[736] I.R.C. § 163(j)(1)(A).

[737] I.R.C. § 163(j)(1)(B); Prop. Reg. §§ 1.163(j)-1(a)(3), 1.163(j)-1(c)(1).

[738] H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. (1989).

Therefore, the corporation is not subject to disallowance of interest deductions for 1991 under Section 163(j).[739]

c. **Consequences in 1992.** For 1992, the sum of 50% of adjusted taxable income, plus the excess limitation carryforward from 1990 that may be taken into account for 1992, equals $55 (*i.e.*, $50 (representing 50% of adjusted taxable income) plus $5 ($5 remaining excess limitation carryforward is utilized)). Therefore, the corporation may be subject to disallowance of up to $5 of interest deductions for 1992 under Section 163(j), assuming that it has paid or incurred disqualified interest for 1992 and assuming that its debt-to-equity ratio for that year exceeds 1.5 to 1.[740]

2. **Example 2**. Under Section 163(j)(5)(B), if a treaty between the U.S. and any foreign country reduces the rate of U.S. tax imposed on interest that the taxpayer pays to a related person, the person is treated as tax exempt (and the interest is treated as disqualified interest) to the extent of the same proportion of such interest paid or accrued as the treaty's rate reduction (from the 30% rate) bears to the 30% rate.[741] For example, a U.S. corporation is a subsidiary of a Japanese parent corporation. Under the U.S./Japan Treaty, interest payments are generally subject to a 10% withholding tax (in lieu of the general 30% rate). The U.S. corporation, which has no interest income, has $50 of adjusted taxable income. It pays $90 of interest expense, all of which is paid to its Japanese parent. That $90 interest payment, which is subject to a $9 withholding tax, is subject to tax at one-third the normal rate (i.e., the ratio of 10% to 30%). That is, two thirds ($60) of the $90 interest payment is tax exempt. Therefore, two-thirds ($60) of the $90 interest payment is treated as disqualified interest, while one-third ($30) of the $90 is not disqualified interest. Deductions for disqualified interest are disallowed to the extent that net interest expense exceeds (i) 50% of adjusted taxable income, plus (2) any excess limitation carryforward (assume $0 in this case). The net interest expense of $90 exceeds 50% of adjusted taxable income ($25) by $65. Inasmuch as $60 of disqualified interest is less than the $65 excess, only $60 is disallowed. A current deduction is allowed for the remaining $30 of related party interest.[742]

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739 H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. (1989).

740 H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. (1989).

741 I.R.C. § 163(j)(5)(B).

742 H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. (1989).

## XV. SECTION 267(A)(3)

Section 267(a)(3) and the regulations thereunder require a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to a related foreign person.[743] An amount is treated as paid if the amount is considered paid for purposes of sections 1441 and 1442. An amount that is owed to a related foreign person and that is otherwise deductible thus may not be deducted by the taxpayer until such amount is paid to the related foreign person.[744]

[743] Treas. Reg. § 1.267(a)-3(b)(1).

[744] Treas. Reg. § 1.267(a)-3(b)(1).

## XVI. ANTI-DEFERRAL MECHANISMS APPLICABLE TO U.S. INVESTORS IN FOREIGN CORPORATIONS

### A. Controlled Foreign Corporations.

**1. Statutory Pattern of Taxation.** Each U.S. shareholder of a controlled foreign corporation ("CFC") is generally required to include in income for U.S. federal income tax purposes his pro rata share of certain categories of income of the CFC, even though undistributed.[745] Such inclusions of undistributed CFC earnings are generally triggered by two different provisions of the CFC rules. Under one such provision, the U.S. shareholder is required to include his pro rata share of the CFC's "Subpart F income" earned during the year.[746] The second provision requires a U.S. shareholder to include his pro rata share of the CFC's earnings that are invested in certain U.S. property for the year.[747] If one of these provisions is triggered, the income is includable for the U.S. shareholder's tax year within which the tax year of the CFC ends.[748]

**2. Classification as a Controlled Foreign Corporation.** A foreign corporation is a "controlled foreign corporation" if more than 50% of (a) the total combined voting power of all classes of voting stock, or (b) the total value of the stock of the corporation, is owned by U.S. shareholders on any day during the tax year.[749] A "U.S. shareholder" for this purposes is a U.S. person who owns 10% or more of the total combined voting power of all classes of voting stock of the corporation.[750] In determining whether a foreign corporation is a CFC and whether a U.S. person is a U.S. shareholder, certain complex ownership attribution rules apply.[751]

**3. Subpart F Income.**

**a. "Subpart F Income" Includes Five Categories of Income.** The Subpart F income of a CFC is the sum of the following categories of income:[752]

**(1)** Insurance income;

**(2)** Foreign base company income which includes:

**(a)** Foreign personal holding company income;

**(b)** Foreign base company sales income;

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[745] I.R.C. § 951(a).

[746] I.R.C. § 951(a)(1)(A)(i).

[747] I.R.C. § 951(a)(1)(B).

[748] I.R.C. § 951(a)(1).

[749] I.R.C. § 957(a); *see also* Treas. Reg. § 1.957-1(b)(1) ("combined voting power" defined); Treas. Reg. § 1.957-1(b)(2) ("Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained.").

[750] I.R.C.§ 951(b); *see also* Treas. Reg. § 1.951-1(b)(2) ("combined voting power" defined).

[751] I.R.C. §§ 958(a), 958(b).

[752] I.R.C. § 952(a).

**(c)** Foreign base company services income; and

**(d)** Foreign base company oil related income;

**(3)** International boycott-related income;

**(4)** The sum of any illegal payments paid by the CFC to an official of a foreign government; and

**(5)** Income derived from (i) countries whose governments support terrorism; (ii) countries that do not have diplomatic relations with the U.S.; and (iii) countries that are not recognized by the U.S.[753]

**b. Income Excludable from Subpart F income.** Subpart F income does not include any United States-sourced income which is effectively connected with the conduct of a trade or business by the CFC within the U.S. unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the U.S. [754]

**c. Subpart F Income Limited to Current Earnings and Profits of a CFC.** The Subpart F income of a CFC is generally limited to the current earnings and profits of the CFC for the year.[755]

**d. Description of "Foreign Base Company Income."** "Foreign base company income" generally means the sum of the following categories of income of the CFC: (1) the foreign personal holding company income; (2) the foreign base company sales income; (3) the foreign base company services income; and (4) the foreign base company oil related income.[756]

**(1) Exclusions and Special Rules Applicable in Computing Foreign Base Company Income.** Certain exclusions and special rules apply in computing foreign base company income, including the following:

**(a) De Minimis Rule.** No part of the gross income of a CFC is foreign base company income if the sum of the gross foreign base company income and the gross insurance income for the taxable year is less than the lesser of: (i) 5 percent of gross income of the CFC, or (ii) $1,000,000.[757]

**(b) Full Inclusion Rule.** If the sum of the foreign base company income and the gross insurance income for the tax year exceeds 70 percent of gross income, the entire gross income for the tax year (with certain exceptions for income subject to high foreign taxes) is treated as foreign base company income or insurance income (whichever is

[753] I.R.C. § 952(a)(5); I.R.C. § 901(j).

[754] I.R.C. § 952(b).

[755] I.R.C. § 952(c)(1)(A).

[756] I.R.C. § 954(a) (as amended by the American Jobs Creation Act of 2004).

[757] I.R.C. § 954(b)(3)(A).

appropriate). If a CFC's entire gross income is treated as foreign base company income under this rule, deductions may, nevertheless, be taken into account as discussed below.[758]

**(c) Exception for Income Subject to High Foreign Taxes.** Foreign base company income and insurance income do not include any item of income received by a CFC if the income was subject to an effective rate of income tax imposed by a foreign country of greater than 90 percent of the maximum U.S. corporate income tax rate. This exception, however, does not apply to foreign based oil-related income.[759]

**(d) Deductions to be Taken into Account.** Each component part of foreign base company income is reduced so as to take into account deductions (including taxes) properly allocable to such income.[760] U.S. federal income taxes, however, are not deductible from gross foreign base company income.[761]

**(2) Foreign Personal Holding Company Income.** "Foreign personal holding company income" ("FPHCI") generally means the portion of a CFC's gross income which consists of dividends, interest, royalties, rents, annuities, and net gains from the sale or exchange of property giving rise to such passive income.[762] FPHCI, however, does not include rents and royalties which are derived in the active conduct of a trade or business and which are received from an unrelated person.[763]

**(3) Foreign Base Company Sales Income.** "Foreign base company sales income" means income (whether in the form of profits, commissions, fees or otherwise) derived in connection with a transaction which has three elements: (a) the related-party element; (b) the manufacturing element; and (c) the use element.

**(a) The Related-Party Element.** A transaction has a related-party element if it is described as follows:

**i)** The purchase of personal property from a related person and its sale to any person;

**ii)** The sale of personal property to any person on behalf of a related person;

**iii)** The purchase of personal property from any person and its sale to a related person;

**iv)** The purchase of personal property from any person on behalf of a related person.

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[758]I.R.C. § 954(b)(3)(B).

[759]I.R.C. § 954(b)(4).

[760]I.R.C.§ 954(b)(5).

[761]I.R.C. § 275(a)(1).

[762]I.R.C. § 954(c)(1).

[763]I.R.C. § 954(c)(2)(A).

**(b) The Manufacturing Element.** A transaction has a manufacturing element if the property which is purchased by the CFC (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured or produced outside the country of incorporation of the CFC.[764]

**(c) The Use Element.** In general, a transaction has a use element if the property is sold for use, consumption, or disposition outside the country of incorporation of the CFC, or, in the case of property purchased on behalf of a related person, the property is purchased for use, consumption, or disposition outside the country of incorporation of the CFC.[765]

**(4) Certain Branch Income.** If a CFC manufactures goods in its country of incorporation, but sells the goods from a branch office in another foreign country, the income attributable to the branch may be treated as income derived by a wholly-owned subsidiary of the CFC and will constitute foreign base company sales income of the CFC.[766] If a CFC manufactures goods at a branch outside of its company of incorporation and the goods are sold from a sales office in its country of incorporation, the branch may be treated as a separate corporation for purposes of determining foreign base company sales income.[767]

**e. Foreign Base Company Services Income.**

**(1) General Definition.** "Foreign base company services income" means income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which meet two elements: (a) the related-party element; and (b) the foreign country element.

**(a) Related-Party Element.** The related-party element is met if the services are performed for or on behalf of any related person.[768]

**(b) Foreign Country Element.** The foreign country element is met if the services are performed outside the country of incorporation of the CFC.[769]

**(2) Certain Income Not Included.** Foreign base company services income does not include income derived in connection with the performance of the following:

**(a)** Services relating to the sale or exchange of property manufactured or produced which are performed before the time of the sale or exchange; or

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[764] I.R.C. § 954(d)(1)(A).

[765] I.R.C. § 954(d)(1)(B).

[766] I.R.C. § 954(d)(2).

[767] Treas. Reg. § 1.954-3(b)(1)(ii).

[768] I.R.C. § 954(e)(1)(A).

[769] I.R.C. § 954(e)(1)(B).

**(b)** Services relating to the offer or effort to sell or exchange property manufactured or produced.[770]

**f. Foreign Base Company Oil-Related Income.**

**(1) Items Included Within "Foreign Base Company Oil-Related Income."** The term "foreign base company oil-related income" generally means the taxable income derived from sources outside the United States and its possessions from the following:

**(a)** The processing of minerals extracted from oil or gas wells into their primary product;

**(b)** The transportation of such minerals or primary products;

**(c)** The distribution or sale of such minerals or primary products;

**(d)** The disposition of assets used by the taxpayer in the trade or business described in paragraphs (a), (b), or (c);

**(e)** The performance of any other related service; and

**(f)** Certain amounts received or deemed to be received from certain foreign corporation and partnerships, to the extent such amounts are attributable to income described in paragraphs (a), (b), (c), (d) and (e).[771]

**(2) Income Excluded from Foreign Base Company Oil-Related Income.** Foreign base company oil-related income does not include income derived from a source within a foreign country in connection with the following:

**(a)** Oil or gas which is extracted from a well located in that foreign country; or

**(b)** Oil, gas, or a primary product of oil or gas which is sold for use or consumption within such foreign country or is loaded in the foreign country in a vessel or aircraft for use as fuel.[772]

**(3) Exemption for Small Oil Producers.** Foreign base company oil-related income does not include any income of a foreign corporation if the average

[770] I.R.C. § 954(e).

[771] I.R.C. § 954(g)(1).

[772] I.R.C. § 954(g)(1).

daily production of foreign crude oil and natural gas by the foreign corporation and any related persons for the tax year and immediately preceding tax year is less than 1,000 barrels.[773]

**4. Increase in Earnings Invested in U.S. Property.** If a CFC invests in certain "U.S. property," each U.S. shareholder in the CFC is generally required to include the U.S. shareholder's pro rata share of the CFC's earnings invested in U.S. property for the year (computed by taking the average of the adjusted bases of U.S. property held by the CFC as of the close of each quarter of the year, less any liability to which the property is subject), but only to the extent that the earnings have not been previously included in the U.S. shareholder's income.[774] The amount includible is limited to the U.S. shareholder's pro rata share of the CFC's current (as reduced by current-year distributions) and accumulated earnings and profits, reduced by the portion of the earnings of the CFC previously included in the income of the U.S. shareholder.[775]

"U.S. property" for this purpose generally includes (with certain exceptions) tangible property located in the U.S., certain stock in U.S. corporations,[776] and certain obligations of a U.S. person.[777] A CFC will be considered as holding an obligation of a U.S. person if the CFC is a pledgor or guarantor on the obligation.[778] In addition, if the assets of a CFC serve at any time, even though indirectly, as security for the performance of an obligation of a U.S. person, the CFC will be considered a pledgor or guarantor of that obligation. For this purpose, the pledge of CFC stock will be considered as an indirect pledge of the assets of the CFC if the following two conditions are met:

**a.** At least 66 2/3 percent of the total voting stock is pledged; and

**b.** The pledge of stock is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the discretion of the CFC with respect to the disposition of assets or the incurrence of liabilities other than in the ordinary course of business.[779]

U.S. property also includes any right to the use in the U.S. of a patent, copyright, invention, model, design, secret formula or process, or any other similar right, which is acquired or developed by the CFC for use in the U.S.[780] U.S. Property includes any trade or service receivable if the following two conditions are met:

**c.** The trade or service receivable is acquired from a related person who is a U.S. person; and

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[773]I.R.C. § 954(g)(2).

[774]I.R.C. § 956(a).

[775]I.R.C. §§ 956(a).

[776]I.R.C. § 956(c)(2)(F).

[777]I.R.C. § 956(c)(1)(C).

[778]I.R.C. § 956(d).

[779]Treas. Reg. § 1.956-2(c)(2).

[780]I.R.C. § 956(c)(1)(D).

**d.** The obligor under the receivable is a U.S. person.[781]

**B. Passive Foreign Investment Company.** Certain U.S. shareholders in a "passive foreign investment company" ("PFIC") are generally required to pay U.S. federal income tax plus an interest charge based on the value of tax deferral at the time the shareholder (i) receives certain "excess distributions" from the PFIC; or (ii) disposes of his or her stock in the PFIC.[782] This general rule, however, does not apply to U.S. shareholders in PFICs that are classified as "qualified electing funds."[783]

**1. Classification as a PFIC.** A "PFIC" means any foreign corporation which meets (i) the "passive income test;" or (ii) the "passive asset test."[784]

**a. Passive Income Test.** The passive income test is met if 75 percent or more of the gross income of the corporation for the tax year is passive income. "Passive income" generally means that portion of the gross income of the corporation which consists of dividends, interest, royalties, rents, annuities, and net gains from the sale or exchange of property giving rise to such passive income. Certain exclusions to the definition of passive income are listed in Section 1297(b)(2).

**b. Passive Asset Test.** The passive asset test is met if the average percentage of "passive assets" (by value or, in certain cases, adjusted tax basis) held by the corporation during the tax year is at least 50 percent.[785] A "passive asset" is any asset which produces passive income or which is held for the production of income.[786]

**2. Consequences of PFIC Classification.**

**a. Treatment of Excess Distributions from PFIC.**

**(1) Computation of Tax on an "Excess Distribution."** If a U.S. person receives an "excess distribution" in respect of stock in a PFIC, gain recognized on receipt of the "excess distribution" is considered to be earned pro rata over the shareholder's holding period of his investment. Under this rule, U.S. tax due in the year of receipt of an "excess distribution" is the sum of the following amounts:

**(a)** U.S. tax computed using the highest rate of U.S. tax for the investor (without regard to other income or expenses the investor may have) on gain attributed to prior years; plus

**(b)** Interest imposed on the deferred tax; plus

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[781] I.R.C. § 956(c)(3).

[782] I.R.C. § 1291.

[783] *See* I.R.C. §§ 1291-1297.

[784] I.R.C. § 1297(a); *see* Notice 88-22, 1988-1 C.B. 489, *modified by* Notice 89-81, 1989-2 C.B. 399 (guidance concerning the application of the passive income test and passive asset test).

[785] I.R.C. § 1297(a).

[786] I.R.C. § 1297(a); I.R.C. § 1297(e).

**(c)** U.S. tax on the gain attributed to the year of receipt and to years in which the foreign corporation was not a PFIC (for which no interest is due).[787]

**(2) What Is an "Excess Distribution?"** An "excess distribution" means any current year distribution to the extent that it represents a ratable portion of the total distributions during the year that are in excess of the "125% Amount." The "125% Amount" is an amount equal to 125 percent of the average amount of distributions during the three years preceding the year of distribution (or, if shorter, the portion of the taxpayer's holding period before the tax year).[788]

**b. Treatment of Dispositions.** If a U.S. person disposes of stock in a PFIC, then any gain recognized will be subject to the rules of excess distribution in the same manner as if the gain were an excess distribution. The total excess distributions with respect to any stock is zero for the year in which the taxpayer's holding period in such stock begins.[789]

**3. Qualified Electing Funds.** If a U.S. shareholder in a PFIC elects to treat the PFIC as a qualified electing fund ("QEF"), such shareholder is required to include currently in gross income his pro rata share of certain of the PFIC's earnings.[790] An electing shareholder is required to include his pro rata share of the following in income:

**a.** Ordinary income for the PFIC's tax year; and

**b.** Net capital gain (not exceeding earnings and profits) for the PFIC's tax year (which may be treated as capital gain income).[791]

A pro rata share is the amount which would have been distributed with respect to the shareholder's stock if the fund had distributed to each shareholder a pro rata share of that day's ratable share of the PFIC's ordinary earnings and net capital gain for the year.[792]

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[787] I.R.C. § 1291(a)(1).

[788] I.R.C. § 1291(b)(1), (2).

[789] I.R.C. § 1291(b)(2)(B).

[790] I.R.C. § 1293(a).

[791] I.R.C. § 1293(a)(1).

[792] I.R.C. § 1293(b).

## C. Other Statutory Mechanisms Imposed to Curtail Deferral of Income.

**1. Accumulated Earnings Tax Rules.** The accumulated earnings tax ("AET") is applicable to any foreign corporation with respect to U.S. source income if any of its shareholders are subject to U.S. federal income tax on the distributions of the corporation by reason of being one of the following:

**a.** U.S. citizens or residents;

**b.** Nonresident aliens subject to U.S. federal income tax under Section 871 of the Code; or

**c.** Foreign corporations if a beneficial interest therein is owned directly or indirectly by any shareholder specified in (a) or (b).[793]

The AET is generally imposed on accumulated taxable income of a corporation. The accumulated taxable income of a foreign corporation which files a return is the corporation's taxable income from U.S. sources (with certain adjustments) minus the sum of the dividends paid deduction and the accumulated earnings credit. If the corporation fails to file a return, the accumulated taxable income is the gross income from U.S. sources without allowance of any deductions.[794]

**D. Coordination of Anti-Deferral Mechanisms.** The Internal Revenue Code coordinates the application of the anti-deferral mechanisms to prevent the double inclusion of income.[795]

[793] *See* Treas. Reg. § 1.532-1(c).

[794] I.R.C. § 535(b).

[795] *See, e.g.,* I.R.C. §§ 951(c) (as amended by the American Jobs Creation Act of 2004), 532(b)(3), 1297(d).

# XVII. THE DIRECT FOREIGN TAX CREDIT

**A. Tax Treatment of Foreign Taxes — In General.** If a U.S. taxpayer pays or accrues foreign income taxes during the tax year, the U.S. taxpayer may elect to either: (1) deduct the amount of the foreign income taxes from gross income for U.S. federal income tax purposes; or (2) claim the amount of the foreign income taxes as a credit against U.S. federal income taxes due.[796] There are generally six issues to analyze in determining whether the foreign tax credit is available to a taxpayer:

**1.** Is the taxpayer eligible to claim the foreign tax credit?

**2.** Is the tax a creditable tax?

**3.** Who is the taxpayer that should claim the foreign tax credit?

**4.** Do any special limitations apply which may reduce the amount of the credit?

**5.** Does the overall limitation on the foreign tax credit under Section 904 limit the amount of the creditable taxes?

**6.** What is the time and manner for claiming the foreign tax credit?

**B. Analysis of Six Issues.**

**1. Is the Taxpayer Eligible to Claim the Foreign Tax Credit?** The following persons are allowed a foreign tax credit subject to certain limitations:[797]

**a.** U.S. citizens and domestic corporations;

**b.** Residents of the U.S. or Puerto Rico;

**c.** Nonresident alien individuals and foreign corporations under certain circumstances; and

**d.** Partners or individual beneficiaries of an estate that are described in the categories a through c above.[798]

**2. Is the Tax a Creditable Tax?** For a tax paid to qualify for the foreign tax credit, it must generally constitute either (i) an income tax, a war profits tax or an excess profits tax; or (ii) a tax in lieu of a tax on income, war profits or excess profits.[799] A foreign levy is a

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[796] I.R.C. §§ 275(a), 901.

[797] I.R.C. § 901(b).

[798] I.R.C. § 901(b)(5) (as amended by the American Jobs Creation Act of 2004); *see also* I.R.C. § 1373(a) (S corporation is treated as a partnership and the shareholders of an S corporation are treated as partners of a partnership).

[799] I.R.C. §§ 901(a), 901(b), 903.

tax if it requires a compulsory foreign payment pursuant to the authority of a foreign country to levy taxes. A penalty, fine, interest, or similar obligation is not a tax, nor is a customs duty a tax. A foreign levy is not a tax to the extent a person receives a specific economic benefit in exchange for payment of the levy.[800]

**a. Predominant Character of Tax Must be that of an Income Tax in the U.S. Sense.** A foreign levy is an income tax if and only if (i) it is a tax; and (ii) the predominant character of that tax is that of an income tax in the U.S. sense.[801] The predominant character of a tax is that of an income tax in the U.S. sense if the tax meets two requirements: (i) the tax is likely to reach net gain in the normal circumstances in which it applies; and (ii) liability for the tax is not dependent on the availability of a credit for the tax against income tax liability to another country.[802]

**b. Tax in Lieu of an Income Tax.** Section 903 generally provides that a foreign tax credit is allowed for a tax paid in lieu of a tax on income, war profits or excess profits which is otherwise generally imposed by a foreign country. A foreign levy is a tax in lieu of an income tax if and only if (i) it is a tax; and (ii) it meets a substitution requirement.[803] The substitution requirement is met if the tax imposed is in substitution for, and not in addition to, an income tax.[804]

**3. Who Is the Taxpayer that Should Claim the Foreign Tax Credit?** The "person who pays the tax" is the person on whom the foreign law imposes the legal liability for tax, even if another person (for example a withholding agent) remits the tax.[805]

**4. Do Any Special Limitations Apply that May Reduce the Amount of the Credit?** Certain special limitations generally applicable to foreign income taxes paid on foreign mineral income may reduce the amount of the foreign tax credit.[806] A discussion of these special limitations is beyond the scope of this outline.

**5. Does the Overall Limitation on the Foreign Tax Credit under Section 904 Limit the Amount of the Creditable Taxes?** Section 904 of the Code limits the amount of a taxpayer's creditable foreign taxes for the year.

**a. Computation of Limitation.** The limitation is computed as follows:

Pre-credit U.S. tax X Foreign source taxable income

[800]Treas. Reg. § 1.901-2(a)(2)(i).

[801]Treas. Reg. § 1.901-2(a)(1).

[802]Treas. Reg. § 1.901-2(a)(3); *see also* Treas. Reg. § 1.901-2(b)(1) (circumstances under which foreign tax is likely to reach net gain).

[803]Treas. Reg. § 1.903-1(a).

[804]Treas. Reg. § 1.903-1(b).

[805]Treas. Reg. § 1.901-2(f)(1); *see also* Rev. Rul. 57-516, 1957-2 C.B. 435 (U.S. shareholders of foreign corporations should report, for Federal income tax purposes, gross amount of dividends received from such corporations (i.e., without reduction for withholding taxes) and claim credit for tax paid on dividends).

[806]*See* I.R.C. §§ 901(e), 901(f), 907.

Worldwide taxable income[807]

**b. Application of Limitation Formula.** A taxpayer is required to compute a separate foreign tax credit limitation for (1) a passive income category; and (2) a general category.[808] Thus, the Section 904(a) limitation formula must be applied separately with respect to each of these categories.

**c. Treatment of Separate Basket Losses.** If a taxpayer realizes a foreign loss when figuring taxable income in a separate category, and the taxpayer has income in another category, the taxpayer must first reduce the income in other baskets by the foreign loss before offsetting U.S. source income.[809] Foreign losses must be allocated among the separate categories in the same proportion as each category's income bears to total foreign income.[810] If (a) a separate basket loss was allocated to income from any other basket, and (b) the loss basket has income for a subsequent year, then income in subsequent years is recharacterized as income from such other basket in proportion to the prior reductions for allocable losses.[811]

**d. Recapture of Overall Foreign Loss.** If a taxpayer has only losses in separate baskets or if a taxpayer has a loss remaining after allocating foreign losses to other separate baskets, the taxpayer has an "overall foreign loss." If a taxpayer has an "overall foreign loss" for a tax year, the taxpayer's foreign source income in later years is treated as U.S. source income to the extent of the lesser of:

**(1)** The amount of the overall foreign loss for the prior year; or

**(2)** 50% (or such larger percent as the taxpayer may choose) of the taxpayer's foreign source taxable income.[812]

The balance is suspended and carried forward.[813]

**e. Carryback and Carryover of Excess Taxes Paid.** If the amount of foreign income taxes paid or accrued to a foreign country or U.S. possession exceeds the Section 904 limitation amount for the tax year, the excess may be carried back one year and carried forward ten years, in that order, and treated as taxes paid in those years (subject to the application of Section 904).[814]

### 6. What Is the Time and Manner for Claiming the Foreign Tax Credit?

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[807] I.R.C. § 904(a).

[808] I.R.C. § 904(d).

[809] I.R.C. § 904(f)(5)(A).

[810] I.R.C. § 904(f)(5)(B).

[811] I.R.C. § 904(f)(5)(C).

[812] I.R.C. § 904(f).

[813] I.R.C. § 904(f).

[814] I.R.C. § 904(c).

**a. Time.** A credit for foreign taxes may generally be claimed in the tax year in which the taxes were paid or accrued, depending on the method of accounting used by a taxpayer. A cash basis taxpayer, however, may elect to claim a credit for foreign taxes accrued. If the election is made, the taxpayer must compute the foreign tax credit for all subsequent years on the same basis.[815]

**b. Manner.** An individual claiming a foreign tax credit must complete and file IRS Form 1116 with his or her Federal income tax return. A corporation claiming a foreign tax credit must complete and file IRS Form 1118 with its Federal income tax return.[816]

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[815] I.R.C. § 905; Treas. Reg. § 1.905-1(a).

[816] Treas. Reg. § 1.905-2(a).

# XVIII. INDIRECT FOREIGN TAX CREDIT

Under the "deemed-paid" or "indirect" foreign tax credit allowed by U.S. tax law, U.S. corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder.[817] By way of example, if a domestic corporation meeting the threshold requirements for claiming an indirect foreign tax credit receives a dividend from a first-tier foreign corporation, the domestic parent corporation is deemed to have paid the amount of post-1986 foreign income taxes paid or deemed paid by the foreign corporation as determined under the following formula:

| Dividend received by <u>the U.S. shareholder</u> Post-1986 undistributed earnings of foreign corporation | X | Post-1986 foreign income taxes paid and deemed paid by first-tier foreign corporation | = | Amount of first-tier foreign corporation's foreign income taxes deemed paid by domestic corporation[818] |
|---|---|---|---|---|

The term "post-1986 undistributed earnings" means current earnings and profits unreduced by current-year distributions plus post-1986 accumulated earnings and profits.[819] The term "post-1986 foreign income taxes" means the sum of the following amounts:

**1.** The foreign income taxes with respect to the tax year of the foreign corporation in which the dividend is distributed; and

**2.** The foreign income taxes with respect to prior post-1986 tax years, to the extent such foreign taxes were not attributable to dividends distributed out of the foreign corporation in prior tax years.[820]

A U.S. corporation may also be deemed to have paid taxes paid by a first, second or third-tier foreign corporation and, if certain special requirements are satisfied, a fourth, fifth and sixth-tier foreign corporation.[821] No taxes paid by a second, third fourth, fifth or sixth-tier foreign corporation are deemed paid by the first foreign corporation unless certain prescribed

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[817] I.R.C. § 902(a).

[818] I.R.C. § 902(a).

[819] I.R.C. § 902(c)(1); *see also* I.R.C. § 902(c)(6) (special rules for dividends paid from earnings and profits accumulated for years prior to January 1, 1987).

[820] I.R.C. § 902(c)(2).

[821] I.R.C. § 902(b).

stock ownership rules are satisfied.[822] A deemed-paid credit generally is also available with subpart F inclusions.[823]

A domestic corporation that claims an indirect foreign tax credit for deemed-paid taxes must include the amount of the credit in gross income.[824] The amount of foreign tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be "grossed-up") and included in the U.S. corporate shareholder's income to treat the shareholder as if it had received its proportionate share of pre-tax profits and paid its proportionate share of foreign tax.[825]

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[822]I.R.C. § 902(b)(2)(B).

[823]I.R.C. § 960.

[824]I.R.C. § 78.

[825]I.R.C. § 78.

## XIX. SECTION 367(A) - TRANSFER OF ASSETS TO A FOREIGN CORPORATION

Section 367(a) generally provides that a foreign corporation will not be considered a corporation for purposes of applying the corporate organization, reorganization, and liquidation rules to a U.S. person's transfer of property to a foreign corporation.[826] Thus, transfers of property to foreign corporations described in Section 367(a) will generally be treated as taxable exchanges. Section 367(a)(1) denies nonrecognition treatment, however, only with respect to transfers of items of property on which gain is realized. The amount of gain recognized because of Section 367(a)(1) is not affected by the transfer of items of property on which loss is realized but not recognized.[827] Thus, under Section 367(a), a taxpayer cannot "net" gains and losses realized on a unitary transfer of property to a foreign corporation. No loss can be recognized through the operation of Section 367.[828]

If a U.S. person is required to recognize gain under Section 367(a)(1) upon a transfer of property to a foreign corporation, the character and source of the gain are determined as if the property had been disposed of in a taxable exchange with the transferee foreign corporation. In addition, adjustments to earnings and profits, basis, and other affected items must be made according to otherwise applicable rules, taking into account the gain recognized because of Section 367(a)(1).[829]

The general rule of Section 367(a) does not apply to certain transfers of stock or securities of a foreign corporation[830] or to property transfers to a foreign corporation for use by the foreign corporation in the active conduct of a trade or business outside of the United States.[831] However, the latter exception does not apply to any inventory, installment obligations, accounts receivable, foreign currency or other property denominated in foreign currency, intangible property, or certain property of which the transferor is a lessor at the time of the transfer.[832]

Section 367(d) applies to transfers of intangibles by a U.S. person to a foreign corporation. Under Section 367(d), if intangible property is transferred by a U.S. person to a foreign corporation in an exchange described in Section 351 or Section 361, the transferor will be deemed to have sold the property in exchange for annual payments contingent on the productivity or use of such property and received the annual payments over the useful life of the intangible property.[833] The amounts deemed to be received under Section 367(d) must be commensurate with the income attributable to the intangible.[834]

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[826] I.R.C. § 367(a)(1).

[827] Temp. Treas. Reg. § 1.367(a)-1T(b)(1).

[828] Temp. Treas. Reg. § 1.367(a)-1T(b)(3)(ii).

[829] Temp. Treas. Reg. § 1.367(a)-1T(b)(4).

[830] I.R.C. § 367(a)(2).

[831] I.R.C. 367(a)(3)(A).

[832] I.R.C. 367(a)(3)(B).

[833] I.R.C. 367(d).

[834] I.R.C. 367(d)(2)(A).

To the extent provided in Treasury Regulations, if a U.S. person transfers property to a foreign corporation as paid-in surplus or as a contribution to capital (in a transaction that is not otherwise described in Section 367(a), such transfer is treated as a sale or exchange for an amount equal to the fair market value of the property transferred.[835] The transferor is required to recognize as gain the excess of (i) the fair market value of the property so transferred, over (ii) the adjusted basis (for purposes of determining gain) of such property in the hands of the transferor.[836]

[835] I.R.C. § 367(f).

[836] I.R.C. § 367(f).

## XX. INTERNATIONAL TRANSFER PRICING OF GOODS AND SERVICES

**A. The Statute.** Section 482 of the Code generally provides that, in the case of two or more businesses controlled by the same interests, the Internal Revenue Service may allocate income, deductions, credits, or allowances between such businesses in order to prevent tax evasion or to reflect income clearly. The IRS may apply Section 482 whether or not the businesses are incorporated, organized in the U.S., or affiliated.[837]

Section 482 also provides that, in the case of any transfer (or license) of intangible property, the income with respect to such transfer or license must be commensurate with the income attributable to the intangible.

**B. Purpose of Section 482.** The purpose of Section 482 is generally to ensure that taxpayers clearly reflect income attributable to transactions between controlled taxpayers. Section 482 attempts to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.[838]

**C. Use of Section 482 by the IRS and Taxpayers.**

**1. Use of Section 482 by the IRS.** If a controlled taxpayer has not reported its true taxable income, the IRS may reallocate any item affecting taxable income, including items of income, deductions, credits, allowances and basis, among the members of a controlled group.[839]

**a. Intent to avoid or evade taxes not a prerequisite.** The application of Section 482 does not require a finding of an intent to avoid or evade taxes in a transaction.[840]

**b. Section 482 also applies to consolidated groups.** Section 482 applies to all controlled taxpayers, whether the controlled taxpayer files a separate or consolidated U.S. tax return.[841]

**2. Taxpayer's use of Section 482**. If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely-filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. Section 482 does not grant taxpayers any other right to apply, or to compel the application of, its provisions.[842]

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[837] I.R.C. § 482.

[838] Treas. Reg. § 1.482-1(a)(1).

[839] Treas. Reg. § 1.482-1(a)(2).

[840] Treas. Reg. § 1.482-1(f)(1)(i).

[841] Treas. Reg. § 1.482-1(f)(1)(iv).

[842] Treas. Reg. § 1.482-1(a)(3).

### D. Arm's length standard.

**1. General rule.** In determining the true taxable income of a controlled taxpayer, the IRS applies the "arm's length" standard. Under the arm's length standard, the IRS generally examines whether the results of the transaction are consistent with the results that would have been obtained if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. An identical transaction is often difficult to locate. Thus, in determining whether a transaction produces an arm's length result, the IRS generally will examine whether the results of a controlled transaction are consistent with the results obtained in comparable transactions under comparable circumstances.[843]

**2. Selection of method for testing whether a transaction meets the arm's length standard; best method rule.** The methods of the IRS for determining whether a particular transaction meets the arm's length standard are set forth in Sections 1.482-2 through 1.482-6, 1.482-7T and 1.482-9 of the Regulations.[844] Treas. Reg. § 1.482-7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm's length result. The IRS will generally use a method that results in the most reliable measure of an arm's length result.[845] A detailed review of the difference pricing methods under Section 482 is beyond the scope of this outline.

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[843]Treas. Reg. § 1.482-1(b)(1).

[844]Treas. Reg. § 1.482-1T(b)(2).

[845]Treas. Reg. § 1.482-1(c)(1).

## XXI. SECTION 1059A

**A.** A U.S. taxpayer that imports property into the United States in a transaction from a person related to the taxpayer may not claim, for purposes of computing the basis or inventory cost of the property, a greater cost than the amount of the cost considered for customs valuation.[846] An item is not subject to this rule if the item is not subject to any customs duty or is subject to a free rate of duty.[847]

[846] I.R.C. § 1059A(a).

[847] Treas. Reg. § 1.1059A-1(c)(1).