International Tax

Text, Cases, Problems, and Questions

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Part 1
U.S. Tax Jurisdiction

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Chapter 1
Introduction to International Tax

§ 1.01. Overview of International Tax

The international income tax rules of the United States determine the U.S. claims to tax revenue from income having a nexus with the United States and one or more foreign tax jurisdictions. These rules are the subject matter of this book. Income having a nexus with more than one country is referred to here as transnational income. Such income comprises a substantial and growing percentage of the income taxable under the Code.[1]

Transnational income may be taxable under the Code because of a nexus between the United States and the activities that generated the income. According to international usage, a jurisdictional claim based upon such a nexus is called "source jurisdiction." All countries imposing an income tax exercise source jurisdiction.

The Code also imposes a tax on transnational income because of a nexus between the United States and the person earning the income. A jurisdictional claim over income based on a nexus between the country making that claim and the person subject to tax is called "residence jurisdiction." A person subject to the residence jurisdiction of the United States is taxable on its worldwide income, without reference to the source of the income.

With a few exceptions, countries that exercise residence jurisdiction do so only with respect to the income of individuals and legal entities that they consider to be residents. Thus the term "residence jurisdiction." The United States is an exception to the general pattern. It asserts the right to impose its income tax not only on the worldwide income of its residents but also on the worldwide income of its citizens. Indeed, citizenship is the primary basis under the Code for exercising residence jurisdiction over individuals.[2] Like other countries, the United States also taxes the worldwide income of domestic corporations and other resident juridical persons. The persons subject to the residence jurisdiction of the United States are referred to in the Code as U.S. persons.[3]

A U.S. person is defined in Code section 7701(a)(30) to be a citizen or resident individual of the United States or a domestic corporation, partnership, trust, or estate.[4] Persons fitting this definition are subject to

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[1] All references in this book to the "Code," unless otherwise stated, are references to the Internal Revenue Code of 1986.

[2] Albania, Bulgaria, Mexico, and the Philippines are other countries that have exercised residence jurisdiction in the past over their citizens as well as their residents.

[3] U.S. tax is imposed on all individuals under IRC § 1 and on all corporations under IRC § 11, without regard for their citizenship, residence, place of incorporation, or any other nexus with the U.S. Under IRC § 61, gross income is defined to include all income, without regard for its geographical source. IRC § 872, however, limits the gross income of nonresident alien individuals to income derived from the United States. A similar rule in IRC § 882 limits U.S. tax jurisdiction over foreign corporations to income derived from the United States.

[4] The Code reference is to "United States person." As a shorthand, the abbreviated term "U.S. person" is used throughout this book in place of the official term.

the residence jurisdiction of the United States. A foreign person, as that term is used in this book, is a person other than a U.S. person. Foreign persons are subject only to the source jurisdiction of the United States.[5]

When a U.S. person earns transnational income, the claim of the United States to tax that income based on its residence jurisdiction may overlap the claim of a foreign country for tax revenue based on source jurisdiction. Similarly, the claims of foreign governments for tax revenue based on their residence jurisdiction may overlap U.S. jurisdictional claims to revenue based on source. Unless resolved satisfactorily, the competing claims for tax revenue based on residence and source would stifle international investment and commerce.[6] In addition, the tax burdens imposed on persons earning transnational income would be unfair under traditional concepts of tax equity.

To reduce the likelihood of double taxation of transnational income, the United States accedes primary tax jurisdiction to the country of source. The Code achieves this result by granting a foreign tax credit to U.S. persons for income taxes paid to foreign governments with respect to foreign source income. Most other countries make similar accommodations, either through their taxing statutes or through bilateral tax treaties.

Although persons earning transnational income face some risks of double taxation, they also have some possibilities for international tax avoidance. Those opportunities result from certain gaps in the jurisdictional reach of the United States and other countries. The undertaxation of transnational income is both inefficient and unfair. Undertaxation is inefficient because it induces taxpayers to engage in the undertaxed activities instead of taxable activities producing a higher before-tax rate of return. It is unfair because taxpayers earning equal amounts of income do not end up paying equal taxes.

Some foreign tax jurisdictions have increased the risks of undertaxation of transnational income by operating as a tax haven. In the typical case, a tax haven country has structured its tax rules so as to allow foreign persons to take advantage of the provisions of foreign law designed to prevent double taxation. Tax haven countries typically obtain some revenue from foreign taxpayers, but the amount is very small in comparison with the amount of tax revenue that other taxing jurisdictions lose on account of their conduct. The Code is replete with complex provisions designed to protect U.S. tax jurisdiction against the beggar-thy-neighbor policies of tax haven countries.[7]

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[5] Under some conditions, former U.S. citizens and certain former U.S. residents who give up their citizenship or their permanent residence status to avoid U.S. taxes would be subject to U.S. tax for a 10-year period on a quasi-residence basis.

[6] Countries may have competing claims to income based upon overlapping residence jurisdiction. For example, a U.S. citizen resident in France might be taxable on a residence basis by both France and the United States. Some efforts are made to prevent such overlaps through tax treaties. See U.S. Model Treaty (2006), Art. 4 (Residence), providing tie-breaker rules so that a person who qualified as a resident of both Contracting States under their domestic tax legislation would be treated as a resident in only one of the Contracting States. Some recent U.S. treaties provide for mandatory arbitration to resolve disputes. See, e.g., Article 25, para. 5-6, of U.S.-Germany treaty, as revised 2008 (providing, *inter alia*, for mandatory arbitration if disputes under Article 4 (Residence) are not resolved by mutual agreement).

[7] The Organization for Economic Cooperation and Development (OECD), of which the United States is a prominent member, has attempted to induce cooperation among countries to mitigate beggar-thy-neighbor tax policies. See OECD Committee on Fiscal Affairs, *Harmful Tax Competition: an Emerging Global Issue*, Paris (1998). For an earlier assessment of the harmful effects of unbridled tax competition on national tax policies, see Michael J. McIntyre, "Taxing Income from Moveable Capital in the EEC After 1992," 2 *Tax Notes Int'l* (May 1990) 461-463; Michael J. McIntyre, "The Design of Tax Rules for the North American Free Trade Alliance," 49 *Tax Law Review* 769-793 (1994).

§ 1.02. The International Tax Advisor

International Tax Primer (2002)

By Brian J. Arnold and Michael J. McIntyre

The tax adviser's role with respect to international transactions is similar to his or her role with respect to domestic transactions. Probably the tax adviser's most important obligation is to ensure that the client does not fall into any traps or anomalies that result in levels of taxation beyond what might reasonably be expected. Such defensive tax planning may put the tax adviser on the same side of an issue as the tax policymaker, who should also be seeking to impose appropriate tax burdens on taxpayers. Domestic and international tax advisers are also expected to be acquainted with international tax schemes that might be used to minimize taxes. These schemes often involve the use of tax havens or special low-tax regimes of countries that generally levy high taxes.

International tax advisers are likely to spend much more of their time engaging in defensive tax planning than their domestic counterparts. The reason is that taxpayers engaged in international transactions frequently confront serious risks of having to pay excessive levels of tax. These risks typically arise when two or more countries claim the right to impose tax on the same items of income. Many of the most important international tax rules are designed to mitigate or eliminate such double taxation. The common measures used to relieve double taxation are discussed [elsewhere in this *Primer*].

Although visible and fashionable, the offensive tax planning activities of most international tax advisers occupy a modest part of their practice. These activities, however, are very important and have generated a great deal of complex anti-avoidance legislation. The most important of the rules designed to combat international tax avoidance are discussed [elsewhere in this *Primer*]. These rules have not driven the tax havens out of business. Opportunities for international tax avoidance are still widely available to many individual investors and to the multinational enterprises of many countries.

The role of the tax adviser depends on whether the transaction involved is an outward-bound investment or an inward-bound investment. In the case of an outward-bound investment, the tax adviser often has an ongoing relationship with the client and is familiar with the client's total affairs. Consequently, the client usually looks primarily to his or her domestic tax adviser for advice concerning both the domestic and foreign tax consequences of the transaction. Although the domestic tax adviser is not generally qualified to provide advice concerning foreign tax law, the client often expects the tax adviser to act as a cipher or filter with respect to foreign tax advice. It is not unusual for foreign tax advisers to deal with the domestic tax adviser rather than with the client directly. In contrast, when the tax adviser is providing advice concerning an inward-bound investment by a nonresident, the role is often more restricted. Usually, the advice is limited to the tax consequences in the adviser's particular country, and the tax adviser is not likely to be involved in the overall tax planning for the nonresident on an ongoing basis. Also, as indicated earlier, in this situation the tax adviser may deal with the foreign tax advisers rather than directly with the client.

Whether an inward-bound or an outward-bound investment is involved, tax advisers consulting on an international transaction will almost invariably deal with foreign lawyers, accountants, or business persons. The role of tax advisers in this regard may often be difficult because of differences between the basic legal concepts, tax laws and accounting practices of the countries involved. These differences may be exacerbated by language and cultural differences.

Although a tax adviser may not be legally qualified to provide advice concerning foreign tax law, he or she should have as much knowledge concerning foreign tax systems as possible. This knowledge enables an adviser to deal more effectively with foreign tax advisers and to suggest alternative methods for structuring transactions that provide desirable tax results under the laws of both countries.

From the taxpayer's viewpoint, the foreign tax consequences of any investment or transaction are often as important as, or even more important than, the domestic tax consequences. Consider, for example, an individual, T, who is resident in one country and who plans to make a portfolio investment in another country. T obviously is concerned about how her country of residence will tax the foreign-source income and what provisions it makes for relieving double taxation. T is also concerned, however, about the level of the foreign tax. If her residence country relieves double taxation by exempting foreign-source income, the foreign tax is the only tax on the income.

If T's country of residence provides a foreign tax credit, the situation is more complex, for reasons explained in some detail [elsewhere in this *Primer*]. In brief, countries granting a credit for foreign taxes typically limit the credit to the amount of the domestic tax imposed on the foreign income — they do not allow a refund of any excess foreign tax. If T can expect to obtain a credit for foreign taxes imposed on her foreign income, then she is concerned with the foreign tax only if it exceeds the domestic tax, in which case T will be subject to an effective rate of tax equal to the foreign tax rate.

To take a more complicated example of the importance of foreign tax law to the tax planner, suppose that a multinational corporation desires for business reasons to reorganize its multinational group of corporations. In the absence of special relief provisions, such a reorganization typically will result in significant adverse tax consequences under the tax laws of most countries. Many countries, however, provide for certain corporate reorganizations to occur on a tax-free (or, more accurately, tax-deferred) basis. In deciding whether the reorganization should go forward, therefore, the multinational corporation will look to its tax advisers for advice on the tax consequences of the reorganization under the tax laws of the country in which the parent corporation is resident and also under the tax laws of the foreign countries in which the foreign subsidiaries of the parent corporation are located. Providing this advice is no easy matter because the tax rules governing corporate reorganizations vary widely and often interrelate in complex ways.

This intersection of domestic tax law and foreign tax law is one of the most challenging features of the study and practice of international tax. Although tax advisers are usually qualified to give advice only on their domestic tax law, they must be sufficiently familiar with foreign tax laws to be able to recognize potential problems and to deal efficiently with foreign tax advisers. Further, the intersection of foreign and domestic law extends beyond tax. Tax consequences generally attach to particular legal results. For example, the tax consequences may differ if income is earned by an individual, a trust, a partnership, or a corporation. Consequently, a tax adviser may be required to determine in particular situations whether an entity is a trust, a partnership, a corporation, or something else. The problem of determining tax consequences on the basis of the underlying legal situation is exacerbated in the foreign context because the domestic tax consequences often must be determined on the basis of foreign legal concepts. For example, if a resident of one country holds an interest in a *limitada* or limited liability company (which is in essence an entity that provides limited liability for its investors and flow-through treatment for income tax purposes), should the ownership rights be characterized as an interest in a partnership or as shares in a corporation?

Tax is not usually a major factor in the initial decision of an enterprise to make a direct investment abroad. Other factors, such as return on investment, political stability, labor costs, and access to foreign markets, are much more important as far as the original investment is concerned. The tax "tail" should not

wag the commercial "dog." Once the decision to invest has been made, however, tax is an important factor in determining the way in which the investment should be structured. Further, tax is important in determining whether to reinvest or repatriate the profits from the investment, or if the investment proves to be unprofitable, how to utilize the losses. Tax advisers are expected to provide advice concerning the tax consequences of the various ways in which the profits of a foreign enterprise might be repatriated to the domestic corporation. Similarly, they are expected to provide advice concerning the tax consequences of providing the foreign enterprise with additional capital.

One important point about tax planning in general which must be kept in mind is that the client's organization must be able to live with the operational implications of the tax plan. If the tax plan is too complex from an operating viewpoint, any tax savings may be offset by additional administrative costs. Moreover, if the business is unable to operate, in fact, in accordance with the tax plan, the effectiveness of the plan for tax purposes may be jeopardized. For example, a tax plan might involve the establishment of a foreign subsidiary in a tax haven to purchase goods from the domestic parent corporation and resell them to customers abroad. Such a tax plan might be conditional on the delivery of the goods to the tax haven subsidiary. Therefore, if the goods are shipped by the parent corporation directly to the ultimate customers because that is the sensible thing to do from a non-tax perspective, the success of the tax plan may be jeopardized, and indeed, significant penalties may be imposed on the taxpayer.

There are many different ways of structuring foreign investments. A manufacturing enterprise might sell its goods in a foreign country in one of several ways. For example, it might:

- sell its manufactured goods directly to customers in the foreign country;
- sell its goods to an arm's length foreign distributor for resale to customers;
- establish a branch in the foreign country with a warehouse and sales employees or agents to sell its goods there;
- establish a foreign sales subsidiary in the foreign country;
- establish a foreign holding company which can incorporate a foreign sales subsidiary in the country; and
- license an unrelated foreign corporation to manufacture and sell its goods in the foreign country.

The tax consequences of these various alternatives may vary considerably under the tax laws of a particular country (and from country to country).

One of the fundamental choices in structuring a foreign investment is between a foreign branch and a foreign subsidiary. The essential difference between a branch and a subsidiary is that the latter is a separate legal and taxable entity, whereas the former is a part or division of the domestic parent corporation. As a result, when a domestic corporation sells its products through a foreign branch, the domestic corporation is taxed on the profits of the branch because the branch is not a legal entity. Further, for general law purposes, it is the domestic corporation that is responsible for any legal obligations arising out of its foreign sales activities. In contrast, if the foreign sales are made by a foreign subsidiary corporation, the foreign subsidiary, as a separate legal entity, is taxable on its profits and is responsible for its own legal obligations. There are, of course, exceptions to this general rule.

In summary, a tax adviser is expected to perform two functions with respect to tax planning for international transactions. First, tax advisers must quantify the tax cost, within a reasonable range, of carrying

out transactions. Second, tax advisers are expected to provide advice for minimizing the amount of tax payable. Often, this tax minimization aspect of international tax planning involves identifying various methods of structuring a transaction and recommending one method over others in light of the tax consequences and the compatibility of the transaction with the overall operating structure of the enterprise.

Although tax planning for international transactions must be tailored to each client's particular situation, certain common types of tax planning can be identified. Below we describe three types of international tax planning to give some flavor of the nature of the exercise. The following examples have been simplified drastically.

Double dip leases. Some cross-border transactions are structured to exploit differences in the tax treatment of the transactions by two countries. Cross-border leasing provides an example of this type of international tax planning.

Assume that an airline company in Country A wishes to acquire, on credit, some new aircraft for use in its business. It can take out a commercial loan and purchase the aircraft directly, or it can acquire the aircraft by utilizing a so-called financial lease. In general, a financial lease is a financing arrangement under which the lessee acquires substantially all ownership rights to the leased property. In effect, the lessor sells its ownership rights in the property and finances the acquisition of the property by the lessee. Instead of receiving interest and repayments of principal as a conventional lender would, the lessor receives "rental" payments which reflect both the sale price of the property and the financing aspect of the transaction.

Under the tax laws of Country A, a financial lease is treated as a sale. Accordingly, if the airline company leases the aircraft, it would be treated as if it borrowed funds and purchased the aircraft. As a result, it would be entitled to deduct depreciation on the aircraft and the interest element of the lease payments. The depreciation deductions may be very large, as many countries provide accelerated depreciation deductions as a tax incentive for investment. The airline company also would be permitted to claim any investment credits that Country A provides for purchases of aircraft.

If the lessor is a resident of Country A, it will be treated as having sold the aircraft, with the appropriate gain or loss recognized on the sale and as having loaned funds to the airline, with the interest element of the lease payment included in its income. Assume, however, that the lessor is a resident of Country B and that Country B treats financial leases for tax purposes as genuine leases. Under these facts, the lessor will be treated as the owner of the aircraft and will be entitled to take depreciation deductions and to claim any tax credits offered by Country B to owners of aircraft. It will be taxable in Country B on the receipt of rent payments. Country A, however, typically will treat a major portion of the payments as nontaxable installment payments of the sale price of the aircraft rather than as taxable rent. The remaining portion will be characterized as interest.

This type of structure is often referred to as a "double dip" lease because the tax benefits of ownership of the aircraft are claimed in both countries as a result of the inconsistent characterization of the transaction by the two countries.

Tax haven companies. Much international tax planning focuses on the use of countries that levy little or no tax. Such tax havens can be used in a wide variety of ways to reduce taxes of residents of high-tax countries. One common way is to establish a controlled foreign corporation in a tax haven.

For example, assume that ACo is resident in and manufactures goods in Country A, which levies corporate tax at a rate of 40 percent. ACo sells its manufactured goods not only in Country A but also in several other countries. ACo is taxable in Country A on its worldwide profits. ACo incorporates a

wholly-owned subsidiary, THCo, in Country TH, which does not impose any income taxes. THCo purchases manufactured goods from ACo at their arm's length price and resells them to clients outside Country A. As a result, the sales profits attributable to sales outside Country A will be earned by THCo, not by ACo. Because THCo is a separate legal entity and because the tax advisers will ensure that it is not resident in Country A, the sales profits derived by THCo are not taxable either by Country A or by Country TH. Thus, assuming that the sales profits are 2 million, this transaction will reduce the taxes payable to Country A by 800,000 (40 percent × 2 million).

If THCo does not have any employees and does not ever take delivery of the goods, Country A may consider the sales profits to be derived by ACo. Even if THCo actually performs the sales function, some countries have rules to attribute the income derived by THCo to ACo. These "controlled foreign corporation" rules are discussed [elsewhere in this *Primer*] dealing with international tax avoidance.

Treaty shopping. Another type of international tax planning involves the use of tax treaties to reduce tax. One common example involves the establishment by a resident of one country of a "conduit" company in another country in order to take advantage of that country's tax treaty network.

Assume that ACo, resident in Country A, has developed valuable intangible property and intends to license the use of the property by manufacturers in several other countries. Country A does not have treaties with some of the countries in which the potential licensees are resident, and the treaties with the other countries provide for withholding taxes on royalties of 15 percent. Country A provides an exemption for dividends received from foreign corporations in which corporations resident in Country A have a substantial participation. ACo transfers its intangible property to a wholly-owned subsidiary, BCo, established in Country B. Country B has tax treaties with all of the countries in which the potential licensees are resident, and those treaties provide for no withholding taxes on royalties. The result is that no tax will be imposed on the royalties by the countries in which the royalties arise. Country B may not tax the royalties derived by BCo, either because it is a tax haven or because it provides generous write-offs for intangible property. When BCo distributes dividends to ACo, Country A will not tax the dividends because of its exemption for dividends. Even if Country A taxes the gain on the transfer of the intangible property by ACo to BCo, Country A may have significant difficulty in taxing the appropriate amount of gain because of the problem of establishing the fair market value of the property with accuracy.

This example illustrates the problem of treaty shopping. In effect, ACo has taken advantage of Country B's treaty network by the simple expedient of establishing a corporation in Country B. BCo functions as a conduit to flow through the royalties as tax-exempt dividends to ACo. The overall effect is that the withholding taxes of the countries in which the royalties arise are avoided. The problem of treaty shopping is dealt with [elsewhere in this *Primer*]. "

§ 1.03. Goals of International Tax Rules

A primary goal of the U.S. income tax system is to raise revenue to finance government spending programs. Raising revenue, however, is the goal of any tax system. That goal, therefore, does not explain why a personal income tax is preferred over other tax mechanisms, such as a sales tax, nor does it explain very much about the design of particular features of an income tax system.

The three goals specific to the U.S. income tax system, as it applies to U.S. citizens and resident aliens, are fairness, efficiency, and administrative economy. Fairness is the primary goal. That goal has two

traditional components: horizontal equity and vertical equity. Horizontal equity is generally understood to mean that individuals in comparable economic circumstances, as measured by their income, should pay equal amounts of tax. Vertical equity means, in general, that the poor should be exempt from tax and that the rich should pay a higher proportion of their income in taxes than members of the middle classes.

Economic efficiency and administrative economy are secondary goals of the U.S. income tax in that they do not justify the basic decision to employ an income tax rather than some other tax mechanism. Many specific Code provisions, however, were designed to achieve efficiency and administrative economy. This is especially true of the international features of the U.S. income tax system.[8]

§ 1.03.1. Revenue Goal

Despite its general lack of explanatory power, the revenue goal does explain some of the rules applicable to foreign persons. The United States is in competition with foreign governments for tax revenue from transnational income. That competition is regulated by a general agreement of countries to defer, in the case of a conflict between residence jurisdiction and source jurisdiction, to the country of source. To implement that general agreement, many countries have entered into tax treaties with the United States that require them to give their residents a credit in many circumstances for the U.S. income taxes that they have paid with respect to income derived from the United States.[9]

A foreign tax credit regime utilized by a foreign government sometimes causes the burden of the U.S. tax to be borne by that government rather than by the foreign person paying the tax. In such circumstances, the U.S. policy makers are likely to be more concerned with the revenue goal than with fairness and efficiency goals.

Assume, for example, that T is a resident of Country K. T is earning investment income of $1,000 in the United States. T is taxable on that income in Country K at a rate of 35 percent. Country K also gives T a credit for withholding taxes paid to the United States as long as the U.S. tax does not exceed a rate of 35 percent. Assume that the United States government is deciding whether it wants to tax investment income of foreigners at a rate of 10 percent or 20 percent. On revenue grounds, it obviously should tax T at a rate of 20 percent. Fairness and economic efficiency arguments for or against that rate would not be relevant because the burden of the U.S. tax will fall on Country K and not on T.

In taxing foreign persons, the United States is committed under its tax treaties and certain other treaties to refrain from imposing discriminatory taxes.[10] It is also required by treaty to limit the withholding tax rate applicable to certain types of investment income payable to residents of the treaty country. The U.S. government is not free, therefore, to make revenue maximization its only goal in designing its tax rules applicable to foreign persons.

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[8] For a more detailed discussion of the goals of international tax regimes, see Michael J. McIntyre, "The Design of Tax Rules for the North American Free Trade Alliance," 49 *Tax Law Review* 769, 771-782 (1994).

[9] Some countries seek to prevent double taxation by exempting their nationals from tax on their foreign source income. The exemption may not extend to income earned through a tax haven jurisdiction. For general discussion of exemption regimes, see Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, 2d Ed. (2002), ch. 3.

[10] See, e.g., U.S. Model Treaty (2006), Art. 24 (Non-Discrimination).

§ 1.03.2. Fairness Goal

Fairness in taxation is often discussed in terms of the twin goals of horizontal equity and vertical equity. For domestic individuals deriving all of their income from U.S. sources, the goal of horizontal equity would be achieved by subjecting all income from whatever source derived to uniform rates of tax. To achieve vertical equity, those uniform rates would be graduated. A zero tax bracket—or some functional equivalent, such as a low-income deduction—would be provided to keep the poor off the tax rolls. Whether vertical equity requires some additional graduation of rates is an issue of debate in the tax literature. In the political arena, that debate has been resolved for now in favor of some additional graduation.

The model tax system described above incorporates an implicit assumption that all of the income of the taxpayer is subject to tax without reference to its geographical source. That simple model must be modified to take account of domestic and foreign taxpayers earning transnational income.

§ 1.03.2.1. Fairness to Resident Individuals

For resident individuals, the modified model would be designed to achieve the distribution of burdens that would have been achieved in the simple model if those taxpayers had derived their income wholly within the United States. Adjustments in the simple model must be made for taxes imposed by foreign governments with respect to income derived within their borders. Those adjustments would require some distinction in the treatment of U.S. source income and foreign source income. In substantial measure, those adjustments are made through the foreign tax credit mechanism.

Adjustments in the simple model also must be made to prevent domestic persons from avoiding U.S. taxes through the use of foreign entities. Those adjustments are accomplished through the rules regulating transfer prices to related parties, through the rules taxing U.S. shareholders on the income of certain foreign corporations under their control and through a variety of other anti-avoidance provisions.

§ 1.03.2.2. Fairness to Foreigners

Fundamental adjustments in the simple model described above must be made in the design of tax rules applicable to foreign taxpayers. The basic premise of the simple model is that the entire income of the taxpayer, from whatever geographical source derived, is subject to taxation. That premise is inappropriate for a model designed to govern the taxation of foreigners because the United States is not prepared to tax foreigners on income unless the income has some nexus with the United States.

Absent treaty limitations and possible constitutional limitations, the United States could impose its income tax on foreign taxpayers with respect to their worldwide income. To the extent that such a tax could be collected, it would provide the United States with a politically attractive source of revenue. In practice, however, the exercise of such jurisdiction would be unthinkable. To induce other sovereign states to accept limits on their exercise of tax jurisdiction, the United States must accept some reasonable restrictions on its own tax jurisdiction.

All international income tax agreements that limit the taxing powers of sovereign states rest on the following three pillars. First, a country can exercise residence jurisdiction only over its own residents and nationals. Second, a country can tax income under its source jurisdiction only if that income has some nexus with that country. Third, the country of residence must yield primary jurisdiction to tax to the country of source.

The United States is generally not in a position to ensure that the burdens ultimately imposed on foreign taxpayers are fair. Its fairness goal, therefore, must be modest. The United States can insist that

foreign taxpayers pay some taxes, and it can assist foreign governments in achieving their legitimate fairness goals. By exercising some restraint in taxing income derived from economic activity within its borders, the United States supports the fairness goals of foreign countries. It also supports those goals through Code provisions that prevent it from being a tax haven for taxpayers from certain foreign countries.

§ 1.03.2.3. Fairness to Corporations

The goals of the U.S. corporate income tax are unsettled. One apparent goal is to collect current tax on income earned by individuals and tax-exempt entities through their ownership of corporate stock. Putting a tax on corporations probably adds some progressivity to the federal tax system because wealthy individuals own a disproportionate percentage of corporate stock.

The concept of fairness, as understood in the context of a personal income tax, is not directly applicable to the design of a tax on corporations. Individual human beings are thought to have certain inalienable rights, including the right to equal treatment under the law. A corporation is merely a legal structure. Its fairness claims are derivative claims, based on the claims to fairness of their shareholders and of other individuals affected by the corporate tax.

In practice, the Code has applied to corporations the basic rules defining taxable income that are applicable to individuals. The special rules developed to govern corporate distributions, reorganizations, and the like are not explainable by reference to criteria applicable to the taxation of individuals. Even these rules, however, have been influenced by analogies to the tax treatment of individuals.

§ 1.03.3. Economic Efficiency Goal

Tax analysts should care about economic efficiency in the sense that they should prefer a tax system that is efficient to one that is inefficient. When economists discuss efficiency, they typically are referring to what is called “Pareto efficiency.” A tax measure achieves Pareto efficiency when it causes the welfare of at least one person to increase without a diminution in the welfare of any other person.

In the international tax context, tax analysts should care less about Pareto efficiency than they do in other contexts. Despite the attention that analysts have been giving to international tax issues in the last few years, they frequently are unable to offer reliable estimates of the Pareto-efficiency consequences of alternative international tax regimes. Given the current state of the economic art, any economic model that purports to measure the efficiency of alternative international tax regimes is going to be hopelessly flawed and subject to manipulation by its designers or sponsors.

In theory, efficiency deserves some weight and perhaps even controlling weight in some circumstances. The problem is that analysts often do not know when efficiency costs of particular international tax rules are high enough to be given significant weight, nor do they know how much weight to give efficiency concerns in particular circumstances. An efficiency principle obviously provides little guidance on the design of international tax rules when analysts do not have a sound basis for deciding when the principle should be applied or what weight to give it.

§ 1.03.3.1. Efficient Taxation of Residents

Commentators have often suggested that the efficient taxation of resident taxpayers (including citizens and domestic corporations) would be advanced by implementing the principle of “capital export neutrality.” According to this principle, a country should design its tax laws so that they are neutral as to whether investment is made domestically or abroad. The underlying logic of this principle is that in a market

economy, investors will tend to maximize the social rate of return on their capital if they are free to make their investments without respect to tax consequences.

Investors that maximize the social rate of return on their capital tend to maximize world welfare, although they may not maximize domestic welfare. Assume, for example, that PCo, a U.S. company, has $1,000 to invest. If it invests in Canada, it can expect to earn annual income before taxes of $100, whereas it can expect to earn only $90 annually if it invests in the United States. Assume that all of the benefits of PCo's after-tax profits enure to the benefit of the U.S. economy[11]and that PCo is subject to a tax on its profits in Canada at a rate of 35 percent. All else being equal, PCo would maximize worldwide welfare (and its own welfare) by investing in Canada. If it invests in the United States, however, it would increase domestic welfare by $90 (U.S. tax of 35% of $90 = $31.50 plus after-tax profit of $58.50), whereas the investment abroad would increase domestic welfare by only $65 ($100 profit minus $35 Canadian tax).

The example above assumed implicitly that the only cost to the United States from pursuing the goal of capital export neutrality was the lost tax revenue. In the real world, a country may suffer additional costs when its residents decide to invest abroad. For example, jobs might be exported along with the investment capital. If a country is more concerned—as most countries are—with maximizing domestic welfare than with maximizing worldwide welfare, it is difficult to understand why it would embrace the principle of capital export neutrality.

Although some bias in favor of domestic investment over foreign investment is rational, an unlimited bias is not. To illustrate, assume that PCo in the above example could earn $400 annually from its Canadian investment, for an after-tax return of $260 to it and to the United States. The domestic investment, however, would yield only $90 of benefits to the United States. All else being equal, therefore, the United States would benefit much more from the foreign investment than from the domestic investment.

In the real world, a country probably cannot follow a policy of favoring domestic investment over foreign investment in an aggressive manner without provoking a tax policy response from foreign countries. In some cases, the response would be sanctioned by treaties to which the United States is a signatory.

Assume, for example, that QCo is a Canadian company that has $1,000 to invest. It can earn a before-tax annual income of $100 by investing in the United States and a before-tax income of $90 by investing in Canada. Assuming that the United States and Canada have a 35 percent tax rate, the Canadian government would prefer that QCo invest in Canada for the same reason that the U.S. government wanted PCo, in the above example, to invest in the United States. If the United States takes measures to guarantee that PCo invests in the United States, Canada can be expected to take retaliatory action to guarantee that QCo invests in Canada. The result would be a loss of domestic welfare for both the United States and Canada and a loss in worldwide welfare.

The examples above assumed that countries could readily take effective action to favor domestic investment over foreign investment. That assumption is unrealistic. Few if any countries have demonstrable success in using tax measures to foster domestic investment in an efficient manner. Virtually all tax incentive programs have ended up serving political objectives rather than economic objectives. Thus the principle of capital export neutrality may be a worthy goal in practice notwithstanding its weak theoretical underpinning.

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[11] Politics aside, U.S. policy makers should not care whether U.S.-based multinationals enjoy greater success than their foreign competitors unless they believe that the U.S. economy benefits in some special way from that success.

Most proponents of capital export neutrality have viewed that principle as an injunction against tax preferences for foreign investment. Whether that principle adds to the case against such preferences is unclear. What is clear is that those preferences are unjustified on efficiency grounds. They clearly reduce worldwide welfare, all else being equal, and they clearly tend to reduce domestic welfare. The prevalence of those preferences in the Code is due almost entirely to the political power of the multinational companies that enjoy the benefits.

Commentators who favor tax preferences for foreign investment have asserted that "capital import neutrality" rather than capital export neutrality is the proper goal of U.S. international tax policy. In their view, residence-based taxation, which is a requirement of capital export neutrality, makes U.S.-based multinationals uncompetitive in foreign markets. This assertion is remarkable, given the overwhelming evidence that U.S.-based multinationals are extremely competitive in foreign markets. In addition, capital import neutrality cannot claim any support from economic theory. This ersatz principle amounts to little more than an assertion that business enterprises should be taxable exclusively in the country of source.

§ 1.03.3.2. Efficient Taxation of Foreigners

To achieve the goal of economic efficiency in taxing foreign persons, the U.S. government should seek to obtain some reasonable degree of tax parity between U.S. persons and foreign persons. Efficiency would suffer if the burdens on foreigners were too high because such burdens would discourage foreign persons from engaging in productive economic activity within the United States. Too low a burden on foreigners would give them an unwarranted competitive advantage over domestic taxpayers. Of course, full tax parity between foreign and domestic taxpayers is impossible to achieve because foreign taxpayers are not taxable by the United States on their income derived from foreign operations.

§ 1.03.4. Administrative Economy Goal

The U.S. international tax regime is so complex that outside observers might be led to conclude that administrative economy has played little role in the design of that regime. In fact, however, many of the major features of that regime have been driven by a desire to minimize compliance problems for the tax authorities and affected taxpayers. That is, administrative economy has been a goal of policy makers, notwithstanding the frequent failures in achieving that goal.

Of course, administrative issues have rarely gotten the attention they deserve. In most political battles over tax policy, the participants are usually willing to give up the goal of administrative economy before surrendering their core objective of lower or high taxes. Under the time pressures of a political battle, moreover, the participants often do not have the time needed to give administrative issues their due.

The withholding rules applicable to nonresident taxpayers are the most obvious example of international rules developed primarily to achieve administrative economy. Withholding at source is the most effective administrative technique yet developed for assessing and collecting income taxes. To facilitate assessment and collection of the tax on the investment income of foreign persons at the source, the United States generally imposes a flat-rate tax of 30 percent on gross investment income, without allowance for deductions properly allocable to such income. Obviously this regime is inconsistent with traditional fairness criteria and is not mandated by economic efficiency concerns.

§ 1.04. Scope and Organization of Book

The international tax rules addressed in this book determine the U.S. income tax consequences to foreign persons from engaging in investment or business activities in the United States. They also determine the U.S. income tax consequences to U.S. persons from engaging in similar activities abroad. Issues relating to the activities of individuals are addressed frequently in this book. The focus, however, is on the activities of corporations. International aspects of the taxation of partnerships, trusts, and estates receive only limited attention. Taxes other than income taxes are not discussed at all.

Chapter 2 of this part deals with the taxation of U.S. citizens. Chapter 3 deals with the taxation of individuals resident in the United States. The tax jurisdiction rules applicable to legal entities are addressed in chapter 4. Some planning problems are presented in Chapter 5.

Part 2 of this book describes the rules employed by the United States for taxing foreign corporations, nonresident alien individuals, and other foreign persons on income derived from economic activity conducted in whole or in part within the United States. Under the Code, the investment income and business income of foreign persons are subject to different tax regimes. In general, investment income is taxed at a 30-percent rate, with no allowance for costs of earning such income. Business income is not taxed unless the foreign person has established some minimum contacts with the U.S. economy. Foreigners having such contacts are taxed on a net basis under the tax rate schedules applicable to U.S. persons.

The rules developed by the United States for determining the source of income are presented in Part 3. Source rules are important to foreign persons primarily because foreign persons are subject to U.S. tax jurisdiction with respect to their U.S. source income. Those rules are important to U.S. persons earning transnational income primarily because the amount of the credit for foreign taxes that they can claim depends in part on the amount of their foreign source income. The general rule is that U.S. persons and foreign persons employ the same source rules. There is a growing list of exceptions, however, to the general rule.

The results reached under the Code for taxing foreign persons may be modified for persons residing in a country having a tax treaty with the United States. Tax treaty issues are addressed in Part 4. In general, foreign persons engaged in business in the United States are not taxable by the United States unless they have a fixed place of business or other permanent establishment located within the United States. In addition, only income attributable to that permanent establishment is subject to U.S. tax. Foreign persons earning investment income in the United States are often provided with a substantial reduction in the 30-percent withholding tax rate if they are resident in a treaty country.

The foreign tax credit is the subject matter of Part 5. In general, a U.S. person may claim as a credit against U.S. tax the amount of foreign income taxes that it has paid. U.S. corporations also may claim a credit for taxes paid by their a foreign affiliates. Complex limitation provisions apply to prevent perceived abuses of the credit. The limitation provisions were modified substantially by the 1986 tax act through the introduction of the so-called "separate basket" rules. These rules, in general, limit opportunities for taxpayers having excess foreign tax credits from obtaining additional foreign tax credits by shifting U.S. source income to foreign sources.

Part 6 presents the rules that the United States employs to limit the ability of taxpayers to minimize taxes by manipulating the prices charged to related parties on intercompany transfers. These rules apply to foreign persons and to U.S. persons. Under Code section 482, taxpayers are required to set their transfer prices equal to the amount that they would have charged in an arm's length transaction with an unrelated

party. Practical and theoretical problems arise in determining an appropriate arm's length price for transactions having no clear market analog. Transfer pricing issues have been much discussed over the past decade and a half. The Treasury Department issued regulations under section 482 in 1994 that replace the much less detailed regulations adopted in 1968. Perhaps stimulated by the U.S. initiatives, many other countries have refined their transfer pricing rules in recent years. The Organization for Economic Cooperation and Development ("OECD") issued a report in 1995 that provides substantial guidance to countries in refining their transfer pricing rules.

Many U.S. persons engaged in international commerce have sought to avoid the residence jurisdiction of the United States through the use of controlled foreign corporations (CFCs) organized in tax haven countries. The measures adopted by the United States to block such tax avoidance attempts are explained in part 7. Many of those measures are found in subpart F of the Code. Under the subpart F provisions, foreign corporations controlled by U.S. interests are deemed to have distributed to their U.S. shareholders the portion of their net profits deemed to have been deflected to a tax haven corporation. The subpart F provisions are supported by other anti-avoidance rules, such as, for example, the rules applicable to foreign passive investment companies (PFICs).

Chapter 2
Taxation of U.S. Citizens

§ 2.01. Citizenship: In the Courts

Cook v. Tait

265 U.S. 47 (1924)

Opinion of the Court (McKenna, Justice)

Action by plaintiff [Cook] . . . to recover the sum of $298.34 as the first installment of an income tax paid, it is charged, under the threats and demands of Tait [Collector of Internal Revenue for District of Maryland].

The tax was imposed under the Revenue Act of 1921, which provides by § 210 (42 Stat. 227, 233): "That, in lieu of the tax imposed by section 210 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 8 per centum of the amount of the net income in excess of the credits provided in section 216: *Provided*, That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 4 per centum."[12]

Plaintiff is a native citizen of the United States and was such when he took up his residence and became domiciled in the City of Mexico. A demand was made upon him by defendant [Tait] . . . to make a return of his income for the purpose of taxation under the Revenue Laws of the United States. Plaintiff complied with the demand, but under protest, the income having been derived from property situated in the City of Mexico. A tax was assessed against him in the sum of $1,193.38, the first installment of which he paid, and for it, as we have said, this action was brought.

The question in the case . . . is . . . whether Congress has power to impose a tax upon income received by a native citizen of the United States who, at the time the income was received, was permanently resident and domiciled in the City of Mexico, the income being from real and personal property located in Mexico.

Plaintiff assigns against the power not only his rights under the Constitution of the United States but under international law, and in support of the assignments cites many cases. It will be observed that the foundation of the assignments is the fact that the citizen receiving the income, and the property of which it is the product, are outside of the territorial limits of the United States. These two facts, the contention is, exclude the existence of the power to tax. Or to put the contention another way, as to the existence of the power and its exercise, the person receiving the income, and the property from which he receives it, must both be within the territorial limits of the United States to be within the taxing power of the United States. The contention is not justified, and that it is not justified is the necessary deduction of recent cases. In *United*

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[12] The following regulation, No. 62, promulgated by the Commissioner of Internal Revenue under the Revenue Act of 1921, provides in Article 3: "Citizens of the United States except those entitled to the benefits of section 262 . . . wherever resident, are liable to the tax. It makes no difference that they may own no assets within the United States and may receive no income from sources within the United States. Every resident alien individual is liable to the tax, even though his income is wholly from sources outside the United States. Every nonresident alien individual is liable to the tax on his income from sources within the United States."

States v. Bennett, 232 U.S. 299, the power of the United States to tax a foreign built yacht owned and used during the taxing period outside of the United States by a citizen domiciled in the United States was sustained. The tax passed on was imposed by a tariff act,[13] but necessarily the power does not depend upon the form by which it is exerted.

> "The sovereign power of the United States as a nation, in its scope and extent . . . is based on the presumption that government by its very nature benefits the citizen and his property wherever found."

It will be observed that the case contained only one of the conditions of the present case, the *property* taxed was outside of the United States. In *United States v. Goelet*, 232 U.S. 293, the yacht taxed was outside of the United States but owned by a citizen of the United States who was "permanently resident and domiciled in a foreign country." It was decided that the yacht was not subject to the tax — but this as a matter of construction. Pains were taken to say that the question of power was determined "wholly irrespective" of the owner's "permanent domicile in a foreign country." And the Court put out of view the situs of the yacht. That the Court had no doubt of the power to tax was illustrated by reference to the income tax laws of prior years and their express extension to those domiciled abroad. The illustration has pertinence to the case at bar, for the case at bar is concerned with an income tax, and the power to impose it.

We may make further exposition of the national power as the case depends upon it. It was illustrated at once in *United States v. Bennett* by a contrast with the power of a State. It was pointed out that there were limitations upon the latter that were not on the national power. The taxing power of a State, it was decided, encountered at its borders the taxing power of other States and was limited by them. There was no such limitation, it was pointed out, upon the national power; and the limitation upon the States affords, it was said, no ground for constructing a barrier around the United States "shutting that government off from the exertion of powers which inherently belong to it by virtue of its sovereignty."

The contention was rejected that a citizen's property without the limits of the United States derives no benefit from the United States. The contention, it was said, came from the confusion of thought in "mistaking the scope and extent of the sovereign power of the United States as a nation and its relations to its citizens and their relations to it." And that power in its scope and extent, it was decided, is based on the presumption that government by its very nature benefits the citizen and his property wherever found, and that opposition to it holds on to citizenship while it "belittles and destroys its advantages and blessings by denying the possession by government of an essential power required to make citizenship completely beneficial." In other words, the principle was declared that the government, by its very nature, benefits the citizen and his property wherever found and, therefore, has the power to make the benefit complete. Or to express it another way, the basis of the power to tax was not and cannot be made dependent upon the situs of the property in all cases, it being in or out of the United States, and was not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation

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[13] Section 37, Tariff Act of August 5, 1909, c. 6, 36 Stat. 11, 112, provided in part as follows: "There shall be levied and collected annually on the first day of September by the collector of customs of the district nearest the residence of the managing owner, upon the use of every foreign-built yacht, pleasure-boat or vessel, not used or intended to be used for trade, now or hereafter owned or chartered for more than six months by any citizen or citizens of the United States, a sum equivalent to a tonnage tax of seven dollars per gross ton."

as citizen to the United States and the relation of the latter to him as citizen. The consequence of the relations is that the native citizen who is taxed may have domicile, and the property from which his income is derived may have situs, in a foreign country and the tax be legal — the government having power to impose the tax.

Case Notes

Norman F. Dacey v. Comm'r, T.C. Memo 1992-187 (1992). Dacey "is an author. His book, *How to Avoid Probate!*, originally published in 1966 with updated versions published in 1980 and 1983, was a best seller and has sold over 2½ million copies." During tax years 1981 to 1985, he earned royalties totaling over $370,000. Appearing *pro se* before the Tax Court, Dacey sought to avoid U.S. tax on his royalty income primarily under Article VIII(1) of the U.S./Ireland income tax treaty. To claim benefits under the treaty, Dacey needed to establish that he was a citizen of Ireland and was not a citizen of the United States. Although he was a natural-born U.S. citizen, Dacey claimed that he had given up his U.S. citizenship in 1980 and had become a citizen of Ireland. He alleged that he had mailed a letter to the U.S. State Department renouncing citizenship on January 1, 1981, from Galway, Ireland, but no copy of the letter could be located. He applied for and received a U.S. passport in 1980 and 1985 — in both instances claiming to be a U.S. citizen. Throughout the 1980s, Dacey resided in Portacarron, Oughterard, in County Galway, Ireland. He formally renounced his United States citizenship on April 27, 1988, by appearing personally before the Vice Consul of the United States at the United States Embassy in Dublin, Ireland, and "signing both an Oath of Renunciation of the Nationality of the United States and a Statement of Understanding." The court held that Dacey was liable for U.S. income taxes and self-employment taxes on his royalty income. The negligence penalty imposed by the IRS was also upheld by the court.

Estate of Efthimios D. Vriniotis v. Comm'r, 79 T.C. 298 (1982). Vriniotis was a naturalized citizen of the United States who had returned to Greece (his country of birth) towards the end of his life. After he died, representatives of his estate argued that he was exempt from the U.S. estate tax under the U.S. tax treaty with Greece. The court held to the contrary. In discussing whether Vriniotis should be characterized as a U.S. citizen, the court observed that "[a]lthough the term 'citizen' is not defined in the estate tax statutes or regulations, it is defined in section 1.1-1(c), Income Tax Regs., as follows:

> (c) *Who is a citizen?* Every person born or naturalized in the United States and subject to its jurisdiction is a citizen. For other rules governing the acquisition of citizenship, see chapters 1 and 2 of title III of the Immigration and Nationality Act (8 U.S.C. 1401-1459). For rules governing loss of citizenship, see sections 349 to 357, inclusive, of such Act (8 U.S.C. 1481-1489), *Schneider v. Rusk*, (1964) 377 U.S. 163, and Rev. Rul. 70-506, C.B. 1970-2, 1. . . .

The court went on to state that "[t]he courts have consistently held that United States citizenship implies not only rights but also duties, one of which duties is the payment of taxes. *United States v. Rexach*, 558 F. 2d 37, 42 (1st Cir. 1977); *United States v. Matheson*, 532 F. 2d 809, 819 (2d Cir. 1976), cert. denied 429 U.S. 823 (1976); *Rexach v. United States*, 390 F. 2d 631, 632 (1st Cir. 1968), cert. denied 393 U.S. 833 (1968). In *Cook v. Tait*, 265 U.S. 47 (1924), the Supreme Court held that a United States citizen domiciled in Mexico with no assets or income from sources within the United States nevertheless was liable for United States income tax. The Court reasoned that since the United States government benefits its citizens and their property wherever found, its power to tax them is based on their relation to it as citizens and not on their domicile or on the situs of their property. 265 U.S. at 56."

Felix Benitez Rexach v. United States

390 F.2d 631 (1968)

Opinion of the Court (Aldrich, Chief Judge)

Felix Benitez Rexach, hereafter taxpayer, a native-born Puerto Rican, became an American citizen by virtue of the Jones Act of March 2, 1917, 48 U.S.C. § 731 et seq. In 1944 he left Puerto Rico and became a resident of the Dominican Republic, where he remained until 1961. In July 1958 he executed a written renunciation of his American citizenship before a United States consulate official in the Dominican Republic pursuant to the Immigration and Nationality Act of 1952, 8 U.S.C. § 1481 (a)(6). A certificate of loss of nationality was duly approved by the Department of State. On July 26 taxpayer was decreed to be a citizen of the Dominican Republic. Thereafter, he naturally suffered certain losses of status and benefits as a consequence of being declared a non-resident alien of the United States.

Taxpayer was engaged in large scale contracting activities in the Dominican Republic in connection with the then dictator, Trujillo. In 1961 Trujillo was assassinated. The following year taxpayer applied for an American passport, claiming that his 1958 renunciation was not voluntary but had been compelled, against his will, by economic pressure and physical threats that he feared to resist. The United States Consul denied his application, and taxpayer appealed to the Department of State. The Board of Review on the Loss of Nationality took taxpayer's testimony and accepted it, as a result of which his certificate of loss of nationality was cancelled, and his passport application granted. There followed the present chapter. The Commissioner of Internal Revenue assessed taxpayer with an income tax on account of income earned in the Dominican Republic during the years following his renunciation of citizenship, alleged to be due because of his continued American citizenship. *Cook v. Tait*, 265 U.S. 47 (1924), 44 S. Ct. 444, 68 L. Ed. 895. Taxpayer not responding, the present suit was brought to foreclose liens in payment of such taxes. Taxpayer moved, unsuccessfully, for summary judgment on the claim that no taxes could be due.

> "Taxpayer applied for an American passport, claiming that his 1958 renunciation . . . had been compelled . . . by economic pressure and physical threats that he feared to resist."

Taxpayer concedes that as a matter of law he is precluded by the record from claiming that he ever ceased to be a United States citizen, and concedes that during the period in question he was a de jure citizen. However, he says that he was not a "de facto" citizen.

> "Appellant does not claim that his citizenship was lost as a result of the renunciation, but that as a result of the determination of the Secretary of State and consequent issue of the Certificate of Loss of Nationality, the United States was freed of its obligations to him as a citizen and he in fact lived and existed as an alien to the United States during the period in question."

He concludes that since the United States "owed" him, or apparently owed him, no citizen's protection, he, in turn, owed no tax.

While there is language in *Cook v. Tait*, supra, indicative that these are reciprocal obligations, the Court also observed that "government by its very nature benefits the citizen * * *." 265 U.S. at 56, 44 S. Ct. at 445. We cannot agree that the reciprocal obligations are mutual, at least in the sense that taxpayer contends. It is sufficient that the government's stem from its de jure relationship without regard to the subjective quid pro

quo in any particular case. We will not hold that assessment of benefits is a prerequisite to assessment of taxes.

§ 2.02. Taxation of U.S. Citizens

The United States imposes an income tax on the worldwide income of those individuals owing it allegiance as citizens or residents.[14] In general, a citizen is a person who was born or naturalized in the United States.[15] An alien individual is someone who is not a U.S. citizen.

Most countries do not follow the U.S. rule of imposing worldwide taxation on native-born and naturalized citizens. For many years, the Philippines employed a citizenship rule, having adopted it while a colony of the United States. So also did Mexico. Albania, Bulgaria, and some of the other states of Central Europe adopted a citizenship rule during the socialist era. The current trend in Central Europe, however, is to abandon a citizenship test so as to conform with the practices of the European Union.

Many countries use citizenship as a positive factor in determining whether an individual is a resident. Bilateral tax treaties typically use citizenship as one of the tie-breaker tests in determining the residence for treaty purposes of an individual who otherwise would be a resident in both treaty countries.[16]

In general, a U.S. citizen may avoid U.S. citizenship jurisdiction by renouncing citizenship in accordance with the formal procedures established by the State Department (in a foreign country) or by the Justice Department (in the United States) or by performing "an expatriating act" within the meaning of the Immigration and Nationality Act.[17] Informal renunciation is not enough.[18] Individuals who lost their citizenship and had it retroactively restored prior to 1993 may obtain tax relief for the period they appeared not to be citizens under rules and procedures established by the Internal Revenue Service.[19]

To reduce the tax benefits otherwise obtainable from renouncing U.S. citizenship, Code section 877A provides that U.S. citizens holding significant amounts of assets who give up their citizenship are taxed when they exit from the United States on the difference between the fair market value of their assets and their basis in those assets. This mark-to-market rule was adopted in 2008 because of difficulties in applying the prior rules under section 877.[20] A similar rule applies to certain individuals who forfeit their U.S. permanent residency status. Under the rule, an individual entitled to a large pension from activities performed while a U.S. citizen or long-term permanent resident would not be able to avoid tax on the pension income by renouncing U.S. citizenship or residence status. Although the tax would be assessed at th time of exit from the United States, the payment of the tax might be deferred. Section 877 had sought to achieve a similar result by altering the source rules for a 10-year period for taxpayers who renounced their citizenship or

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[14] Reg. § 1.1-1(b) (2008).

[15] See Reg. § 1.1-1(c) (2008).

[16] See, e.g., U.S./Spain treaty, Art. 4(c).

[17] Section 8, 8 U.S.C. § 1481 (Matthew Bender, 2009).

[18] See, e.g., *Darcy v. Comm'r,* TC Memo 1992-187, 63 TC.M 2584 (1992).

[19] See Rev. Rul. 92-109, 1992-2 C.B.3.

[20] For a criticism of the rule of IRC § 877for taxing individuals as citizens who are not citizens under federal law, see Michael S. Kirsch, "The Tax Code as Nationality Law," 43 HARVARD JOURNAL ON LEGISLATION 375 (2006) (objecting on the ground that the rule violates customary international law).

long-term residence status for tax avoidance reasons. Section 877 continues to apply to individuals who renounced U.S. citizenship or long-term residence status prior to the adoption of section 877A.

The United States unilaterally surrenders much of its jurisdiction to tax nonresident citizens working abroad under Code section 911. For 2002 and thereafter, that section allows U.S. citizens having a substantial foreign presence to exclude up to $80,000 of earned income from U.S. taxable income.[21] Certain foreign housing expenses are also made nontaxable under section 911.[22] For 2006, approximately 50 percent ($18 billion out of $37 billion) of foreign source earned income reported by American citizens was exempt from tax under Code section 911.[23]

U.S. income tax treaties include a so-called Saving Clause that allows the United States, with some exceptions, to tax its citizens and residents as if the tax convention had not gone into effect.[24] For example, a U.S. citizen residing in Canada is not entitled to a reduced withholding rate under the U.S./Canada tax treaty on dividends he receives from the United States. A few treaty benefits, such as exemption for government pensions, are available notwithstanding the Saving Clause. Many treaties extend the Saving Clause, for a ten-year period, to cover former citizens who gave up citizenship to avoid tax.[25]

Compared to a residence test, a citizenship test is remarkably easy to administer. Most taxpayers rarely change their citizenship status, and then only with some ceremony. The only significant administrative problem with the test is that it commits the tax authorities to collect tax from nonresident citizens who have long absented themselves from their home country. Few countries have the administrative resources to pursue such taxpayers effectively, and most do not have the inclination to do so. The United States is the exception on both counts.

A country could obtain many of the administrative benefits of a citizenship rule by establishing the presumption that a citizen is a resident taxpayer under certain circumstances. The presumption might apply, for example, unless the citizen showed that he was absent from the country for an extended period and had established residency in a foreign country.

Questions

1. Should it matter, in deciding whether a taxpayer ought to be taxable by the United States, whether that taxpayer has received a benefit from the United States? Can the "presumption" of benefit mentioned in *Cook v. Tait* be rebutted? Or is the actual or potential benefit irrelevant? If benefits matter, must the tax be proportional in some way to the benefit? How might that goal be achieved? Does the U.S. Constitution require *any* benefit link? What provision, if any? Is it enough for constitutional purposes if the government shows that some taxpayers in comparable circumstances might receive a benefit? What is the gloss put on *Cook v. Tait* by *Rexach*?

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[21] IRC § 911(b)(2)(D). For taxable years beginning after 2007, the $80,000 is adjusted for inflation. Id.

[22] [21]IRC § 911(c). The housing exemption is also indexed for inflation.

[23] See Scott Hollenbeck and Maureen Keenan Kahr, "Individual Foreign-earned Income and Foreign Tax Credit, 2006," 29 *SOI Bulletin* 54-84 (Spring 2009), at 54.

[24] See, e.g., U.S. Model Treaty (2006), Art. 1(3).

[25] See, e.g., U.S./Spain treaty, Protocol to Art. 1(3).

2. *Cook v. Tait* simply affirms the constitutional power of the federal government to tax U.S. citizens living abroad. Should the federal government exercise that power? Always? Is it appropriate, for example, for the United States to tax the American spouse of a British citizen and resident living permanently in England? What about American citizens living for short periods abroad? What about American living in Canada or Mexico? What about American citizens working in the diplomatic service abroad? See Code sections 911 and 912.

3. There is nothing despotic about taxing citizens living abroad, in that the power to tax is grounded on the assent of the citizen through his allegiance to the U.S. government. Is it also appropriate to tax U.S. resident aliens who are living abroad for some period?

4. How should individuals who have repudiated their U.S. citizenship be taxed? Assume, for example, that a wealthy American writer gives up her U.S. citizenship and becomes a resident of Ireland, or some other tax haven? Should it matter what the source of the taxpayer's income is? See Code section 877.

5. The list of countries using citizenship as a basis for asserting tax jurisdiction is pretty short. The main country is the United States. The list once included Mexico, the Philippines, Bulgaria, and perhaps a few other former communist states of Eastern Europe. Why is the list so short, and why did countries that once used citizenship abandon it? Is residency a superior or a complimentary basis for taxation? Note that citizenship is sometimes used as a tie-breaker in determining residence under a tax treaty. See Article IV(2)(d) of the U.S./Canada income tax treaty.

Chapter 3
Residence Jurisdiction over Alien Individuals

§ 3.01. Historical Development

Prior to the revision of Code section 7701(b) in 1984, which introduced certain objective tests of residence, the residence status of an alien individual was determined under a "facts and circumstances" test. This test is still applicable in determining the residence of U.S. citizens and in determining the residence of alien individuals when the objective tests are inapplicable. The following case illustrates the operation of the facts and circumstances test. The test was difficult to apply in many cases, which is why Congress chose to replace it in many cases with more objective tests. The case also provides a helpful fact pattern for discussion of the operation of the objective tests.

Park v. Comm'r

79 T.C. 252 (1982), aff'd without opinion 755 F2d 181 (1985)

Editor's Summary of Facts

The Commissioner determined a deficiency in Tongsun Park's Federal income tax and an addition to the tax for failure to pay estimated tax (under Code section 6654) for each of the years 1972, 1973, 1974, and 1975. The only issue in the case is whether Park (petitioner) was a resident or nonresident alien during the years in question.

"Petitioner was born on March 16, 1935, in the City of Sinchang, County of Sunchun, which is now part of the Peoples Republic of Korea (North Korea). He is, and at all relevant times has been, a citizen of the Republic of Korea (South Korea). Petitioner has never filed a declaration of intention to become a citizen of the United States and has never filed a Form 1078 ("Certificate of Alien Claiming Residence in the United States"), or its equivalent, as referred to in section 1.871-4(c)(2), Income Tax Regs. Petitioner has at all times traveled only under passports issued by Korea."

From 1952 to 1954, Park attended high school in the United States, and from August of 1956 to June of 1963, he attended college at Georgetown and Fordham. During most of that period, Park held an F-1 (student) visa. After his schooling was completed, Park was granted a B-2 (temporary visitor for pleasure) visa and an extension of stay until August of 1963.

"After the expiration of his B-2 visa in 1963, petitioner was issued a B-1 (temporary visitor for business) visa at least as early as August 28, 1964. The expiration date of this visa, and whether it was a single or multiple entry visa, is not shown on available records. On September 4, 1968, petitioner was issued a multiple entry E-2 (Treaty investor) visa, and between that date and the latter part of 1971 he was in the United States on numerous occasions." * * *

"Petitioner was issued a multiple entry E-2 visa on October 27, 1971, and he was issued another multiple entry E-2 visa on August 10, 1972. The expiration dates of these visas are not shown on available records. On July 10, 1973, petitioner was issued a multiple entry B-1 visa which was valid through July 9,

Table 1
Days Spent by Tongsun Park in the U.S. and Korea, 1972-1975

Year	Number of Days	
	U.S.	Korea
1972	180	159
1973	199	109
1974	198	95
1975	161	79

Counting the day of entry but not of departure.

1977. Pursuant to these three visas, petitioner entered and departed the United States during the period from December 18, 1971 through January 3, 1976 . . . [on many occasions.]"

The total number of days that Park spent in the United States and Korea during each of the years in question is shown in table 1.

"In the early 1960's, petitioner began organizing, financing, and managing, directly or through employees, business and investment activities in the United States. These activities continued at an increasing rate throughout the years in question. . . ."

"At approximately the same time that petitioner began pursuing business and investment activities in the United States, he became involved with similar activities in

Korea. As in the case of his activities in the United States, petitioner's business and investment activities in Korea continued at an increasing rate throughout the years in question."

* * *

"From February 10, 1961 through June 26, 1963, when in Washington, D.C., petitioner lived in a rented townhouse located at 3059 Q Street, N.W. On June 26, 1963, petitioner purchased a three-story brick house at 1713 22d Street, N.W., Washington, D.C. (the 22d Street house) for $60,000. To make this purchase, petitioner assumed a $15,000 mortgage on the property and secured a $45,000 mortgage loan on the property from the Washington Permanent Bank. The house was elegantly furnished, and petitioner maintained a valuable collection of art objects, which he had brought to the United States from Korea, in the house. At least as early as 1968, petitioner employed a housekeeper, a full-time cook, and a chauffeur at the 22d Street house. On June 3, 1976, . . . the house was sold . . . for $165,000. . . ."

"From October 1, 1971 to October 24, 1972, petitioner leased a house located at 1825 24th Street, N.W., Washington, D.C. (the 24th Street house), in [which] he stayed when in Washington, D.C., for a rental of $1,800 per month. . . . On October 24, 1972, petitioner purchased a house located at 2211 30th Street, N.W., Washington, D.C. (the 30th Street house), for $270,000. . . . The house contained two stories and a basement comprising a living room, dining room, study, powder room, kitchen, pantry, sitting room, dressing room, wine room, laundry room, and several bathrooms and bedrooms. The house was in need of certain improvements, and petitioner did not move into it until sometime in 1973. . . . Petitioner sold the house on June 19, 1978, for $520,000." * * *

"On December 5, 1975, petitioner purchased a large three-story house located at 2850 Woodland Drive, N.W., Washington, D.C., for $480,000. He continued to own this property through at least the end of 1977. Petitioner had planned to renovate this house and install an indoor pool, but he never occupied the house." * * *

"From November 30, 1960 through December 1974, when in Korea, petitioner usually stayed with his mother at the Park family home located at 79-6, Kahae-Dong, Chongro-Ku, Seoul. Petitioner maintained a bedroom at the family home in which he kept clothing, personal effects, and a portion of his art collection. The family maintained a household staff consisting of a driver, a cook, a gardener, a doorman, a seamstress, and a cleaning lady . . . ."

"From March 1969 through at least December 1972, petitioner leased a villa at a resort owned by the government of Korea. Petitioner sometimes stayed at the villa when in Korea, but he used it primarily for entertainment purposes. Petitioner kept some personal property at the villa, including clothing and a few works of art. He employed a butler and a cleaning lady at the villa. . . ."

"In late 1974, petitioner, his mother, and [a family corporation] jointly acquired a 22-acre estate (the Hang-Dong estate) for approximately $817,000. This property, which petitioner and the co-owners continued to own at least through the time of trial, consists of a main house, a guesthouse, a swimming pool, a large cabana, a tennis court, a guard house, and an orchid greenhouse and related laboratory facilities.

Following the acquisition of the Hang-Dong estate, petitioner maintained personal effects and a portion of his art collection at both the Hang-Dong estate and the Park family home. When petitioner was in Korea, he spent weekends with his mother at the family home, and she spent part of her time with him at the Hang-Dong estate. A household staff consisting of three gardeners, a cook, a cleaning lady, a butler, a driver, and two security guards was maintained at the Hang-Dong estate." * * *

"Beginning in 1975, petitioner maintained a permanent staff, including a houseman, a cook, a cleaning lady, a gardener, and a security guard, at a house that he owned in the Dominican Republic. Petitioner visited this house no more than twice during each of the years 1975 and 1976 . . . ."

"In 1976, when in London, petitioner stayed at a townhouse owned by one of his corporations and used in part for offices. Petitioner maintained personal effects and a portion of his art collection at the townhouse. He employed a staff of three at the London townhouse, including a butler, a housekeeper, and a chauffeur." * * *

"Petitioner was not employed by the Korean government or by any agency thereof during the period 1968 through 1975. He has never run for an elected office in Korea and has never been appointed to any office by the Korean government. During the years in question, he voted in the Korean presidential and parliamentary elections. He also voted on a referendum in Korea during those years." * * *

"During July 1976, the Public Integrity Section of the Criminal Division of the United States Department of Justice empaneled a Grand Jury to investigate the legality of certain payments allegedly made by petitioner to various Congressmen. Petitioner complied with numerous

Tongsun's Taxes

Among other things, Korean entrepreneur Tongsun Park has been accused of being an influence peddler and a Korean CIA agent, and of passing money to U.S. congressmen. Last week one more allegation was dropped into the hopper: that he owed the U.S. Government an enormous sum of money. The Internal Revenue Service filed a tax lien against Park's property, alleging that he owed $4.5 million in back taxes, interest and penalties for the years 1972 through 1975. During that period, Park allegedly spent at least $500,000 a year on cultivating, entertaining and giving gifts to members of Congress. The IRS claimed that he owed $2.1 million in taxes and penalties for 1974 alone — the year in which South Korea purportedly tried to influence the U.S. Congressional elections. Park was said to be in London last week, and he had no comment on the IRS move. But recently he told associates that it was not in his "best interests" to return to the U.S. at present.

requests for documents in his possession and, in September 1976, he attended a conference at the Department of Justice at which he was informed of the purpose of the Grand Jury investigation. . . ."

"An indictment against petitioner was handed down on August 26, 1977, charging him with various violations of Titles 18 and 22 of the United States Code. On January 11, 1978, petitioner entered into an agreement of cooperation with the Department of Justice, as a result of which the indictment against him was dismissed." * * *

"Under Korean law, residents of Korea are taxable on their worldwide income, against which may be credited the payment of foreign income taxes. Nonresidents of Korea are taxable only upon Korean source income. Wages and salaries payable by a Korean corporation are subject to withholding taxes. A resident of Korea who receives income from a non-Korean person or entity is required to file a Korean income tax return reporting such income . . . ."

"Petitioner has not taken the position that he is a nonresident of Korea or that his income is not Korean source income. Korean income taxes on the amounts that petitioner received from Korean corporations were withheld and paid by those corporations. With respect to [other amounts of income earned] petitioner did not pay income taxes to Korea or any other country. Petitioner did not file individual income tax returns with any country during the years 1970 through 1976. Petitioner has never filed an individual income tax return in the United States."

Opinion of the Court (Featherstone, Judge)

The issue for decision is whether petitioner, an alien, was a resident of the United States for income tax purposes during the years in question. A resident alien is taxable on all income from whatever source derived; on the other hand, a nonresident alien is taxable only on income derived from sources within the United States. Secs. 871 and 872; secs. 1.1-1(b) and 1.871-1(a), Income Tax Regs. Because petitioner had income that was not derived from United States sources, he is taxable on such income only if he was a resident of the United States during 1972 through 1975.

The issue of residency is factual and must be resolved through a consideration of all the relevant facts and circumstances. *Adams v. Commissioner*, 46 T.C. 352, 358 (1966); *Jellinek v. Commissioner*, 36 T.C. 826, 834 (1961). Because the determination of residency depends so heavily upon the unique personal circumstances of the taxpayer, one case does not always provide reliable guidance for the decision of another. For this reason, the cases relied upon by the parties are of limited value here.

As general guidelines for making the determination of residency, the regulations (sec. 1.871-2(b), Income Tax Regs. provide that an alien actually present in the United States "who is not a mere transient or sojourner" is a resident of the United States for income tax purposes. Whether he is a transient is determined by his "intentions with regard to the length and nature of his stay." One who comes to the United States "for a definite purpose which in its nature may be promptly accomplished" is a transient; but if his purpose is of such a nature that "an extended stay may be necessary for its accomplishment" and to that end the alien "makes his home temporarily in the United States," he becomes a resident even though he may at all times intend to return to his domicile. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States "in the absence of exceptional circumstances." Sec. 1.871-2(b), Income Tax Regs. In applying these guidelines, an alien, by reason of his alienage, is presumed to be a nonresident, but that presumption is a rebuttable one.

To these general guidelines, it may be added that the term "resident" does not have the same meaning as "domicile," but to be a resident "does require that the taxpayer have some degree of permanent

attachment for the country of which he is an alien." *Jellinek v. Commissioner*, supra at 834. In other words, some permanence of living within borders is necessary to establish residence. *de la Begassiere v. Commissioner*, 31 T.C. 1031, 1036 (1959), affd. per curiam 272 F.2d 709 (5th Cir. 1959). One may be a resident of more than one country, *Marsh v. Commissioner*, 68 T.C. 68 (1977), affd. per order 588 F.2d 1350 (4th Cir. 1978), and neither the termination nor the abandonment of a residence in another country is considered a prerequisite to a finding of United States residence. [Citations omitted.]

Focusing on the definition of residence contained in the regulations, petitioner contends that he was a "mere transient or sojourner" and not a resident for tax purposes. He argues that the record establishes that he made a series of visits to the United States during the years in question and that each visit was for definite purposes which could be and were promptly accomplished. In further support of his position, petitioner asserts that he had extensive business and personal ties to Korea, and a deep, continuing involvement in his Korean community, which were irreconcilable with a "mere floating intention, indefinite as to time," to return to Korea. Further, petitioner emphasizes that each of his stays in the United States was limited by the immigration laws, and he contends that the record does not demonstrate the "exceptional circumstances" contemplated by the regulations as necessary to support a finding of residency in the face of such limitations. Finally, petitioner argues that respondent has failed to overcome the rebuttable presumption of alien nonresidence set forth in section 1.871-4, Income Tax Regs. * * *

Respondent takes the position that the record clearly shows that petitioner was a resident of the United States during the years 1972 through 1975.[26] He disputes petitioner's contention that the record establishes petitioner's presence in the United States for "definite" purposes susceptible of "prompt" accomplishment. Respondent argues that, at best, the evidence relied upon by petitioner indicates dual or multiple residence but does not detract from his obvious relationship with the United States.

"We think the duration and nature of his presence in this country, as evidenced by his deep and continuing involvement in business, personal, social, and political affairs, were sufficient to establish . . . residency."

Petitioner's case was well tried and briefed, and handled with professionalism, but in the final analysis, we think the record requires that respondent's position be sustained. It is true that petitioner came to the United States on visas that technically limited his stays, and he was frequently absent from the United States. Because of the international character of some of his business activities, however, he did not stay continuously in any country. We think the duration and nature of his presence in this country, as evidenced by his deep and continuing involvement in business, personal, social, and political affairs, were sufficient to establish the kind of attachment and relationship to this country that constitutes residency within the meaning of the regulations under section 871. Therefore, in the light of all the facts, we hold that petitioner was a resident of the United States during 1972, 1973, 1974, and 1975.

[26] Part of respondent's argument on brief was that petitioner became a resident of the United States long before 1972 and did not abandon his residence in this country until he departed under the cloud of a Federal indictment in 1977. In this connection, see sec. 1.871-5, Income Tax Regs. Although the facts with respect to petitioner's pre-1972 connection with this country are relevant to our inquiry, we find it unnecessary to decide whether petitioner acquired residence in the United States at some time prior to 1972. . . .

In reaching this conclusion, we begin with the fact that, when petitioner was in the United States during 1972 through 1975, he was not a stranger in an alien land. He had spent a large part of the immediately preceding 20 years in this country. He had completed high school, attended the College of Puget Sound and Fordham University, and graduated from Georgetown University in June 1963 with a Bachelor of Science Degree in Foreign Service. During this period, petitioner became a part of the Washington, D.C., community. From 1968 and extending through 1977, for example, he was listed in the "Social List of Washington, D.C.," popularly known as the Green Book, a compendium of socially prominent individuals in Washington, D.C. He had a host of friends whom he entertained frequently, and he often attended social functions given by others. His United States business interests were growing. Petitioner's extended stay in the United States during this pre-1972 period gave him an opportunity to obtain an excellent facility in the English language, an acquaintanceship with many American people, and an understanding of this country's social, political, and cultural fabric. During 1972 through 1975, the years here in question, petitioner did not live as a "transient or sojourner" intending to stay for only a temporary period. Throughout those years, petitioner spent a good deal more time in the United States than anywhere else in the world, and he spent increasingly less of his time in Korea. During all 4 years he owned his own home in Washington, D.C., and home ownership reflects a degree of permanent attachment to, and integration into, the community.

As early as 1963, petitioner had bought a three-story brick house on 22d Street, and he continued to own it until June 1976. From October 1, 1971 to October 24, 1972, because the entertainment facilities in the 22d Street house had become inadequate for his purposes, he rented a larger house on 24th Street for $1,800 per month. On October 24, 1972, petitioner purchased the house on 30th Street which he owned through June 19, 1978. In this house, he made extensive renovations, including the installation of a $20,000 central music system. He furnished the house elegantly with items from the 22d Street house and with newly acquired furnishings. At least as early as 1968 and through the years in question, petitioner employed a staff of servants for these houses. On December 5, 1975, he bought still another house, a three-story residence on Woodland Drive which he owned through 1977. He had planned to install an indoor pool and make other renovations in this house, but he never actually occupied it.

Not only was petitioner's style of living inconsistent with that of a transient or sojourner, his investment and business activities reflect with equal clarity an on-going attachment to and relationship with this country. . . . In fact, Washington, D.C., became the center of his business activity. The houses which served as petitioner's living quarters alone represented large investments of capital and credit, and some of the houses were sold for large gains. . . . A transient or sojourner present in the United States for a purpose which could be promptly accomplished would hardly be expected to make such large commitments, particularly for personal living quarters.

In addition to making large residential investments, petitioner also, as detailed in our findings, engaged in extensive business activities within the United States which were consistent only with an extended stay in this country. In 1965, through his controlled corporation, Suter's, he had purchased the valuable 1530 property on Wisconsin Avenue, N.W., giving a $325,000 first mortgage. Petitioner became one of the prime movers, along with various social and political leaders in Washington, in the promotion of the George Town Club, which he used as one of the centers of his extensive social life in Washington, D.C. Suter's leased the 1530 property to the George Town Club under a 25-year lease scheduled to expire August 31, 1990. As Suter's controlling shareholder, petitioner thus established what could only have been intended to be a substantial long-term business connection with this country. This connection was not merely a capital investment; Suter's was not only entitled to rent, but it also operated the restaurant and bar in the George Town Club. And, in 1971, Suter's and petitioner leased property adjoining the 1530 property and then

subleased it to the club for expansion of its operations. Although petitioner did not concern himself with Suter's day-to-day operations, he made the major financial decisions, including the acquisition of equipment, furniture, and real property throughout the years here in controversy.

Perhaps petitioner's most extensive business undertakings in this country, however, were carried out through his wholly owned PDI which, as noted in our findings, was "fundamentally an extension of its taxpayer-owner." *Valley Finance, Inc. v. United States*, 629 F.2d 162, 173 (D.C. Cir. 1980). Its business, in part, was to serve as a matchmaker and consultant to various American firms interested in trade in Korea and Formosa. In addition, it invested large sums in the United States. . . .

Although petitioner was PDI's president and sole shareholder, he seeks to dismiss its extensive business activities on the ground that he only furnished capital while his agents and employees made all the decisions. Based on a review of PDI's operations, however, the Court of Appeals for the District of Columbia in *Valley Finance, Inc. v. United States*, 629 F.2d at 172, rejected that view:

> Despite protestations in the record, there is no evidence that a major corporate decision was ever made by anyone other than Park [petitioner in the instant case]. The Board of Directors played no meaningful role. There is serious doubt as to whether a Board existed at all prior to December, 1974. After that date, directors met infrequently. When they did meet, Board members approved corporate decisions and policies without discussion or question. * * * Individual officers performed ministerial functions at the behest of the president. They exercised no significant discretionary authority. * * *

Similarly, the record here refutes petitioner's disavowal of any real involvement in PDI's business. It is clear that PDI's activities could have been conducted only by one with a continuing relationship with this country — in this country on an extended stay for purposes which could not be promptly accomplished. Petitioner's most lucrative business activity was his representation of Connell Rice, a New Jersey corporation that sold rice to Korea and other countries. As explained in our findings, he received over $40,000 from that company in 1970. He then lost favor with the Korean government and was not employed by Connell Rice in 1971. However, petitioner revitalized his relationship in 1972, and during the years in question petitioner or his designees received sums from Connell Rice totaling approximately $8.5 million. One big factor enabling petitioner to reestablish his relationship with the Korean government in 1972, according to his testimony, was the intervention at his request of powerful United States politicians. Maintaining good relationships with those United States political figures was thus important to this ongoing business activity in case he should need again to use this country's political processes and power. Certainly, the cultivation of such political relationships in this country could not be accomplished by a transient or sojourner. Our findings detail some of petitioner's other extensive business dealings, including his investment in the Pisces Club and the M Street Corporation, involving hundreds of thousands of dollars in loans and loan guarantees.[27] Such deep involvement in business, as well as social and political, activities is wholly inconsistent with the status of a mere transient or sojourner.

Petitioner's main argument is based on that portion of the regulation . . . which provides that an alien individual who comes to the United States for a definite purpose, which in its nature may be promptly accomplished, is a transient and not a resident of the United States. Petitioner states on brief that he made

[27] We do not intend to suggest that mere investment in a country by an alien constitutes residency. However, as we have discussed, it is important that the nature and breadth of petitioner's business and investment activities in the United States were such as to require continuous attention.

36 "trips" to the United States during 1972 through 1975 and stayed an average of 22 days on each "trip," the longest stay being 50 days and the shortest 4 days. Based on his testimony as to the purpose for each trip, petitioner asks us to find that the purpose of each trip could be accomplished promptly and that, therefore, under the regulation, he was not a United States resident. Respondent counters with the argument that in the years 1972 through 1975 petitioner made a series of "trips" to Korea for purposes which could be promptly accomplished, most of which were for 5 days or less, and spent considerably more time in the United States than in Korea.

We have not made the findings requested by petitioner because we think petitioner had longterm ties to this country which explain his extended presence. We are not convinced that the purposes he gave for his presence in the United States were the exclusive or dominant ones. For example, in none of petitioner's testimony on his purposes nor in the related requested findings is there any reference to the myriad business problems and decisions he dealt with in this country.

* * *

Businessmen do not enter into transactions of such magnitude without advance planning, forethought, analyses, appraisals, and comparisons. It will not do to say that one as highly intelligent, money oriented, and status conscious as petitioner left all of his business decisions to his employees and advisors. As pointed out above, the Court of Appeals for the District of Columbia in *Valley Finance, Inc. v. United States, supra*, rejected that argument with respect to PDI, and we reject it here. Petitioner may have left the ministerial details to his employees, but he made the important decisions. We think these business activities and the subsequent continuous management problems related to his investments, as well as the promotion and protection of his Connell Rice-Korean government connection, tied him to the United States. We do not think that the statute was intended to relieve aliens who engage in business and other activities as extensively as did petitioner. The length and nature of his presence in this country made him a resident.[28]

Petitioner, however, emphasizes that, during 1972 through 1975, he was present in the United States on E-2 (Treaty investor) or B-1 (temporary visitor for business) visas which, under the immigration laws, limited his stay to "a definite period." In this connection, he argues that under the last sentence of section 1.871-2(b), Income Tax Regs. . . . he was not, therefore, a resident of the United States. That sentence states, in part, that an alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States. Significantly, however, that provision applies only in the "absence of exceptional circumstances," and we think the facts here show exceptional circumstances.

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[28] In *Commissioner v. Nubar*, 185 F.2d 584 (4th Cir. 1950), rev'g. 13 T.C. 566 (1949), the taxpayer came to the United States on Aug. 1, 1939, on a 3-month visitor's visa which, on application was extended to Dec. 31, 1940. In Jan. 1941, he was arrested and ordered deported; appeals of that order culminated in an order that he leave the United States within 90 days after termination of hostilities in Europe. Prior to his departure, he traded extensively in stocks and bonds during 1941 through 1945. Holding that, despite the deportation order, he was a resident alien, the court said (185 F.2d at 586):

> We find nothing in the law or in the facts to justify the exemption of this alien, who had lived in our country during the war years because of the difficulties and dangers of departure, and who had availed himself of his presence here to make a fortune by trading on our exchanges, from taxes required of others by the country whose protection he had enjoyed and whose economic organization he had utilized for his profit. * * * Whether taxpayer was a non-resident within the meaning of the statute is to be determined not in vacuo, but with reference to the purpose for which the statute was passed, which was to exempt from taxation, except as to taxes which could be collected at the source, aliens over whom no effective jurisdiction in enforcement of the tax laws could be exercised. It was never intended that persons who were present within the country for long periods of time and had taken advantage of its facilities for the purpose of carrying on business, should be exempted from taxation on income derived from sources within the country merely because they were aliens. * * *

It is true that petitioner's stay in the United States was nominally restricted to limited time periods. As set forth in our findings, however, beginning at least as early as September 4, 1968, petitioner's visas were all relatively long-term multiple entry visas. For the 4 years in controversy, he had only three visas, issued October 27, 1971, August 10, 1972, and July 10, 1973, respectively. This last visa was valid for 4 years or until July 9, 1977. Under these visas, by careful observance of the immigration regulations, petitioner could go, come, or stay as he pleased substantially without restrictions, and he spent considerably more time in the United States during each of the years in question than in any other country in the world.

Due to the international nature of some of petitioner's business activities and the resulting requirement that he travel often, petitioner was absent from the United States on numerous occasions; but these absences did not affect his assimilation into the Washington, D.C., community. We have pointed out that he was listed in the Green Book, the compendium of socially prominent individuals in that City. He had numerous accounts in local banks through which literally millions of dollars passed during the years in issue. He borrowed money in his own name and for his corporations and personally guaranteed loans. He owned automobiles bearing personalized license plates. He attended local churches on a regular basis and was involved with local charitable and civic endeavors. In addition, he entertained frequently and lavishly, thereby becoming closely associated with numerous Senators, Congressmen, cabinet officers, ambassadors, military personages, and other civic, business, and society leaders in Washington, D.C. This assimilation into the Washington, D.C., community is evidence that petitioner was not a transient or sojourner but that he intended to (and did) stay in the United States for an indefinite period notwithstanding his technically limited visa status. * * *

"[H]e entertained frequently and lavishly, thereby becoming closely associated with numerous Senators, Congressmen, cabinet officers, ambassadors, military personages, and other civic, business, and society leaders."

It is no doubt true that petitioner was domiciled in Korea during the years in issue, and his relationship with that country may have been sufficiently close to constitute residency. After all, he was born there and his mother lived there. His family was wealthy, and he had significant business and social ties to Korea, more fully described in our findings. But we do not agree with petitioner that his ties to Korea, vis-a-vis those to the United States during 1972 through 1975, were so strong as to negate a finding that he was a United States resident.

Except for Korean income taxes withheld from amounts that petitioner received from Korean corporations, petitioner did not pay income taxes to either the United States or Korea on any portion of the substantial income which he received during the years in question. Significantly, petitioner testified that his major contribution to his Korean corporations was in the development of new business, and this appears to have been done mainly in the United States. Further, as previously indicated . . . the fact that petitioner had ties to and may never have abandoned a residence in Korea does not preclude the conclusion that petitioner was a resident of the United States during the years in question. In our opinion, his United States homes, investments, business activities, and political, social, and other ties were so deep and extensive as to show that his stay in this country throughout 1972, 1973, 1974, and 1975, was "of such an extended nature as to constitute him a resident." Sec. 1.871-4(c)(2)(iii), Income Tax Regs.

All About 'Koreagate'

Back in 1977, it was not so tired a conceit to give the suffix "gate" to a budding scandal. In any event, the tempest surrounding Tongsun Park came to be called "Koreagate." At one point, it threatened to engulf the Congress. Park was accused of "influence peddling" and perhaps of bribery on behalf of the Korean government. In all, 30 members of Congress were tainted by the scandal, three received a Congressional reprimand, and one (Richard Hanna, D-CA) was convicted of receiving bribes and spent a year in jail.

In response to public concerns about Park's involvement in the U.S. political process, a House ethics committee investigation was launched. When that investigation got nowhere and the chief investigator quit in a huff, House Speaker Thomas P. O'Neill and Majority Leader Jim Wright turned to the one man they thought best qualified to overcome any charges of a coverup. The man of the hour was former Watergate special prosecutor Leon Jaworski. Jaworski rooted out some improprieties, but his investigation was largely a failure. A 36-count indictment of Park was dropped, in a face-saving deal that brought Park to testify before Congress.

Tongsun Park was 41 years old in 1977. He was and is a Korean businessman who, according to *Newsweek* (August 1, 1977), "charmed his way into high-level Washington with generous gifts, lavish parties at his George Town Club and numerous campaign contributions." Leaked reports from American intelligence sources in Seoul suggested that the Korean government had directed Park "to spend money in the U.S. to create a favorable attitude among the congressmen whose votes on foreign aid and troop withdrawals are critical to Korea's well-being."

The evidence of wrongdoing was rather weak in most cases. Congressmen who admitted to having accepted "favors" from Mr. Park claimed that they had not acted illegally or even unethically. Some campaign contributions made by Park, for example, were lawful and duly reported at the time. The evidence that Park received a *quid pro quo* for his largesse never surfaced.

In 1966, Park started the exclusive George Town Club for Capital VIP's, including, according to *Newsweek*, "several Supreme Court Justices, two Cabinet members and scores of legislators." The money to finance his social life may have come from the Korean government. Kim Hyung Wook, a former head of the Korean Central Intelligence Agency who defected to the U.S., testified that he let Park use $3 million in KCIA funds to help finance the club. (Mr. Kim later disappeared mysteriously — the news accounts suggest that the KCIA was responsible.)

Kim also confirmed that Park had obtained financing through the action of the South Korean Government in making him the principal agent for sales of U.S. rice to Korea. According to *Newsweek*, "the commissions on such deals may have exceeded $5 million a year — enough to pay for two mansions, a fleet of cars (including a Rolls-Royce and a Mercedes) and a jetset life with blonde companion Tandy Dickenson." (*Newsweek* seemed obsessed with the Tandy Dickenson angle, characterizing Park as "the Asian Great Gatsby.")

Although Park probably engaged in some illegal activities, Koreagate was a classic Washington summer scandal blown out of proportion by the news media. In the end, about all that everyone could agree on was that there was a "perception" of scandal. Commenting on the life cycle of Washington summer scandals, Michael Kinsley, in his TRB column in *The New Republic* (1991), suggests that "with general agreement" a summer scandal eventually becomes a problem merely of perception, and then it

"drift[s] off into a misty afterlife realm where Tongsun Park is eternally dancing with Donna Rice while the Wedtech Orchestra plays hits from the Watergate tapes."

Obituaries Mentioning Tongsun Park

Robert B. Boettcher: "From 1971 until 1979, Mr. Boettcher directed the staff of the House Subcommittee on International Organizations. In that capacity, he was in charge . . . of gathering evidence of a scandal in which Tongsun Park, a South Korean millionaire businessman, and others were accused of unlawfully seeking to influence American political figures in providing military and economic aid to Seoul." *New York Times*, May 30, 1984. *Leon Jaworski*: "In his long legal career, Leon Jaworski served as a prosecutor at the Nuremburg trials of Nazi war criminals, built up a large, prosperous law practice and a reputation as a litigator in Houston, served as president of the American Bar Association and was counsel to the House committee that investigated the relationships of members of Congress with a South Korean rice broker, Tongsun Park." *New York Times*, December 10, 1982.

William Minshall: "A few years after he left Congress, he was one of several members of Congress whom Tongsun Park, a South Korean businessman accused of buying influence in Washington for his Government, identified as recipients of campaign contributions. . . ." *New York Times*, October 17, 1990.

Otto Ernest Passman: "Mr Passman, who became a central figure in a case of reported influence-peddling by a Korean businessman a decade ago, was first elected to Congress in 1946. Two years after he was out of Congress, he was charged with taking illegal gratuities while in the House. He was found not guilty in 1979 after a lengthy trial in Monroe of taking $273,000 from Tongsun Park, a wealthy Korean rice trader in exchange for using his influence to help him." *New York Times*, August 14, 1988.

Donald L. Ranard: "In 1976, more than a year after he retired as director of Korean affairs at the State Department, Mr. Ranard was persuaded to testify before a Congressional committee on his awareness in the early 1970's that the South Korean Central Intelligence Agency was providing funds to influence American politicians. His revelations prompted a major investigation that led to the indictment of Tongsun Park, a South Korean businessman who was a lavish entertainer of members of Congress and other legislators. In the end, Mr. Ranard felt that the Federal prosecutors had swept the scandal under the rug." *New York Times*, August 1, 1990.

Richard Sneider: "As Ambassador to Seoul from 1974 to 1978, Mr. Sneider dealt with disputes then growing between the two countries over trade, American military aid and the Congressional influence-buying scandal involving Tongsun Park." *New York Times*, August 16, 1986.

Brittingham v. Comm'r

66 T.C. 373 (1976), aff'd 598 F.2d 1375 (5th Cir. 1979)

Finding of Facts

[Material relating to seven other issues omitted.] The petitioner, Roberta M. Brittingham, is a citizen of the Republic of Mexico, whose address at the time of filing her petition herein was Monterrey, Mex. She filed no U.S. Federal income tax returns for the years 1960 through 1966. Roberta M. Brittingham is the mother of Robert and Juan and will sometimes be referred to as Roberta. . . .

Roberta was born on March 22, 1891, in Janesville, Wis., and moved to Mexico when she was 5 years old. She was a U.S. citizen at birth, and in 1943, she also became a naturalized citizen of the Republic of Mexico and remained so during the years in issue. At the time of the trial in this case, she was living in Monterrey, Mex., was bedridden, and was unable to testify.

During the years in issue, Roberta received the following income:

Year	Interest and dividend income	Long-term capital gains
1960	$117,197.37	$0
1961	106,066.44	0
1962	169,875.09	0
1963	120,897.15	7,521.21
1964	108,587.20	98,090.20
1965	153,901.00	0
1966	178,245.27	976.77

All of such income was derived from sources outside the United States, except for the long-term capital gain earned in 1966.

In 1941, 1942, and 1946, Roberta filed an Alien Registration Foreign Service Form with the U.S. Immigration and Naturalization Service. Each such form indicated that she was entering the United States for a period of 6 months for recreational purposes.

"Residence is an elusive concept. . . . A person may acquire a residence even though he does not intend to reside permanently and has a domicile elsewhere."

From 1945 to 1968, Roberta maintained an apartment in Beverly Hills, Calif. She regularly lived in such apartment and was seen there often by the mail carrier who delivered her mail for over 20 years. A phone was listed in her name in the local telephone directory for Los Angeles, Calif., from 1945 to 1968, and during the period 1963 through 1966, an average of almost 3 phone calls per month were made from Dallas Ceramic's offices in Dallas to Roberta's telephone number in Beverly Hills. She maintained a checking account in the Bank of America in Beverly Hills, Calif., and wrote approximately 35 checks on that account each month from 1961 through 1966.

At least during some of the years 1960 through 1966, Roberta held a passport issued by the Republic of Mexico. On June 27, 1965, and January 6, 1966, she filed an "Application to Extend Time of Temporary Stay" with the U.S. Immigration and Naturalization Service. The record does not disclose whether such applications were also made in prior years.

In 1965, after an investigation by the California Franchise Tax Board, Roberta filed late California resident income tax returns for 1960 and 1963. These returns include the statement that she had not filed returns for prior years because she thought she was not a resident of California. She filed timely California resident tax returns for 1964, 1965, and 1966. One question asked on each return was whether the total income reported on the California tax return was the same as the total income reported on the Federal income tax return, and if not, an explanation was required. Roberta stated that she was a nonresident alien and did not file a Federal return.

Opinion of the Court

* * * *Residence of Roberta*

The parties have stipulated the amount of Roberta's income for the years in issue. The issue to be decided is whether she was an alien resident of the United States during the years 1960 through 1966.[29] If she was a resident alien, she is taxable on income from all sources. See sec. 1.1-1(a), Income Tax Regs. However, if she was a nonresident alien, she is taxable only on her income from sources within the United States. Sec. 872.

Residence is an elusive concept which is undefined by both the Code and the legislative history of section 872. See *Weible v. United States*, 244 F. 2d 158, 163 (9th Cir. 1957). It has been frequently said that residence does not necessarily mean domicile for Federal income tax purposes. See, e.g., *Cristina de Bourbon Patino*, 13 T.C. 816, 821 (1949), affd. 186 F. 2d 962 (4th Cir. 1950); *Florica Constantinescu*, 11 T.C. 37, 41 (1948); *J. P. Schumacher*, 32 B.T.A. 1242, 1247 (1935). Thus, a person may acquire a residence even though he does not intend to reside permanently and has a domicile elsewhere. See *Marsman v. Commissioner*, 205 F. 2d 335, 338 (4th Cir. 1953). . . .

Both physical presence plus the definite intent to make one's home at that place is necessary to establish a residence. *William E. Adams*, 46 T.C. 352, 361 (1966). "[A] nonresident alien cannot establish a residence in the United States by intent alone since there must be an act or fact of being present, of dwelling, of making one's home in the United States for some time in order to become a resident of the United States." *Joyce de la Begassiere*, 31 T.C. 1031, 1036 (1959), affd. per curiam 272 F. 2d 709 (5th Cir. 1959); see *William E. Adams*, *supra* at 361. Likewise, mere physical presence in a country does not by itself establish residence. *Florica Constantinescu*, *supra* at 43-44. However, the unexplained continued presence in a country for a prolonged period is strong evidence of an intent to make that place one's residence. *Cristina de Bourbon Patino*, *supra* at 821-822; see *Rudolf Jellinek*, 36 T.C. 826 (1961); cf. Carpenter v. United States, 495 F. 2d 175 (5th Cir. 1974). The determination of residence is factual and must be made in light of all the facts and circumstances. See, e.g., *William E. Adams*, *supra* at 358; *Ceska Cooper*, supra at 762; *Herman Frederick Baehre*, 15 T.C. 236, 241 (1950).

Roberta relies upon section 1.871-4(b) of the regulations, which provides:

> *Nonresidence presumed.* An alien, by reason of his alienage, is presumed to be a nonresident alien.

However, the evidence presented by the Commissioner clearly rebuts the presumption of nonresidency. Roberta maintained and regularly lived in an apartment in Beverly Hills, Calif., for a period in excess of 20 years extending through the years in issue. Section 1.871-4(c) (2)(iii) of the regulations provides that the presumption may be rebutted by showing that the alien's stay in the United States "has been of such an extended nature as to constitute him a resident." A stay of over 20 years is obviously extended in nature. Furthermore, to argue that a person who regularly lives in an apartment for over 20 years is a mere transient or sojourner is clearly untenable. Roberta presented no evidence which tended to show that she was anything other than a resident of the United States.

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[29] The parties have assumed that Roberta was not a citizen of the United States during the years in issue, and we will accept that assumption as true for purposes of deciding this case. However, there is no evidence that she ever relinquished or otherwise lost her U.S. citizenship. See *United States v. Matheson*, F.2d 809 (2d Cir. 1976).

> [Although] "residence" does not require a permanent home * * * or even a definite and settled abode, * * * it does require that the taxpayer have some degree of permanent attachment for the country of which he is an alien, * * * and it has been said that it is this degree of permanence of an individual's attachment for a country in which he is at some time physically present which determines whether he is a domiciliary, a resident, or a transient of that country * * * [*Rudolf Jellinek*, 36 T.C. at 834; citations omitted.]

It is clear to us that 20 years of almost continuous presence is sufficiently permanent to classify Roberta as a resident of the United States.

Roberta also argues that she was a nonresident during the years in issue since her stay was limited to a definite period by the immigration laws. She relies upon section 1.871-2(b) of the regulations, which provides in part: "An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances." However, the evidence supporting this contention is very sparse. . . .

> "The unexplained continued presence in a country for a prolonged period is strong evidence of an intent to make that place one's residence."

Moreover, even if Roberta had established that her presence each year was limited by the immigration laws, we are nonetheless convinced that she was a resident of the United States during each of the years in issue. We have held on several occasions that aliens whose stay in the United States was limited by immigration laws were nevertheless residents of the United States. See, e.g., *Marsman v. Commissioner, supra*; *Ceska Cooper, supra*; *Joe May*, 39 B.T.A. 946 (1939); *J. P. Schumacher, supra*. While the facts of each of these cases may be distinguishable, such cases clearly establish that the immigration status of an alien does not conclusively determine whether she is a resident of the United States. *J. P. Schumacher*, 32 B.T.A. at 1247. Roberta lived in an apartment in the United States for over 20 years on an apparently permanent basis. No evidence was presented to show why she chose to reside in the United States for such an extended period. Although she was unable to testify at trial, her sons, who did testify extensively, provided no evidence on this issue. Based on these facts, it is apparent that "exceptional circumstances" exist in this case. While Roberta's stay may have been nominally limited by the immigration laws, the fact remains that she was able to continuously reside in the United States for over 20 years.

§ 3.02. Taxation of U.S. Residents

Prior to the adoption of the 1984 tax act, a resident was defined as an individual who intended to be a resident, as evidenced by his actions. The intent test is compatible with the political theory that governmental power comes from the consent of the governed. The 1984 tax act replaced the intent test, which was exceedingly difficult to administer, with a test that uses objective criteria to determine whether an

individual should be treated as owing allegiance to the United States.[30] An alien who is not a resident under these criteria is a nonresident alien individual for purposes of the Code.[31]

Under the Code, an alien individual is considered to be a resident of the United States if that person satisfies either the lawful-permanent-resident test or the substantial-presence test. In the typical case, an individual treated as a U.S. resident during the taxable year under either of these tests would be a U.S. resident for the entire year. An alien applying for a U.S. passport or for permanent residence status is required to file an information report that would allow the tax authorities to determine whether the applicant is subject to U.S. residence jurisdiction.[32]

Several exceptions are provided to the general rule that residence status is determined on an annual basis. For example, an individual taking up residence in the United States for the first time typically would not become a resident until he entered the United States.[33] And an individual giving up U.S. residency and establishing a foreign tax home typically would cease to be a resident when he left the United States or gave up his lawful residence status.[34] An individual otherwise treated as a resident for only part of a taxable year may elect, under some conditions, to be a resident for the entire year.[35] An individual will not be treated as a lawful permanent resident of the United States if that individual is able to claim the benefits of a U.S. tax treaty as a foreign person and does not waive those benefits, and provides notice to the Secretary of the Treasury.[36]

The rules of Code section 7701(b) do not apply in determining the residence of U.S. citizens in some cases. For example, a U.S. citizen claiming to be a resident of a foreign country in order to avail of the benefits of Code section 911 must establish foreign residency under the old facts-and-circumstances test.[37] The Congressional purpose in adopting the section 7701(b) rules was to reduce compliance problems relating to nonresident alien individuals, not to expand the availability of special tax preferences for U.S. citizens. The substantial-presence test does apply to U.S. citizens in determining whether they are also residents of the United States.[38]

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[30] IRC § 7701(b), adopted by P.L. 98-369, § 138(a) (1984).

[31] The definition of residence under IRC § 7701(b) and accompanying regulations does not apply to the estate and gift tax.

[32] IRC § 6039E. See Prop. Reg. § 301.6039E-1 (1993). Under the proposed regulations, passport applicants must provide their name, address, taxpayer identification number (TIN), date of birth, and country of residence. Applicants for immigration must also inform the tax authorities whether they had any U.S. source income during their three most recent taxable years and whether they had been present in the United States for more than 182 days in any year during that period. Additional information may also be required on the application form for immigration or for a passport. Prop. Reg. § 301.6039E-1(c) (1993).

[33] IRC § 7701(b)(2)(A) and Reg. § 301.7701(b)-4(a) (1992).

[34] IRC § 7701(b)(2)(B) and Reg. § 301.7701(b)-4(b) (1992).

[35] IRC § 7701(b)(4) and Reg. § 301.7701(b)-4(c)(3) (1992).

[36] IRC § 7701(b)(6) (flush language) (2008).

[37] The IRC § 7701(b) rules also do not apply in determining whether U.S. citizens are residents of the Commonwealth of the Northern Mariana Islands for purposes of the mirror-image exemption provided in IRC § 935. See *Preece v. Comm'r*, 95 T.C. 594 (1990).

[38] Reg. § 301.7701(b)-1(a) (1992). The residency of a U.S. citizen may be relevant in determining the source of income. See, e.g., IRC § 861(a)(1), which treats income from interest-bearing obligations of residents as income from sources within the United States.

The Code definition of residence may conflict in some cases with a definition of residence contained in a U.S. tax treaty. In such circumstances, the taxpayer may elect the treaty rule.[39] U.S. tax treaties that follow the U.S. Model Treaty have a series of tie-breaker rules for individuals who are resident in both Contracting States under the laws of those States.[40] Those tie-breaker rules would determine the residence of a dual-resident individual for treaty purposes. The Code rule would prevail, however, for purposes of the Code other than those that determine the taxpayer's own tax liability.[41] For example, in determining whether a foreign corporation is controlled by U.S. residents for purposes of subpart F, the Code definition is applicable.[42]

§ 3.02.1. Lawful-Permanent-Resident Test

The lawful-permanent-resident test is satisfied if the individual has been granted the right under U.S. immigration law to reside permanently in the United States as an immigrant.[43] This test is usually called the green card test. The "green card" is an immigration form furnished to a legal immigrant by the immigration authorities (U.S. Citizenship and Immigration Services (USCIS)) as evidence of that person's legal status as an immigrant.[44]

An individual cannot cause himself to fail the green card test simply by renouncing residence status.[45] An individual loses residence status for tax purposes only if that status has been revoked by the immigration authorities or an administrative or judicial decision has determined that the individual abandoned it.[46]

§ 3.02.2. Substantial-Presence Test

In general, an individual satisfies the substantial-presence test if (1) he is present in the United States for at least 31 days during the calendar year,[47] and (2) he satisfies the 183-day test, applied with respect to the current and two preceding calendar years.[48] The 183-day test is satisfied if the sum of the number of days the individual is present in the United States in the current year, plus one-third of the number of days the person was present in the preceding calendar year, plus one sixth of the number of days the individual

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[39] Reg. § 301.7701(b)-7(a) (1997). Under the regulations, a taxpayer cannot claim to be a U.S. resident for purposes of the Code and also claim to be a nonresident alien eligible for treaty benefits. He must elect either to forgo all treaty benefits and be taxable as a resident or to claim treaty benefits and be taxable as a nonresident.

[40] Art. 4(2). See also U.S./Spain treaty, Art. 4(2).

[41] Reg. § 301.7701(b)-7(a)(3) (1997).

[42] Id. See Staff of Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (1984) at 468.

[43] IRC § 7701(b)(1)(A)(i) and Reg. § 301.7701(b)-1(b)(1) (1992).

[44] The card is Permanent Resident Card Form I-551. At one time, that card was green; the name continues, although the color of the card has been changed several times. The current card contains the holder's picture, fingerprint, and signature. It also has an expiration date, set 10 years from the date of issuance. The expectation is that the card will be refined from time to time to improve security.

[45] Reg. § 301.7701(b)-1(b)(1) (1992).

[46] Reg. § 301.7701(b)-1(b)(2)-(3) (1992).

[47] IRC § 7701(b)(3)(A)(i) and Reg. § 301.7701(b)-1(c)(4) (1992).

[48] IRC § 7701(b)(3)(A)(ii) and Reg. § 301.7701(b)-1(c)(1) (1992).

was present in the second preceding year equals or exceeds 183 days.[49] An individual present for 183 days or more in the current year would always satisfy the 183-day test.[50]

§ 3.02.2.1. Excluded Days

In determining whether an individual is present in the United States for the requisite days, certain days do not count. Days that an individual is present because of a medical emergency do not count.[51] According to the regulations, the taxpayer must *intend* to leave the United States and be prevented from doing so by the medical emergency.[52] An intent to leave may be established by showing that the person was present in the United States for a purpose that could be accomplished over a period that would not make the person a U.S. resident.[24] Holding a return airline ticket might also prove an intent to leave on the date of the ticketed flight.[53]

In addition, days that an individual from Canada or Mexico is in the United States as a regular commuter do not count.[54] Nor do the days count that a person spends within the United States in transit between two foreign points.[55] None of the days counts that an exempt person spends in the United States while enjoying that exempt status.[56] Diplomats, employees of international organizations, and any accompanying family members are exempt persons.[57] So also are certain teachers, trainees, and students who are present in the United States on a visa appropriate for that status.[58] Professional athletes present in the United States to compete in certain charitable sporting events are also exempt persons.[59]

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[49] Id. For application of the substantial-presence test, see *Salami v. Comm'r*, T.C. Memo 1997-347 (1997) (taxpayer was physically present in the United States, working as a taxicab driver in Chicago, for more than 183 days during 1992 and 1993 and was a resident under the substantial-presence test); *Josi Angel Lujan v. Comm'r*, T.C. Memo 2000-365 (2000) (holding that the taxpayer, living with his wife and children in Texas, satisfied the substantial presence test by being present in the United States for over 182 days for both of the years at issue).

[50] In addition, the closer-connection exemption to the substantial-presence test, discussed below, would not be applicable to such an individual.

[51] IRC § 7701(b)(3)(D)(ii). The medical emergency exception does not apply if the payer entered the United States to receive medical treatment or was aware of the condition requiring medical treatment prior to his entry into the United States. Reg. § 301.7701(b)-(3)(c)(3) (1997). To claim this exception, the taxpayer must complete Form 8843 (Statement for Exempt Individuals and Individuals with a Medical Condition). Reg. § 301.7701(b)-8(b)(2) (1997).

[52] See Reg. § 301.7701(b)-(3)(c)(1) and (2) (1997). [24]Reg. § 301.7701(b)-3(c)(2) (1997).

[53] Reg. § 301.7701(b)-3(c)(4)(Ex. 1) (1997).

[54] IRC § 7701(b) (7)(B) and Reg. § 301.7701(b)-3(e). A commute is "regular" if the individual commuted more than 75 percent of the working days during the working period. Reg. § 301.7701(b)-3(e)(1) (1997).

[55] IRC § 7701(b)(7)(B) and Reg. § 301.7701(b)-3(d) (1997). But business meetings in airports do count. Id.

[56] IRC § 7701(b)(3)(D)(i) and Reg. § 301.7701(b)-3(b) (1997). But days do count once the exempt status lapses. See *Anderson v. Comm'r*, TC Memo 1989-381 (citizen of Liberia and former budget director does not qualify for the exception for "foreign government-related individuals" under section 7701(b)(5) after the overthrow of Liberia's government).

[57] IRC §§ 7701(b)(5)(A)(i) (exempting "a foreign government-related individual") and 7701(b)(5)(B) (giving the definition of a foreign government-related individual).

[58] IRC § 7701(b) (5)(A)((ii)-(iii) and (C)-(E); Reg. § 1.7701(b)-3(b)(3)-(4) (1997). Various rules apply to prevent certain perpetual students and teachers from being treated as exempt persons.

[59] IRC § 7701(b) (5)(A)(iv); Reg. § 7701(b)-3(b)(5) (1997). An athlete is exempt only for days in which he performs, not for practice days, for days used to perform promotional activities, or for days used to travel between athletic events. Id.

§ 3.02.2.2. Closer-Connection Exception

Under some conditions, an individual having a tax home in a foreign country and a closer connection to that country than to the United States would qualify for the closer-connection exception to the substantial-presence test.[60] An individual qualifying for the exception would be classified under the Code as a nonresident alien.

In general, a tax home is a geographical area at or near a taxpayer's primary place of business or duty post.[61] If a taxpayer has no regular place of business or is not engaged in business, his tax home is his place of abode.[62]

To qualify for the closer-connection exception, an individual must have been present in the United States in the current year for less than 183 days.[35] In addition, the individual must establish that he has a closer connection to the country where his tax home is located than he has to the United States.[63] To avail himself of the exception, the taxpayer must file with the tax authorities a form that sets forth the basis for the claim.[64] The closer-connection exception is not available to any individual who has taken affirmative steps to become a permanent resident of the United States.[65]

§ 3.02.2.3. Operation of Substantial-Presence Test

The substantial-presence test comes into play only if the alien individual is present in the United States for more than 30 days in the current year and those days are not exempt days. If he is present for 183 days or more for the current year, after excluding exempt days, then he is a resident for that year without further inquiry. If the alien individual is present in the current year for more than 30 days (excluding exempt days) and less than 183 days (excluding exempt days), and is present for 183 days or more for the three-year period under the 183-day test, then he is a U.S. resident unless he is able to avoid that classification under the closer-connection exception. The operation of the substantial-presence test is illustrated by the following example.

Example 3.1: Substantial-Presence Test for Residence

A is a citizen of Brazil. He has a full-time job in that country and generally lives there with his family in a home that he has owned for more than 20 years. In year one, A comes to the United States for the first time. The sole purpose of the trip is business. A intends to stay in the United States for only 180 days, but he runs into problems with his business and is required to stay for 300 days.

In year two, A comes to the United States again on business and stays for 90 days. He returns to Brazil as planned.

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[60] Code § 7701(b)(3)(B); Reg. § 301.7701(b)-2 (1993).

[61] See IRC § 911(d)(3), referring to the definition of tax home used under IRC § 162(a)(2) (relating to the deduction while traveling away from home).

[62] Reg. § 301.7701(b)-2(c) (1993). [35]IRC § 7701(b)(3)(B)(i).

[63] IRC § 7701(b)(3)(B)(ii) and Reg. § 301.7701(b)-2 (1993). Factors to be taken into account in determining whether an individual has maintained more significant contacts with the United States than with a foreign country are listed in Reg. § 301.7701(b)-2(d) (1993). See also Reg. § 301.7701(b)-2(e) (1993).

[64] The claim is filed on Form 8840 (Closer Connection Exception Statement). See Reg. § 301.7701(b)8(b)(1) (1997).

[65] IRC § 7701(b)(3)(C). Filing Immigration and Naturalization Form I-485 or other related forms would be an affirmative step disqualifying an individual from the closer-connection exception to the substantial presence test. Reg. § 301.7701(b)-2(f) (1993).

Early in year three, A comes to the United States on business and stays for 170 days. Later in year three, he returns to the United States to take his 6-year-old son to Disney World in Florida. He plans to stay at Disney World for 10 days and then return to Brazil. On the last day of the planned visit, the son breaks his leg in an automobile accident. The son is put into a Florida hospital for treatment, where he remains for five days. To be near his son and provide the boy with necessary support, A remains in Florida. They both leave the United States as soon as possible after the son is released from the hospital. In total, A is present in the United States in year three for 180 days plus the five days that his son was under medical treatment. Under these facts, A is a U.S. resident for year one. He is present in the United States for more than 183 days and does not qualify for any exceptions to the general rule of the substantial-presence test.[66] *His intent to stay less than 183 days is not relevant.*

A is not a U.S. resident in year two. Under the formula of IRC § 7701(b)(3)(A), A is deemed present in the United States for 190 days (90 + 1/3 × 300). But A is actually present in the United States for less than 183 days in that year. A has his tax home in Brazil and has substantially closer ties to Brazil than to the United States. Thus A qualifies for the closer-connection exemption of IRC § 7701(b)(3)(B).[40]

A's residence status for year three is unclear. Under the formula of IRC § 7701(b)(3)(A), A is deemed present in the United States for 260 days even if the five days he remained because of the medical emergency of his son do not count toward the total (180 + 1/3 × 90 + 1/6 × 300 = 260). A may qualify for the closer-connection exception, but only if he is treated as being actually present in the United States for less than 183 days in year three. Thus, the treatment of the five days he remained on account of the medical emergency is crucial in determining his residence status. According to the Code, a day does not count toward establishing the residency of an individual if that individual was unable to leave the United States on that day "because of a medical condition which arose while such individual was present in the United States."[67] *The Code does not specify whether the "medical condition" referred to must be that of the taxpayer, and the regulations provide no clarification.*[68]

Questions

1. Under current U.S. law, would Tongsun Park be a resident of the United States for any of the years from 1972 to 1975? In answering that question, assume that Mr. Park was present in the United States for 50 days in 1971 and for 60 days in 1970. Is any other information necessary to determine his residency under current law?

2. Assume that Mr. Park was able to prove that he suffered from a medical condition in 1975 that required him to stay in the United States for an additional 15 days. Any effect on his residency? Would Mr. Park be a U.S. resident under the U.S./Korea tax treaty? Would he be a resident of Korea? That treaty did not go into effect until 1979. Article 3 of that treaty contains a tie-breaker rule similar to the one recommended by the OECD and contained in Article IV of the U.S./Canada treaty.

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[66] See IRC § 7701(b) (1)(A)(ii) and (3)(A). [40]See Reg. § 301.7701(b)-2(d) (1993).

[67] See IRC § 7701(b)(3)(D) and Reg. § 301.7701(b)-3(a)(2) and (c) (1997).

[68] Although the language of the Code and regulations is ambiguous, a reasonable inference is that the medical emergency must be that of the taxpayer. The Commentary to Article 15 (Income from Employment) of the OECD Model Treaty suggests that days spent in a country only on account of a medical emergency of the taxpayer or a family member should not count toward meeting the treaty version of the 183day test.

3. In footnote 19 of *Park*, the Tax Court cites *Nubar v. Comm'r*. This is a rather famous residency case. Would Mr. Nubar be a resident of the United States under the current Code? Should he be taxed as a resident? Is he a U.S. resident under the U.S./Egypt tax treaty, which went into effect at the end of 1981 and which contains the standard tie-breaker rule?

4. Would Mrs. Brittingham be considered a U.S. resident under current U.S. law? How would the lawful-permanent-resident test apply? What about the substantial-presence test? What additional facts, if any do you need to apply these tests?

5. Assume that Mrs. Brittingham spends more than 100 but less than 183 days in the United States each year. Is she a resident under the substantial-presence test?

6. Is Mrs. Brittingham a U.S. citizen? The IRS conceded that she was not. Why?

7. Would Mrs. Brittingham be a resident of the United States by treaty if the United States and Mexico entered into a tax treaty similar to the U.S. Model Treaty?

8. A taxpayer separated from his wife was planning to live in a foreign country and, based on his own activity, expects to meet the so-called 548-day rule of New York law, which is the test for residency in New York. His estranged wife expects to live in Manhattan with their child. The wife has custody of the child, but the husband has limited visitation rights. The question asked was the effect of these facts on the husband's ability to avoid qualifying as a New York resident under the 548-day rule. The "548-day rule" is contained in Tax Law Section 605(b)(1)(A)(ii). This provision states that a New York State domiciliary will not be deemed a New York State resident notwithstanding his or her domiciliary status if that person:

> (1) Within any consecutive 548-day period, is present in a foreign country or countries for at least 450 days; and
>
> (2) During the period of 548 consecutive days, the taxpayer, the taxpayer's spouse (unless the taxpayer and spouse are legally separated) and the taxpayer's minor child are not present in New York State for more than 90 days; and
>
> (3) During the nonresident portion of the taxable years within which the 548-day period begins and ends, the number of days in which the taxpayer is present in New York State does not exceed the same ratio to 90 as the number of days in that taxable year bears to 548.

The New York tax department concluded that the husband generally would not be treated as present in New York for the days that the child spent with the spouse in New York with the exception that if the child was in New York on days that the husband had visitation rights, the husband would be treated as present in New York on those days. See New York State Department of Taxation and Finance, Office of Counsel, TSB-A-12(3)I (July 5, 2012).

Do you support New York's use of domiciliary status as part of the test of residency? Do you prefer the longer New York period (548 days) to the shorter Federal period (183 days). Which rule is more lenient? Which is easier to administer?

§ 3.03 Residence under U.S. Tax Treaties

The residence of an individual is primarily a matter of domestic law. When the residence rules of treaty partners conflict, however, the typical tax treaty provides a tie-breaker rule. Article 4 of the OECD model treaty, which is contained in only slightly modified form in almost all U.S. tax treaties, provides in relevant part as follows:

> 1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.
>
> 2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
>
> > a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
> >
> > b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
> >
> > c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
> >
> > d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

In accordance with the above treaty language, the first step in determining the residence of an individual for treaty purposes is to ascertain whether that person is liable to tax as a resident under the respective taxation laws of the Contracting States. As a general matter, if a person is a resident of one Contracting State under its internal law and not of the other, he is treated as a resident of that Contracting State for treaty purposes.

If an individual is a dual resident under the domestic laws of the Contracting States, the second step comes into play. In that step, the treaty tie-breaker rules illustrated above are applied. There are five rules. The first rule has priority over the second, and so forth. Thus a tie-breaker rule is not applied if the issue has been resolved by a rule having a higher priority.

Rule one provides that a dual-resident taxpayer is resident for treaty purposes only in the Contracting State where the individual has a permanent home. If the individual has a permanent home available to him in both Contracting States or in neither, then rule one is not applicable.

Rule two provides that an individual who has a permanent home in both Contracting States is considered to be a resident of the Contracting State where his personal and economic relations are closest. The treaty phrase is "the location of his center of vital interests." If the center of the individual's vital interests cannot be determined or if the individual does not have a permanent home available to him in either Contracting State, then rule two is not applicable.

Rule three provides that an individual will be treated as a resident of the Contracting State where he maintains an habitual abode. If he has an habitual abode in both States or in neither of them, then rule three is not applicable.

Rule four provides that an individual who is a citizen of one and only one Contracting State will be treated as a resident of that Contracting State. This rule does not apply if the individual is a national of both Contracting States or of neither.

Rule five pushes the matter to the competent authorities. Under U.S. tax treaties, the competent authorities must *attempt* to agree to make a dual-resident individual a resident for treaty purposes of one and only one Contracting State.[69] In the unlikely event that they fail, the individual presumably will be treated as a resident of both Contracting States for treaty purposes.

[69] Article 4(2)(d) of the U.S. Model Treaty (2006) provides that the competent authorities "shall endeavor to settle the question by mutual agreement." The comparable clause of the OECD Model Treaty (2008) provides that the competent authorities "*shall settle* the question by mutual agreement." (Emphasis added.) Some recent U.S. treaties (e.g., Belgium, Canada, France, and Germany) include a mandatory arbitration clause that would require that the matter be settled.

Chapter 4
Residence Jurisdiction over Legal Entities

§ 4.01. Residence of Legal Entities

§ 4.01.1. Corporations

A corporation is identified as a "domestic" corporation under the Code if it was "created or organized in the United States or under the laws of the United States or of any state."[70] A foreign corporation is a corporation other than a domestic corporation.[71] Thus the organizers of a corporation can determine whether a corporation is subject to the residence jurisdiction of the United States by their choice of the place of incorporation. If a corporation is organized under the laws of the United States and also the laws of a foreign country, it is treated as a domestic corporation.[72]

The mechanical place-of-incorporation test for determining the tax status of a corporation provides a high degree of certainty, to the government and to taxpayers, in the case of corporations that are organized as such under local law. The public policy cost of obtaining that certainty is high, however, because the mechanical test gives taxpayers the power to control the reach of U.S. residence jurisdiction.[73]

To regain some control over its tax jurisdiction, Congress has enacted elaborate provisions under subpart F of the Code for taxing the profits of foreign corporations controlled by U.S. interests. In some sense, the subpart F rules can be understood as a refinement of the place-of-incorporation test.[74]

In recent years, some U.S. corporations have attempted to avoid subpart F and otherwise minimize their U.S. tax obligations by converting themselves into foreign corporations through a corporate reorganization. A transaction for expatriating a corporation is typically referred to as an "inversion" transaction. In a typical inversion transaction, the U.S. shareholders of a U.S. corporation exchange their shares in that corporation for shares in a foreign subsidiary of that corporation. The subsidiary is typically organized in a tax haven country, such as the Bermuda. After the inversion transaction, the U.S. residents formerly owning shares in the U.S. corporation become shareholders of the tax-haven corporation, and the tax-haven corporation becomes the parent of the U.S. corporation. Thus the former relationship between the two companies is inverted, with the former subsidiary becoming the parent and the former parent becoming a subsidiary. The parent corporation, however, is now a foreign corporation that is not subject to the subpart F rules and is not subject to U.S. residence jurisdiction.

Consider, for example, a U.S. corporation, SCo, that manufactures hammers and other tools in the United States. The stock of SCo is widely held by U.S. resident individuals. SCo establishes a foreign

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[70] IRC § 7701(a)(4). See Reg. § 301.7701-5 (2006). The term "U.S. corporation" is occasionally used in this book as a synonym for "domestic corporation." Under the stapled stock rule of IRC § 269B and the anti-inversion rule of IRC § 7874, certain foreign corporations may be treated as U.S. corporations.

[71] IRC § 7701(a)(5).

[72] Reg. § 301.7701-5(a) (2006).

[73] Some countries, such as Australia and the United Kingdom, use a place-of-management test for determining the residence status of a corporation. It is possible for a corporation to be a U.S. corporation under the place-of-incorporation test and to be, for example, a U.K. corporation under U.K. law.

[74] For discussion of the residence status of affiliated companies, see Michael J. McIntyre, "Determining the Residence of Members of a Corporate Group," 51/4 CANADIAN TAX JOURNAL 1567-73 (2003).

subsidiary, BCo, under the laws of Bermuda. It arranges for its shareholders to exchange their shares in SCo for the same number of shares in BCo. Now the U.S. resident individuals are the owners of BCo, and BCo is the owner of SCo.

In the typical case, an inversion transaction is combined with various transactions designed to strip profits out of the United States. For example, SCo might arrange to make deductible payments to BCo for its use in the United States of intangible property owned by BCo. Those payments typically would be routed through a foreign corporation entitled to U.S. treaty benefits in order to avoid or minimize U.S. withholding taxes.

In 2004, Congress acted to limit the benefits of inversion transactions by adopting Code section 7874. Under that provision, the new foreign parent (the "surrogate foreign corporation") is treated as a U.S. corporation for all purposes of the code if at least 80 percent of the stock (by vote or value) of the entity is held by the former owners of the domestic corporation that was inverted.[75] If at least 60 percent of the stock is held by the former owners but less than 80 percent, Code section 7874 denies the use of some tax attributes to offset any gain that resulted from the inversion transaction.[76] A similar rule applies to inverted partnerships.[77]

An entity may be treated as a "corporation" for tax purposes even if it is not so treated under local law. Under the current and prior regulations dealing with the classification of entities, a juridical person that is taxed under the Code as a corporation is called an "association." Prior to the adoption of the check-the-box regulations, an entity characterized as a trust or partnership under local law would be treated as an "association" if it had most of the important legal characteristics of a corporation.[78] Under check-the-box, an unincorporated entity generally is treated as a corporation at the discretion of the taxpayer.

When an association is treated as a corporation for federal tax purposes but is not organized as a corporation under local law, the bright-line test—place-of incorporation—obviously is not applicable. Under such circumstances, the place of residence of the association depends on the locus of the various contractual arrangements that led to its creation or organization. The place of residence is often obvious under this test, but not always. For example, residency of an association may be difficult to determine if the contractual arrangements under which it was formed are governed by the laws of more than one country or if the associating parties did not enter into any formal contractual arrangements.

Assume, for example, that UCo, a U.S. corporation, enters into a joint venture with FCo, an unrelated company organized in Country F, to construct an airport facility in Country R. UCo and FCo do not incorporate their joint venture arrangement, but UCo elects to have that arrangement classified as a corporation under the check-the-box rules described below. The question arises as to where this ersatz corporation is resident. Some of the contractual arrangements for establishing the joint venture were made in Country F, some in the United States, and some in Country R. In addition, the parties have stipulated in

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[75] IRC § 7874(b).

[76] IRC § 7874(a).

[77] IRC § 7874(a)(2)(A).

[78] Under the prior regulations, an association resembled a corporation to the extent it had the following characteristics: (1) associates, (2) an objective to carry on business and divide resulting profits, (3) continuity of life, (4) centralized management, (5) limited liability, and (6) free transferability of ownership interests. The last four characteristics were used to distinguish corporations from partnerships in that both partnerships and corporations always possessed the first two characteristics. An association was a corporation rather than a partnership under the prior regulations if it possessed three out of four of the last four characteristics. A common criticism of the prior regulations was that they gave equal weight to the last four characteristics instead of giving extra weight to characteristics five and six. An additional telling criticism of the prior regulations is that they frequently permitted the taxpayer in the international setting to repudiate for tax purposes the form of organization it had chosen for business purposes.

one of their agreements that disputes between the parties over the terms of the joint venture are to be resolved in accordance with the laws of Country N. Under these facts, the country of residence of the joint venture arrangement is unclear.

§ 4.01.2. Partnerships

The rules for determining the residence status of partnerships are roughly comparable to those for determining the status of associations and other entities treated as corporations. In general, a partnership created or organized under U.S. law is a domestic partnership, and all other partnerships are foreign.[79] The tax authorities are permitted to modify this rule by regulation in appropriate cases.[80]

A partnership often is organized exclusively under the local law of a particular country. In such a case, its country of residence typically is easy to determine. In other circumstances, however, the place of organization or creation is unclear, especially when the "partnership" is an informal association, not created by a specific legal act. In the example above of the joint venture between UCo and FCo, the same question of where that arrangement was resident would arise if UCo had elected to treat the arrangement as a partnership.

§ 4.01.3. Trusts

A trust is treated as a domestic trust if a court within the United States is able to exercise primary supervision over the administration of the trust (the "court" test), and one or more United States persons have the authority to control all substantial decisions of the trust (the "control" test).[81] In general, the rules defining the residence of trusts are biased toward foreign trust classification.[82]

The control test, set forth in the regulations, is met if one or more U.S. persons have the authority to control "all substantial decisions of the trust."[83] If a foreign person has the power to veto the substantial decisions of the U.S. person, the U.S. person will not be treated as controlling the trust.[84] Substantial decisions include, for example, decisions on (1) whether or when to distribute income or corpus, (2) the amount of such distributions, (3) the selection of beneficiaries, and (4) whether to remove, add, or replace a trustee.[85] U.S. persons are not considered to control all substantial decisions of the trust if an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust no longer to be controlled by U.S. persons.[86]

A safe-harbor rule allows certain individual retirement accounts (IRAs) and other tax-exempt trusts, including certain qualified pension plan trusts, to satisfy the control test even if the grantor or beneficiary of the trust is a foreign person. For that safe harbor rule to apply, United States fiduciaries must control all of the substantial decisions of the trust that are made by trust fiduciaries.[87] The safe harbor is important

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[79] IRC § 7701(a)(4) and (5).

[80] IRC § 7701(a)(4) (as amended by the 1997 tax act). Regulations have not been issued. The legislative history suggests that this authority might be used in the case of certain joint ventures but that the general rule would continue to apply in most cases.

[81] IRC § 7701(a)(30)(E).

[82] See T.D. 8813, 64 FR 4967-4975, Feb. 2, 1999.

[83] IRC § 7701(a)(30)(E)(ii); Reg. § 301.7701-7(a)(1)(ii) (2001).

[84] Reg. § 301.7701-7(d)(1)(ii) (2001).

[85] Reg. § 301.7701-7(d)(1)(ii) (2001).

[86] Reg. § 301.7701-7(d)(3) (2001).

[87] Reg. § 301.7701-7(d)(1)(iv) (2001).

because trusts established to hold retirement funds must be domestic trusts to have tax-exempt status under U.S. law.

For the court test to be satisfied, a U.S. court must be able "to exercise primary supervision over the administration of the trust."[88] That test is satisfied if (1) the trust instrument does not direct that the trust be administered outside of the United States, (2) the trust in fact is administered exclusively in the United States, and (3) the trust is not subject to an "automatic migration provision."[89] An automatic migratory provision is defined as a provision that would cause the trust to migrate from the United States—that is, become a foreign trust not subject to the jurisdiction of a U.S. court—if a U.S. court attempted to assert jurisdiction or otherwise to supervise the administration of the trust.[90] A U.S. court may have "primary supervision" over a trust even if a foreign court has jurisdiction over a trustee, a beneficiary, or some trust property.[91] In addition, the court test is met if both a foreign court and a U.S. court are able to exercise primary supervision over the administration of the trust.[92]

A safe-harbor rule provides that the court test is satisfied for a non-migrating trust in certain circumstances. Examples include: (1) a trust that is properly registered with a U.S. court under the Uniform Probate Code or a functional equivalent; (2) a testamentary trust that is probated within the United States if all fiduciaries of the trust have been qualified as trustees by a U.S. court; and (3) an *inter vivos* trust if the fiduciaries or beneficiaries cause the administration of the trust to be subject to the primary supervision of a U.S. court.[93]

Prior to a change in the Code adopted in 1996, a domestic trust was defined as a trust that was not taxable as a foreign trust, using the same circular definition that is currently applicable to estates. Taxpayers generally can create a foreign trust more easily under current law than they could under pre-1996 law. Creating a domestic trust, however, is often more difficult. As a transition measure, a trust that was treated as a domestic trust prior to August 20, 1996, may elect to continue to be treated as a domestic trust if a variety of conditions are met.[94]

If a U.S. person transfers property to a foreign trust with a U.S. beneficiary, the transferor may be treated as the owner of that property under Code section 679. In that event, the U.S. person is taxable on that portion of the income of the trust attributable to the transferred property, notwithstanding the status of the trust as a foreign person. Certain loopholes in section 679 were closed by amendments to that section in 2010.

For tax planning purposes, there are some advantages of being a foreign trust and some advantages of being a domestic trust. The grantor of a trust having one or more U.S. beneficiaries typically would prefer that the trust be treated as a domestic trust when it is initially established. This characterization generally allows the grantor to make transfers of property to the trust without the trust being characterized as a grantor trust. Once the property has been transferred to the trust, however, the grantor would prefer that the trust be characterized as a foreign trust so that its foreign source income would not be subject to U.S.

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[88] IRC § 7701(a)(30)(E)(ii); Reg. § 301.7701-7(a)(1)(i) (2001). A U.S. court is a court of one of the several states or the District of Columbia. A court of Puerto Rico or a U.S. territory is not a U.S. court for purposes of the court test. Reg. § 7701-7(c)(3)(ii) (1999).

[89] Reg. § 301.7701-7(c)(1) (2001).

[90] Reg. § 301.7701-7(c)(4)(ii) (2001).

[91] Reg. § 301.7701-7(c)(3)(iv) (2001).

[92] Reg. § 301.7701-7(c)(4)(i)(D) (2001).

[93] Reg. § 301.7701-7(c)(4)(i)(A)-(C) (2001).

[94] Reg. § 301.7701-7(f) (2001).

taxation. The rules defining a domestic trust are designed in part to prevent migration of domestic trusts—that is, the conversion of domestic trusts into foreign trusts.

Once a trust is determined to be a foreign trust, its taxable income is computed in the same manner as the taxable income of a nonresident alien individual who is not present in the United States at any time.[95] In general, the foreign trust is not taxable on its foreign source income but is taxable on income that is effectively connected with a U.S. business and on U.S. source periodical income. The residency rules of Code section 7701(b) are not applicable to foreign trusts.[96]

§ 4.01.4. Estates

In contrast to domestic corporations, partnerships, and trusts, domestic estates are defined as the residual category. That is, a domestic estate is any estate other than a foreign estate.

The Code definition of a foreign estate is circular. It provides that an estate is foreign if it is not subject to U.S. residence jurisdiction.[97] As noted above, that same definition was applicable to trusts under pre-1996 law. That circular definition of trusts and estates provoked considerable litigation, most of which related to the residency of trusts. Case law suggests that, in the absence of special circumstances, an estate is a foreign estate for federal income tax purposes if it is managed outside the United States, has its major assets located outside the United States, and is engaged in only minimal operations within the United States.

A Matter of Definition: "Foreign" and "Domestic" Taxpayers

2 *International Tax & Business Lawyer* 239-272, 258-266 (1984)

by David R. Tillinghast

Entities are not people. One needs to recognize this fundamental difference at the outset of any search for the most acceptable rule or rules for determining the domestic or foreign nature of legal entities. Both tax laws and tax lawyers tend to attach to these entities the same labels used to describe the connections between individuals and taxing jurisdictions. For instance, the English courts have struggled to analogize the residence of a company to that of an individual. There are common threads in the two situations, but each case is different and requires separate consideration. It is reasonable and appropriate for a country to tax a legal entity on income which originates within its borders. The question then is what kind of "ligatures," to use Ralf Dahrendorf's coinage,[98] between the entity and the country justify going beyond this simple rule to tax income of the entity which is conceded to have its source elsewhere. Each kind of entity must be considered separately, for on empirical and, perhaps, theoretical grounds there may be significant differences among them. The fact that a partnership is not a taxable entity whereas a corporation is a taxable entity may, for example, have an effect on the outcome. And the fact that an estate is intimately identified with the personal affairs of the decedent may suggest treatment different from that of a corporation, even if the corporation is owned by a single individual.

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[95] Reg. § 301.7701-7(a)(3) (2001).

[96] Id.

[97] IRC § 7701(a)(31)(A) ("The term "foreign estate" means an estate the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A").

[98] R. Dahrendorf, Life Chances 30-39 (1979).

Corporations. Although the rationale for the "place of incorporation" test has seldom been articulated, the test seems to rely on the notion that a corporation is able to earn income by virtue of being a juridical entity, in that it derives its income-earning capacity from the granting of its charter. The jurisdiction granting the charter and investing the entity with the legal capacity to earn income then has the right to tax that income when it arises. Taxing a corporation based on its place of incorporation is analogous to taxing an individual on the basis of citizenship because both focus on the grant of legal status to the taxpayer by the taxing country. Broadly stated, the policy of existing law is to allow a corporation to freely choose domestic or foreign status, including the status of an existing subsidiary, but to impose a consistency requirement. After the first free chance, a mid-life shift in a corporation's status may be achieved only at the price of "killing" the old corporation and "creating" a new one, with consequent tax effects under such recognition provisions as Code sections 367, 1491, and 1248.

"Taxing a corporation based on its place of incorporation is analogous to taxing an individual on the basis of citizenship because both focus on the grant of legal status to the taxpayer by the taxing country."

The "place of incorporation" test has one distinct advantage and one serious drawback. Its advantage lies in the certainty which arises from its application. If the test is applied by reference solely to the jurisdiction in which the corporation's charter is filed and by whose laws, therefore, the relations among its shareholders are governed, there can be no doubt as to what is a domestic and what is a foreign corporation.[99] The drawback of the "place of incorporation" test is that a corporation is by nature androgynous; it can and does autonomously create progeny. In this characteristic lies the important difference between the corporation and the individual. While there are some factors which may strongly influence the decision to incorporate a business in the United States rather than abroad, it is unlikely that a business such as IBM would have been incorporated outside the United States under any circumstances. Once the decision to incorporate in the United States is made, there are tax restraints on changing the decision and re-incorporating abroad. There are far fewer restraints, however, on the ability of a U.S. corporation simply to incorporate a subsidiary abroad, thus creating another taxpayer having a different status.

There is little question that the place of incorporation is a crude, if not naive, criterion of domestic corporate status. The question really is whether there exists a more rational and workable alternative. Some of the alternative tests that have been devised seem workable, but they do not address the central problem of U.S.-connected entities deriving entirely foreign income. For example, the United States might provide, as is done in Pakistan, that any corporation which has more than half of its gross income for a requisite period effectively connected with the conduct of a trade or business in the United States is a U.S. corporation. Such a rule would accomplish relatively little, however, as the effectively connected income of even a foreign

[99] Even this long-revered axiom may no longer be wholly true. Under recently enacted amendments to the Delaware Corporation Law, a foreign corporation may domesticate itself by filing its charter in Delaware. Del. Code, ch. 1, tit. 8, §§388, 389. At least under the first of these provisions, which relates to a permanent rather than a temporary change in the corporation's domicile, domestication will occur regardless of the effect of the filing under the foreign law governing the corporation's affairs at the time of the filing. Thus, a corporation could be considered a Delaware corporation under Delaware law while still being treated under foreign law as organized under the law of a foreign country. The problem is aggravated by the fact that the Delaware law in such a case specifies that "the existence of the corporation shall be deemed to have commenced on the date the corporation commenced its existence in the jurisdiction in which the corporation was first formed, incorporated or otherwise came into being." *Id.* §388(d). *Quaere*: whether this means that the corporation should be deemed always to have been a U.S. corporation for any relevant federal income tax purpose?

corporation is already taxable under the Code. Thus, any increase in taxability under U.S. laws would be only on the remaining income of the corporation.

> "It is difficult to see why the United States should even consider adopting the central management and control test, with its attendant difficulties, if the effect is to base the tax status of a corporation on the geographical location of its Board of Directors meetings."

Moreover, a change of this kind could be made effectively only by overriding the provisions of existing income tax treaties. The reaction of trading partners to actions which depart this far from traditional international tax conceptions can be judged by the outcry over unitary taxation and the longer-standing resentment over the United States' "extra-territorial" imposition of the "secondary" dividend tax on certain distributions by foreign corporations. Here the gain does not seem worth the stakes. The same is true of similar rules which base the domestic status of a corporation on the conduct of business within the jurisdiction, in combination with other factors relating to ownership and control.

The obvious and more responsive possibility would be to fashion a test under which a corporation would be considered a U.S. person on the basis of what is popularly known as its "residence." The test might be cast in any of several ways, including reference to the place of the corporation's central management and control, the place of its effective management, or the place in which its business is principally transacted. Although the particular factors to be taken into account would vary according to the exact formulation of the test, the concept would be to identify, not the jurisdiction which gives the corporation its legal life, but rather the jurisdiction in which its economic life is centered, focusing on inputs such as the capital, technology, and management skills which give the corporation the economic ability to earn income. This jurisdiction may be easier to identify in concept than in practice, however.

England and the other Commonwealth countries provide a good example of the problems associated with the "residence" test. In these countries, the residence of a company is a matter of common law. The courts have for many years followed, or purported to follow, the landmark decision in the *de Beers* case.[100] De Beers enunciated the test that the residence of a company, while a question of fact, depends upon the location of the "central management and control" of the company. The most important factor in determining the location of the central management and control is the location at which the company's Board of Directors meets or otherwise discharges its functions. At least one leading case suggests that this factor is decisive and, in the broad range of cases, the law has in fact been so applied.

The English reports are littered, however, with more disturbing opinions. One case, for example, holds that an English company was resident in England although all of its Board of Directors meetings were held and its entire business was carried on in Sweden. Another case states that a company may be simultaneously resident in two countries because parts of its management process are carried on in each.[70] An opinion in this case further maintains that when a company engages in more than two businesses, each business may have a different place of management and control. Although the case did not specify this result, presumably this view requires either that the world-wide income of the company be taxed in full by both jurisdictions, or

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[100] De Beers Consol. Mines, Ltd. v. Howe, 5 T.C. 198 (1905). [70] Unit Construction Co. v. Bullock, 1960 A.C. 351 (H.L).

that the two businesses be separated and the separate income of each taxed by the country of its domicile.[101]

This uncertain state of affairs seems highly unsatisfactory for several reasons. First, even if the place where the Board of Directors discharges its functions is held to be decisive, in the modern world this location may not be easy to determine. Many corporations rotate their Board meetings from one country to another. Directors are often of differing residence and nationality. With increasing frequency, Board actions are taken by written consent or in telephonic meetings. Directors waive their participation or give proxies to other directors. Management functions of large corporations are, moreover, often shared by the Board and its committees, which may, of course, meet at different places or by different means. Even if this process is correctly stage-managed, companies are always at risk that a different finding will be made. Under the English practice, such factual findings are made by Commissioners, who are employees of the Inland Revenue and the courts have reviewed the findings of the Commissioners with the utmost deference.

Indeed, in recent years, the English Inland Revenue, apparently of the view that the "central management and control" test is too malleable, has sought a legislative definition of corporate residence based on the presence in England of a company's "principal office." Denied this legislative change, in 1983 the Inland Revenue issued a "Statement of Practice" designed to clarify the application of the existing common law test. The views expressed in it, if ultimately upheld by the courts, would move the English law far in the direction of the "principal place of business" rule. The Statement emphasizes that the place where a company's Board of Directors acts is not always determinative of the place where central management and control is exercised. It notes, for example, that central management and control may be exercised by a single individual, as in a case when a chairman or a managing director "exercises powers formally conferred [on the Board] by the company's Articles and the other board members are little more than cyphers. . . . "

It is difficult to see why the United States should even consider adopting the central management and control test, with its attendant difficulties, if the effect is to base the tax status of a corporation on the geographical location of its Board of Directors meetings. The only results of such a change would be a mild stimulus to the economies of Canada, Bermuda, or our Caribbean neighbors, inconvenience in the taking of timely Board actions, and a not insubstantial measure of unfairness to small enterprises which would find it more difficult or expensive to keep their overseas subsidiaries "foreign." Further, if the central management and control test is not as simple as looking to the place where the Directors act, it may present a wholly different set of more difficult problems. The test is, after all, a factual analysis, carrying with it a degree of uncertainty and administrative complexity, and uncertainty in the test for corporate residence may prove even less tolerable than similar uncertainty in the individual case simply because the stakes are so large and the facts often so complex.

The U.S. might pass over the "centralized management and control" test in favor of the OECD's formula, which places residence where the "effective management" of the corporation is carried out. Phrased, undoubtedly, to ignore legal formalities in favor of economic realities, the OECD test might produce clear answers in at least some straightforward cases.

For example: Bermuda Corporation X is wholly-owned by U.S. citizen and resident A. Corporation X engages in the business of purchasing and reselling petroleum and petroleum products, dealing entirely with unrelated parties. All of its everyday activities are carried on by a staff located in Hamilton, and its Board of Directors, consisting of A, his Bermuda lawyer, and his banker meets there. However, all policy decisions are

[101] *See* Tillinghast, *Tax Aspects of International Transactions* § 1.2 (2d ed. 1984), 1 CAN. TAX REP. 2d (CCH) §§1120-26 (discussing Union Corp. Ltd. v. C.I.R., [1952] 1 All E.R. 646, [1952] T.R. 69, *aff'd*, [1953] 1 All E.R. 729 (H.L.), and Swedish Central Railway Co. v. Thompson, 1925 A.C. 495).

made by A from his apartment in New York. In this case, there would be a wide measure of agreement that the place of effective management of Corporation X is in the United States. The test still relies on an analysis of all the facts presented, however, and even if the rule works in a simple case such as this, there will be many other cases in which the result is not so clear.

For example: publicly-held U.S. Corporation A owns all of the stock of Corporation X, incorporated in Country X, and this corporation in turn owns all of the stock of Corporation Y, incorporated in Country Y. Corporation X serves not only as a holding company but as the European management center for the group of which Corporation A is the parent. Corporation Y, which engages in the manufacture of high-technology products, has its executive office in Country Y, fully staffed with qualified personnel. However, in each of its principal functions — technical, production, finance, and administration — its top line officer reports to a regional officer who is employed by Corporation X in Country X. In turn, each such officer reports to an officer of Corporation A, located in the United States, who has responsibility for the functional area to which he is assigned.

Employees of Corporation A and Corporation X constitute the Board of Directors of Corporation X and employees of all the corporations sit on the Board of Directors of Corporation Y. Under the corporate manual of approvals used by the Corporation A group, officers of Corporation Y are authorized to make certain decisions affecting production and sales without express approval from higher authority. Certain more important decisions can be made only with the concurrence of the appropriate officers of Corporation X. Major decisions — such as major capital expenditures or changes in products produced (switches of production to or from Corporation Y) — can be made only with the concurrence of the responsible officer of Corporation A. These decisions are, however, rare, and the actual commitment of funds or other action is always taken formally on behalf of Corporation Y by its Board of Directors.

In this situation, it is difficult to say where the "effective management" of Corporation X is located. It is clear that ultimate authority rests in Corporation A. On the other hand, the decisions actually made by Corporation A are those on which even a fully independent management might seek the views of its principal shareholder. From the U.S. point of view, of course, it is immaterial whether Corporation Y may be deemed to be effectively managed by officers of Corporation X in Country X.

> "Domestic or foreign status [for corporations] will remain in effect elective over a broad range of cases under any rule which is likely to be adopted."

These ambiguities in the determination of the place of effective management could be resolved in either of two ways. First a distinction could be made between shareholder or "stewardship" activities, which are not to be considered, and management functions, which are. This approach, however, creates other problems. Considering only management functions, the corporations in the above examples would clearly be treated as foreign corporations, unless the corporations have insufficient management staff abroad. Such a deficiency can be cured simply by increasing that staff, which raises questions of fairness as between large multinationals, which can afford to employ numerous management personnel to run their foreign enterprises, and small businesses, which do not enjoy this option. The protests of the small business community against the "foreign presence" requirement of the Reagan Administration's Foreign Sales Corporation initiative demonstrate the difficulties, real and political, which this kind of requirement would raise.

The second way of resolving the factual ambiguities of the "place of effective management" test would be to adopt the view that, in the end, the effective management of a corporation is lodged with its

controlling shareholder or shareholders, regardless of where the directors meet or the officers work. This approach would lead to a definition based on the domestic ownership of a controlling stock interest in an otherwise foreign corporation. Such a "back-door" termination of the deferral of taxation on foreign subsidiary earnings is no more likely to succeed than more direct approaches, however. The policy trade-offs between capital import and capital export neutrality have given us Subpart F in its present form, and it is unreasonable to suppose that that compromise will be upset by toying with the Code's definitional structure. Moreover, even advocates of ending deferral may have serious reservations about taxing that portion of the foreign earnings of a less-than-wholly-owned controlled foreign corporation which accrues to the benefit of foreign shareholders.

Similar analyses could be made of the analogous tests which refer to the corporation's principal place of business. These tests either stumble in the face of factual ambiguity or resolve the ambiguities by resorting to tests which favor those (mainly large) companies which have a relatively high degree of flexibility in arranging the corporate pieces of the enterprise. Further, the place of incorporation test, or some substitute, would have to be retained as an alternative, lest all U.S. subsidiaries of foreign parents be treated as foreign.

The conclusion which emerges is that domestic or foreign status will remain in effect elective over a broad range of cases under any rule which is likely to be adopted. Big companies with a range of choices concerning the deployment of personnel and access to good legal advice will normally be able to qualify for foreign status, even under standards more stringent than the place of incorporation test. An attempt to impose more stringent standards is likely to weigh particularly heavily on smaller enterprises or those which for one reason or another do not have the range of flexibility that most multinationals have. Under these circumstances, the case seems persuasive for continuing the approach of current law, making domestic or foreign status effectively elective under the place of incorporation test and utilizing Subpart F to tax through to U.S. shareholders their shares of the income of foreign corporations whose activities are not sufficiently enmeshed in the economies of foreign countries to justify, in the Congress' view, tax deferral.

The logic of this conclusion leads to another view so radical that it has not even been whispered for twenty years, that U.S. persons might be given the election to treat a U.S. incorporated entity as a foreign one. Experience shows that few purchasers are willing to pay full federal income tax as the price for access to the law of Delaware as governing law and prefer, if it comes to that, the laws of Canada, Bermuda, or other jurisdictions whose prices for nearly identical goods are more reasonable. The object of allowing such an election would be the rationalization of this recognized electivity, and nothing more. The proposal is senseless if an attempt is made to attach conditions to such an election that do not attach to owning a foreign corporation. On the other hand, all of the effects of "foreignness," such as the application of Code sections 367 and 1248, as well as Subpart F, must flow from the election, lest unintended benefits arise.

§ 4.02. Classification of Juridical Persons

This section describes the rules governing the classification of a legal entity for federal tax purposes as a corporation, partnership, trust, or estate, or as an entity having no independent juridical status ("disregarded entity"). Under regulations initially issued in 1996, the tax authorities have granted broad discretion to the taxpayer to determine for itself whether it will be classified as a corporation, partnership, or disregarded entity for federal tax purposes. These regulations are popularly referred to as the check-the-box regulations to signify that taxpayers may elect the classification that best serves their tax planning goals

simply by checking a box (metaphorically) on a tax form.[102] The classification of an entity as a trust or estate is not elective under those regulations.

The entity classification scheme adopted under the so-called check-the-box regulations in 1996 divides all entities subject to classification into two categories. The first category is business entities, and the second is non-business entities. Subject to some important limitations, taxpayers are permitted to elect the tax status to be given to legal entities in the first category. Section 4.02.1, below, sets forth the main features of this elective system.

Section 4.02.2, below, describes the rules for classifying non-business entities. Trusts and estates are the only two types of non-business entities recognized under the regulations. Some policy notes, critical of the check-the-box regulations, are presented in § 4.02.3.

In a press release dated May 4, 2009, the Obama administration signaled a limited assault on the check-the-box regulations. It stated as follows:

> ***Eliminating Loopholes for "Disappearing" Offshore Subsidiaries***: Traditionally, U.S. companies have been required to report certain income shifted from one foreign subsidiary to another as passive income subject to U.S. tax. But over the past decade, so-called "check-the-box" rules have allowed companies to make their foreign subsidiaries "disappear" for tax purposes—permitting them to legally shift income to tax havens and make the taxes they owe the United States disappear as well. The Obama administration proposes to reform these rules to require certain foreign subsidiaries to be considered as separate corporations for U.S. tax purposes. This provision would take effect in 2011, raising $86.5 billion from 2011 to 2019.

Time will tell whether the Obama administration will be successful in this endeavor. Supporters of tax reform in the House and Senate may attempt to expand the Obama initiative to mount a more extensive attack on check-the-box abuses. Opponents may try to derail the proposal.

§ 4.02.1. Business Entities

A business entity is "any entity recognized for federal tax purposes . . . that is not properly classified as a trust. . . or otherwise subject to special treatment under the Internal Revenue Code."[103] The intended effect of the rule is to treat an entity used to conduct business as a business entity. A joint venture or other contractual arrangement may constitute a business entity.[104] Little positive guidance is given as to the conditions that must be met for a contractual arrangement or organizational structure to constitute an "entity." An arrangement does not need to have legal status in its country of residence to be considered an entity.[105] The tax authorities apparently intended that a branch or division of a corporation not be treated as an entity, although the regulations never actually make that point explicitly.[106]

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[102] The election is made on Form 8832 (Entity Classification Election), and, indeed, that form provides some boxes to check.

[103] Reg. § 301.7701-2(a) (2012).

[104] Reg. § 301.7701-1(a)(2) (2011).

[105] Reg. § 301.7701-3(a) (2006).

[106] Reg. § 301.7701-1(a)(4) (2011) states that certain organizations having a single owner "can choose to be recognized or disregarded as entities separate from their owners." The use of the word "organizations" rather than "entities" is significant. Branches are treated as separate entities for some purposes under the Code. See, e.g., IRC §§ 954(d)(2) (branch rule under the anti-avoidance rules of subpart F) and 989(a) (qualified business unit under the foreign currency rules of subpart J). Those ersatz entities, however, are not "organizations." Obviously a regulatory definition of the term "organization" would have been useful in clarifying the regulatory intent.

The three types of business entities that are recognized under the check-the-box regulations are corporations, partnerships, and "disregarded entities." A disregarded entity is an entity that is not recognized as a distinct entity for federal tax purposes. A business entity with two or more members is either a corporation or a partnership,[107] and a business entity with only one member (single-member entity) is either a corporation or a disregarded entity.[108] A single-member entity is popularly called a "SME" (rhymes with glee). Many of the tax planning opportunities made available under the check-the-box regulations involve the classification of SMEs. Presumably, that is the reason that SMEs are the prime target of the Obama administration's proposed reform of check-the-box.

§ 4.02.1.1. Operative Rules

Subject to various restrictions, a taxpayer may elect to treat a business entity with two or more members as either a partnership or a corporation for federal tax purposes.[109] The taxpayer generally may elect to treat an entity with a single owner as a corporation or as a disregarded entity.[110] A disregarded entity is treated as a sole proprietorship when owned by an individual and as a branch or division when owned by a juridical person.[111] This classification election is available only to "eligible entities."[112] An eligible entity is a business entity that is not listed as an ineligible entity.

Ineligible Entities. An ineligible entity is a business entity that must be treated as a corporation under the regulations. All entities organized as a corporation under the law of a U.S. state or the District of Columbia or a Federal statute are ineligible entities.[113] That is, they are taxed as associations under the Code without regard to any election the taxpayer may wish to make. Entities organized as a limited liability company (LLC) under state law, however, are not listed as ineligible. Publicly traded partnerships generally are ineligible, as provided in Code section 7704. Insurance companies[114] and some domestic banks[115] are ineligible entities, but other financial services companies generally are eligible entities.

The list of ineligible entities includes some foreign entities. In general, the tax authorities have treated one type of entity in each of a long list of foreign countries as constituting a corporation. For example, in several countries, including Australia, India, Malta, and the United Kingdom, a "Public Limited Company" must be treated as a corporation; in several other countries, including France, Luxembourg, and Morocco, it is a "Societe Anonyme" that is ineligible for elective treatment; in Poland, it is a "Spolka Akcyjna."[116] A variance from the general rules is provided to certain taxpayers who had treated various listed entities under color of law as partnerships under the old regulations.[117] In general, the ineligible foreign entities are corporations that typically are not closely held and the shares of which can be traded on a securities exchange.

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[107] Reg. § 301.7701-2(a) (2012).

[108] Id.

[109] Reg. § 301.7701-3(a) (2006).

[110] Id.

[111] Reg. § 301.7701-2(a) (2012).

[112] Reg. § 301.7701-3(a) (2006).

[113] Reg. § 301.7701-2(b)(1) (2012). This rule includes corporations created under the laws of a federally recognized Indian tribe.

[114] Reg. § 301.7701-2(b)(4) (2012) and IRC § 7701(a)(3).

[115] Reg. § 301.7701-2(b)(5) (2012). To be ineligible, the bank must be chartered by a state and its deposits must be guaranteed by the Federal Deposit Insurance Act. Id. The various "plaque-on-the-door" banks are eligible entities.

[116] Reg. § 301.7701-2(d)(1) (2012).

[117] Reg. § 301.7701-2(b)(8)(ii) (2012).

Default Election. To simplify administration of the system, taxpayers that fail to file an election with respect to an eligible entity are treated under specified default rules.[118] The default rules generally reflect the best guess of the tax authorities as to the classification that would be preferred by the taxpayer. This favorable default system is part of an overall objective of the regulation writers to give taxpayers whatever outcome they might have been able to achieve through tax planning under the prior rules, but without the transactional costs.

Changing an Election. Some modest limitations are imposed on making and changing an election. In general, an entity is entitled to change an election only once in any 5-year period.[119] It may do so at will by transferring its business and assets to a new entity, but such a transfer may have adverse tax consequences.

An entity that has been treated as a corporation that elects to be treated as a partnership is treated as if it distributed its assets and liabilities to its shareholders in liquidation and the shareholders immediately contributed those assets and liabilities to a newly formed partnership.[120] Gain is recognized on the deemed liquidation, and the deemed basis of the partners is carried over to the partnership on the deemed contribution to the partnership.[121] Similarly, if an entity taxable as a partnership elects to be classified as a corporation, it is deemed to have contributed its assets and liabilities to the corporation in exchange for stock and to have distributed the stock to the partners on liquidation of the partnership.[122]

If a corporation elects to be treated as a disregarded entity, the owner is treated as having received the assets and liabilities of the corporation in liquidation.[123] Conversely, if a disregarded entity elects to be treated as a corporation, the owner of the organization is treated as having contributed all of the assets and liabilities of the organization to the corporation in exchange for its stock.[124]

If the membership of an eligible entity that has elected to be treated as a partnership is reduced to one, then the entity becomes a disregarded entity.[125] If the membership of a disregarded entity should become greater than one, then the entity is classified as a partnership unless the parties make an election to have the entity classified as a corporation.[126] For example, if A, the owner of a disregarded entity, sells a 50-percent interest in that entity to B, then the entity will be classified as a partnership.[127] A and B may elect, however, to have the entity classified as a corporation.[128]

The check-the-box regulations offer many tax planning opportunities to U.S. taxpayers in the international arena, as illustrated by the following example.

Example 4.1: Check-the-Box Regulations

UCo is a domestic corporation organized under the laws of Delaware. It conducts business in the United States at a profit. UCo owns all of the stock of MCo, a corporation organized under the laws of

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[118] Reg. § 301.7701-3(b) (2006).

[119] Reg. § 301.7701-3(c)(1)(iv) (2006).

[120] Reg. § 301.7701-3(g)(1)(ii) (2006).

[121] Reg. § 301.7701-3(g)(2) (2006).

[122] Reg. § 301.7701-3(g)(1)(i) (2006).

[123] Reg. § 301.7701-3(g)(1)(iii) (2006).

[124] Reg. § 301.7701-3(g)(1)(iv) (2006).

[125] Reg. § 301.7701-3(f)(2) (2006).

[126] Id.

[127] Reg. § 301.7701-3(f)(4) (2006).

[128] Id.

Country M that has been operating at a loss. To minimize U.S. tax on its U.S. source income, UCo elects under the check-the-box regulations to treat MCo as a branch. As a result of that election, the foreign losses incurred by MCo may be used to offset UCo's income earned in the United States.

Besides owning MCo, UCo also owns a six percent interest in RCo, a corporation organized under the laws of Country R. RCo was formed by a consortium of companies, mostly European, to construct oil-refining facilities in Country R. RCo pays substantial income taxes to Country R and pays substantial dividends to its shareholders. MCo cannot claim an indirect foreign tax credit for the Country R income taxes, however, because it fails to satisfy the 10-percent ownership test of Code section 902(a). It arranges, therefore, for RCo to elect to be treated as a partnership for U.S. tax purposes.[129] *As a deemed partner in RCo, UCo becomes eligible to claim a direct foreign tax credit under Code section 901. It is treated under that section as having paid its pro rata share of RCo's taxes.*

UCo also owns SCo, a holding company organized under the laws of Country S, a tax haven. SCo pays no taxes in Country S. SCo has three wholly owned European subsidiaries, FCo, GCo, and ICo, that operate, respectively, in Country F, Country G, and Country I. All of these affiliates operate at a profit. To take advantage of business opportunities that arise from time to time, UCo arranges for funds to be transferred from one of the affiliates to another. The transfers take place by having one of the affiliates pay a dividend to SCo and having SCo make a capital contribution to the affiliate in need of the funds.

Under the anti-avoidance rules of subpart F, a dividend from GCo, FCo, or ICo to SCo would be treated as "subpart F" income, currently taxable to UCo as a deemed dividend. To avoid that result, UCo arranges for the European affiliates to check the box to be treated as branches of SCo. As a result of that election, the dividends from the affiliates to SCo are treated for U.S. tax purposes as intra-company transfers with no U.S. tax consequences.

The check-the-box regulations increase the opportunities for avoiding foreign income taxes as well as U.S. taxes. To illustrate, assume that SCo, the holding company in the example above, owns a valuable trademark, which it makes available to GCo for a royalty. GCo deducts the royalty payment in computing its income taxes owed to Country G. Before the check-the-box regulations were adopted, the royalty payments from GCo to SCo would have constituted subpart F income, taxable currently to UCo as a deemed dividend. UCo would have little incentive, therefore, to cause SCo to inflate the royalty charge to GCo.

That result is changed under check-the-box. If GCo, in *Example 4.1*, above, checks the box to be treated as a branch of SCo, royalty payments between GCo and SCo are ignored for U.S. tax purposes and do not generate subpart F income. An inflated royalty, therefore, has become beneficial. Of course, Country G might prevent GCo from deducting an excessive royalty payment, assuming it has in place an effective set of transfer pricing rules. To do so, however, it must detect the misstatement of income and expend resources to correct it.

§ 4.02.1.2. Anti-Avoidance Measures

Some commentators and some governments profess to be unconcerned about the type of tax avoidance illustrated in *Example 4.1*, above. They insist that a country should be concerned only about the avoidance of its own taxes. It should not, they claim, be a tax policeman for the world.[130]

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[129] The assumption in the example is that the affiliates were not ineligible entities—that is, they were not organized as one of the listed foreign entities that *must* be treated as a corporation under the check-the-box regulations. *See* Reg. § 301.7701-2(b)(8)(i) (2012).

[130] Old-timers may recall that this argument was made against the adoption of the subpart F rules in the early 1960s.

From the government perspective, this solipsistic approach to international taxation is grand folly. The United States, and indeed all major industrial countries, have a major stake in buttressing the tax systems of their trading partners. The relationship between source taxation and residence taxation is symbiotic. Source countries are dependent on residence countries to mitigate the competitive pressures that tend to undermine their ability to tax income from moveable capital. Residence countries are likewise dependent on source countries, for only the source country can reduce the potential profit from tax avoidance and evasion by collecting taxes through withholding or by providing the residence country with regular and accurate information on the income flows of its residents.

The U.S. tax authorities belatedly acknowledged that the check-the-box rules they championed were allowing taxpayers to sidestep the anti-avoidance rules of subpart F and otherwise were wrecking havoc with the international tax regime that the United States had constructed over the past four decades.[131] On January 16, 1998, it issued Notice 98-11,[132] announcing that regulations were forthcoming that would restrict the use of hybrid entities—entities treated as one type of entity under check-the-box and as another type of entity under foreign law. The promised regulations, temporary and proposed, were issued on March 23, 1998. On June 19, 1998, in response to a firestorm of protests from multinational companies and the threat of Congressional action to roll back the regulations,[133] the tax authorities withdrew the regulations and announced an intent to issue new regulations that would be effective after a lengthy transition period.[134] Companies that had set up hybrid entities prior to June 19, 1998, were promised that they would be permanently exempt from the anti-avoidance rules contained in the new regulations.[135] The new proposed regulations, based on the March 23, 1999, temporary regulations that were withdrawn, were issued on July 9, 1999. They are to be effective no sooner than July 1, 2005—indicating that many of the tax avoidance

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[131] The U.S. tax authorities have been reluctant to acknowledge that check-the-box, from the government's perspective, has been an abysmal failure. This reluctance is understandable, as the tax authorities developed and promoted the check-the-box concept. The tax avoidance opportunities available under check-the-box were explained in detail in the first edition of this book, long before Notice 98-11 was under consideration by the Service. For a primer on international tax avoidance under check-the-box, see John B. Magee, F. Scott Farmer, and Robert A. Katcher, "Branching Out – Reexamining Branch Rules in the Context of Check-the-Box," 15/25 *Tax Notes Int'l* 1951-1972 (Dec. 15, 1997). See also Henry J. Lischer, Jr., "Elective Tax Classification for Qualifying Foreign and Domestic Business Entities Under the Final Check-the-Box Regulations," 51 *Southern Methodist University Law Review* 99 (1997) (providing an excellent analysis and description of the check-the-box rules); Victor E. Fleischer, Note, "'If It Looks Like a Duck': Corporate Resemblance and Check-the-Box Elective Tax Classification," 96 *Columbia Law Review* 518 (1996); Thomas M. Hayes, Note, "Checkmate, the Treasury Finally Surrenders: The Check-the-Box Treasury Regulations and Their Effect on Entity Classification," 54 *Washington & Lee Law Review* 1147 (1997).

[132] Notice 98-11, 1998-6 I.R.B. 13 (Jan. 16, 1998). See also Lee Sheppard, "U.S. Cross-Border Tax Arbitrage, 'Hybridity,' Mules, and Hinnies," 16/8 *Tax Notes Int'l* 579-585 (Feb. 23, 1998).

[133] See Staff of Joint Committee on Taxation, *Description of Additional Modifications to Senate Finance Committee Chairman's Mark Relating to Reform And Restructuring of The Internal Revenue Service And Tax Technical Correction Provisions* (JCX-23-98), March 31, 1998 (stating that it is the sense of the Finance Committee that the regulations contemplated by Notice 98-11 should not be implemented for at least 6 months).

[134] Notice 98-35, 1998-27 I.R.B. 35 (June 19, 1998). For discussion of the political difficulties that forced the Treasury Department to withdraw the regulations, see Leslie Wayne, "U.S. Corporate Giants Save a Tax Loophole," *New York Times* p. 17 (July 12, 1998) (describing the "intense lobbying campaign" by U.S.-based multinationals and the big accounting firms that had aggressively marketed tax avoidance schemes based on check-the-box). Multinational companies stand to reduce their annual tax bill by many billions of dollars, notwithstanding the low-ball estimate by the Joint Committee on Taxation that the revenue cost of rolling back the regulations would amount to only $1.8 billion over ten years. That estimate does not take account of the huge tax savings that U.S.-based multinationals would enjoy from avoiding foreign taxes and the likely retaliatory responses of U.S. trading partners to the U.S.-sponsored avoidance of their taxes. For additional discussion of the IRS retreat on Notice 98-11, see Dave Benson, Hal Hicks, Margie Rollinson, and Vickie Kraay, "U.S. IRS Notice 98-35 Withdraws Regulations on Hybrid Branch Payments," 16/26 *Tax Notes Int'l* 2033-2036 (June 29, 1998); Lee Sheppard, "U.S. Notice 98-11 Withdrawn: Who Won?," 17/1 *Tax Notes Int'l* 57 (July 6, 1998).

[135] Notice 98-35, 1998-27 I.R.B. 35 (June 19, 1998).

opportunities derived from the use of hybrid entities will be available for at least another six years.[136] In fact, they never went into effect.

Although the U.S. tax authorities in the Clinton administration were forced by political concerns to surrender on the hybrid-entity issue, they had indicated a willingness to continue to oppose other perceived abuses of the check-the-box rules. On November 29, 1999, they issued proposed regulations that would prevent a taxpayer in some circumstances from using check-the-box to characterize a foreign subsidiary as a disregarded entity when it sells the stock in that entity.[137] A typical taxpayer purpose for having the subsidiary treated as an disregarded entity would be to convert, for U.S. tax purposes, the sale of stock in a foreign affiliate—which typically would generate U.S. source income[138] or subpart F income[139]—into a sale of its assets.[140]

In the preamble to the November 29, 1999, proposed regulations, the U.S. tax authorities indicated a concern that abuse of check-the-box was undermining some important U.S. tax policies and that its proposed solution is to void the effect of a check-the-box election in some cases. The preamble states:

> These regulations [modifying the check-the-box rules] are intended to address inappropriate Federal tax consequences that would otherwise result from certain of these transactions under a number of international provisions of the Code. These provisions include the rules governing source of income under sections 861 through 865, foreign tax credit limitation categories under section 904, the disposition of ownership interests under Subpart F (sections 951-964), and outbound transfers under section 367. . . .

The IRS and Treasury considered several responses to these transactions and determined that a special rule completely revoking the entity's classification as a disregarded entity was the most equitable and administrable approach. Of the responses considered, the IRS and Treasury believe that this approach also gives the greatest certainty to all parties involved in the transactions covered by this rule.[141]

The proposed regulations signaled a change in strategy by the U.S. tax authorities. Rather than attacking perceived abuses by amending the substantive tax rules that check-the-box has undermined, the U.S. tax authorities in the Clinton administration apparently were prepared to curtail certain perceived abuses by amending the check-the-box regulations. The advantage of this latter approach, from the perspective of the tax authorities, is that they appear to have plenary power to revise the check-the-box regulations, having usurped the power to issue the regulations in the first place.[142] In fact, however, nothing

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[136] For discussion, see David Benson & Margaret O'Connor, "U.S. Treasury Backs Off Its Attack on Hybrid Branches, Withdraws Notice 98-35 and Temporary Regulations," 19/4 *Tax Notes Int'l* 389 (July 26, 1999).

[137] Prop. Reg. § 301.7701-3(h) (1999).

[138] Compare IRC §§ 865(a) (setting forth general rule that the source of income from sale of personal property, including stock, is country of residence of the seller), 865(c) (sale of depreciable property used outside the United States produces foreign source income), and 865(d) (sale of certain intangible property used outside the United States produces foreign-source income).

[139] See IRC § 954(c)(1)(B) (classifying gain sale of stock as foreign personal holding company income subpart F income).

[140] For discussion of the proposed regulations, see Thomas R. May, "Warning: Hybrid Entities—Proceed With Caution," 19/25 *Tax Notes Int'l* 2357 (December 20, 1999).

[141] REG. 110385-99, 64 F.R. 66591 (Nov. 29, 1999).

[142] The creation of an elective system would appear to go beyond the authority of the tax authorities to interpret statutory terms such as "partnership" and "corporation," especially when the system routinely results in the same types of entities being classified differently for similarly situated taxpayers. The possible illegality of the regulations is discussed in Staff of the Joint Committee on Taxation, *Review of Selected Entity Classification and Partnership Tax Issues* (JCS-6-97), April 8, 1997, at 13-16; see also W. McKee, W. Nelson and R. Whitmire, *Federal Taxation of Partnerships and Partners*, 3-102 (3d ed. 1997), para. 3.08; New York State Bar Association Tax Section, "Report on the 'Check the Box' Entity Classification System Proposed in Notice 95-14," Aug. 30, 1995.

much was done, by the Clinton administration or the subsequent Bush administration. The Obama administration indicated some willingness to restrict certain perceived abuses of check-the-box, but, as of August of 2012, no legislative changes have been adopted..

The importance of the check-the-box rules for international tax planning is hard to overstate. A recent assessment of those rules in the international field reported that the application of the rules to foreign entities is "complex and difficult to administer, and is revenue reducing as a result of potentially inefficient tax planning activity that is contrary to the objectives of the Code provisions for taxing foreign income".[143] According to IRS figures, a total of 97,922 elections were made under the check-the-box rules by foreign entities from 1997 to 2007. Of that number, 68,218 such elections were made to classify entities as disregarded (SMEs).[144]

§ 4.02.2. Trusts and Estates

In general, trusts and estates are classified under the check-the-box regulations according to their actual legal characteristics. That is, they are not part of the elective system described in § 4.02.1, above.

In general, an organization that is treated under the check-the-box regulations as a separate entity for federal tax purposes is either a "trust" or a "business entity."[145] A trust is an entity that does not have associates or an objective to carry on business for profit.[146]

A trust is typically created by will or *inter vivos* declaration. Under the trust arrangement, the trustees typically hold title to property contributed to the trust and preserve or conserve the property for the beneficiaries of the trust. In general, the beneficiaries may not share the management responsibilities of the trustees. Consequently, they are "not associates in a joint enterprise for the conduct of business for profit."[147]

An entity will not be classified as a trust for federal tax purposes simply because it is referred to as a trust or has a trustee who holds legal title to contributed property. The general rule is that if the entity carries on business for profit, it will not be a trust, notwithstanding its name.[148]

No guidance is given in the Code or the regulations as to when an entity might be classified as an estate for purposes of entity classification. In this context, however, an estate is simply a special kind of trust. The "grantor" of that trust is the decedent, and the beneficiaries are the persons entitled to receive the property of the estate pursuant to a will or to the applicable laws of descent and distribution. The fiduciary of this special trust is the executor or administrator of the estate.

Viewed as a type of trust, an estate would not be classified as a business entity if it does not have associates or an objective to carry on business for profit.[149] Its defining characteristics would be that it came into being as a result of the death of the decedent, that its property is held in a fiduciary capacity by the administrator or executor, that the primary responsibility of that fiduciary is to preserve and conserve the estate for its beneficiaries, and that the beneficiaries do not share in the discharge of that responsibility. By

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[143] See Heather M. Field, "Checking in on 'Check-the-Box,'" 42 Loyola L.A. Law Rev. 451, 490 (2009).

[144] Id. at n. 205.

[145] Reg. § 301.7701-2(a) (2012).

[146] Reg. §§ 301.7701-1(b) (2011) and 301.7701-4(a) (1996).

[147] Reg. § 301.7701-4(a) (1996).

[148] Reg. § 301.7701-4(b) (1996)

[149] By classifying all entities that are not business entities as "trusts," Reg. § 301.7701-2(a) (2012) has implicitly treated an estate as a type of trust. Yet Reg. § 301.7701-4 (1996) distinguishes sharply between trusts and estates.

analogy to the trust rules, it appears that an estate that is used to conduct business or to manage investments for persons who are not beneficiaries would be treated as a business entity under the regulations.

§ 4.02.3. Policy Notes on Check-the-Box

The check-the-box system for classifying business entities violates the basic principle that tax policy should be made by the government acting for the citizenry as a whole, not by individual taxpayers acting in their own self interest. As illustrated by *Example 4.2*, above, check-the-box permits taxpayers to defeat freely some of the fundamental policy goals of the corporate income tax. For example, by utilizing the check-the-box regulations, a U.S. corporation that wants to take losses incurred by a foreign affiliate can do so by electing to have the foreign affiliate treated as its foreign branch. Similarly, U.S. taxpayers can defeat the anti-avoidance rules of subpart F in many cases by electing to have their foreign controlled corporations treated as branches. As the U.S. tax authorities acknowledged in the preamble to proposed regulations issued on November 29, 1999, check-the-box is being used to defeat U.S. source rules, U.S. rules on expatriation of assets, U.S. credit limitation rules, subpart F rules, and many other major rules. Surely, check-the-box is a sign that U.S. international income tax policy is in disarray.

Defenders of check-the-box contend that the system it replaced was "insane." Not only was it insane in terms of policy results, but it also imposed high administrative costs on the government and forced taxpayers to pay extravagant legal fees.[150] Check-the-box is better, they assert, because it achieves about the same results as the old insane system at substantially reduced costs.[151]

Members of the tax bar, and particularly the international tax bar, have responded euphorically to check-the-box.[152] Their euphoria cannot be explained entirely by the prospect that they will be losing extravagant legal fees. At least in part, the euphoria is due to the dramatic new opportunities for tax avoidance that check-the-box offers.[153]

Check-the-box has surely simplified the law relating to the classification of foreign entities. Some of the simplification gains, however, may be short lived. Check-the-box is not grounded on tax policy principles. It is an ad hoc response to the problems created by the unprincipled, perhaps insane, classification system that it replaced. All legal rules, including the extensive rules in the check-the-box regulations, require interpretation. In a principled system, the underlying principles give guidance on how interpretive lines ought to be

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[150] The characterization of the old classification rules as insane comes from Gerald T. Ball and Michael A. Siegel, "Current Developments in Foreign Entity Classification—Stop the Insanity," 9 *Tax Notes Int'l* 759-767 (Sept. 5, 1994).

[151] See, e.g., David A. Weisbach, "Line Drawing, Doctrine, and Efficiency in the Tax Law," 84 Cornell Law Review 1627-1681 (1999) (praising check-the-box on efficiency grounds without noting the enormous efficiency costs that almost certainly result from allowing taxpayers to engage in cross-border tax arbitrage through the use of hybrid entities).

[152] See, e.g., Daniel M. Shefter, "Check the Box Partnership Classification: A Legitimate Exercise in Tax Simplification," 67 *Tax Notes* 279 (April 10, 1995) (suggesting that the proposed check-the-box system "almost sounds too good to be true"). Some academics were also enthusiastic. See, e.g., Reuven S. Avi-Yonah, "To End Deferral As We Know It: Simplification Potential of Check-the-Box," 74 *Tax Notes* 219 (January 13, 1997) ("check-the-box makes it possible for taxpayers to avoid transaction costs, without putting the IRS in a significantly worse position than it was under prior law, and also reduces the likelihood that classification issues will be the subject of litigation, which is costly for both taxpayers and the IRS").

[153] For a useful description of the check-the-box regulations and a discussion of the tax planning opportunities they present, see Joni L. Walser and Robert E. Culbertson, "Encore Une Fois: Check-the-Box on the International Stage," 15 *Tax Notes Int'l* 53-74 (July 7, 1997). In describing the importance of check-the-box to tax planners, those authors observe:

> The regulations . . . are said to have merely made *de jure* an elective classification scheme that already existed *de facto* under prior law. But [the fact of the matter] is that electivity could only be achieved at significant expense and *with significant uncertainty*—and not at all in some cases—while elective classification is now cheap, certain, and available in all but a few well defined cases. Thus, the regulations will *substantially broaden* the practical utility of U.S. classification as an international tax planning tool. (Emphasis added.)

Id. at 55.

drawn. Unprincipled systems tend to get complex because the line drawing cannot be accomplished without creating a host of new anomalies. The one operative principle under check-the-box—that no taxpayer should be worse off than under the old rules—is not a useful principle for maintaining a coherent system of taxation.[154]

The check-the-box regulations, in the international arena, do not appear to serve any public purpose, unless undermining the international tax regime of the United States and its trading partners is viewed as a public purpose. As one commentator has noted:

> [I]t is difficult to believe that the original purpose for which the [check-the-box] regulations were issued has been accomplished to any significant degree. That purpose was to reduce the total amount of time Treasury must spend addressing issues relating to entity classification. Instead, it seems that nowadays Treasury wastes much more time in attacking the use (or misuse) of hybrid entities in international tax planning than it ever did on domestic and foreign entity classification.[155]

Given the lack of apparent public purpose, the case on tax policy grounds for retaining the check-the-box regulations in their present form apparently does not exist. The political obstacles to fundamental reform of the regulations, however, appear to be formidable.

Reform cannot come without the development of some new system for classifying foreign entities. The old system of looking at "corporate attributes" was flawed conceptually, and in practice it worked out as an expensive, albeit limited, version of check-the-box. That system was designed primarily to deal with the issue of whether income earned through an entity of questionable status should be taxable both at the corporate level and at the individual level. In the international arena, virtually all of the entities of questionable status are owned by corporations. The individual shareholders of these corporations are not going to be taxed directly (*i.e.,* on a pass-through basis) on income earned through those entities however the classification issue is resolved. The primary issue in the international arena is whether corporations should be allowed to use inconsistencies among countries in the classification of their controlled entities to minimize their taxes. The old system allowed that type of tax planning, but only at some cost in administrative fees and some risk. Check-the-box, as initially implemented, made it inexpensive and virtually risk free. The Treasury's anti-avoidance campaign, however, is likely to increase both the costs and the risks.

A reformed classification system in the international arena would have two important characteristics—certainty and consistency. Certainty would be advanced by identifying the status of an entity once and for all, based on ascertainable historical facts. For example, certainty would be advanced by preventing taxpayers from treating an entity as a "disregarded entity" if they have organized it as a corporation under local law.

Consistency is achieved if an entity that is treated as a corporation, branch, or partnership in one country is given that same treatment in all other countries in which the entity conducts significant business activities. In a world replete with tax havens, full consistency is impossible to achieve. It would be advanced, however, if the major taxing countries agreed to give nearly determinative weight, in classifying an entity, to the classification given to it under the laws of the member state in which it was organized.

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[154] The point made in the text might have been controversial when initially written—soon after publication of the check-the-box regulations. At the time, tax practitioners and Internal Revenue officials were still expecting to garner major simplification gains from check-the-box. It is now clear, however, that those gains did not materialize.

[155] Thomas R. May, "Warning: Hybrid Entities—Proceed With Caution," 19/25 *Tax Notes Int'l* 2357 (December 20, 1999).

Like the sack of Rome by Alaric and his Visigoths in the early fifth century, the adoption of check-the-box punctuated and finalized a decline and fall that had occurred through many small steps over a very long time.[156] The unruly and undisciplined check-the-box system that replaced it, however, is far worse than the old regime, for the only rule of law that now applies is the law asserted by the taxpayer as ruler of its private domain. Reform of check-the-box should be high on America's tax reform agenda, for that unwise and possibly illegal system is undermining its international tax policies and the tax polices of its major trading partners.

[156] Those steps would include (1) the original classification regulations (*Kintner* regulations), adopted in 1960, which placed heavy emphasis on formal attributes under control of the taxpayer and were improperly weighted in favor of conduit treatment; (2) the *per se* treatment of a limited partnership as a conduit entity (the rule that launched a million tax shelters); (3) the general treatment of a partnership with a corporate general partner as a conduit; (4) the treatment of very large partnerships with centralized management, such as American Express, as conduits; and, most recently, (5) the treatment of limited liability companies (LLCs) as conduits.

Chapter 5
Problems on Tax Jurisdiction

§ 5.01. Review Problems

1. A is a citizen of Brazil. He has a full-time job in that country and generally lives there with his family in a home that he has owned for over 20 years. In year 1, A comes to the United States for the first time. The sole purpose of the trip is business. A intends to stay in the United States for only 180 days, but he runs into problems with his business and is required to stay for 300 days. He comes to the United States again on business in year 2 and stays for 180 days. Early in year 3, he comes to the United States on business and stays for 60 days. Later in the year, he returns to the United States to take his 6-year old son to Disney World in Florida. He stays at Disney World for 10 days and then returns to Brazil with his son.

In year 4, A comes to the United States and remains for 170 days on business. At the end of his business trip, he is joined by his 10-year old daughter, who also wants to see Disney World. They plan to stay in Florida for no more than 10 days. On day 10 of the planned visit, the daughter breaks her leg trying to avoid being crushed by a crowd of people trying to get into Fantasy Land. She is put into the hospital for treatment, where she is required to stay for 10 days. A remains in Florida to be near his daughter. They both leave the United States on the day that the daughter is released from the hospital. Is A a U.S. resident for tax purposes in years 1, 2, 3, or 4?

2. In December of 1989, U.S. President George Bush ordered an airlift of 11,500 American troops to participate in a war against General Manuel Antonio Noriega, the "pineapple-faced narco-dictator of Panama" and his Panama Defense Forces (the facial slur is *Newsweek's*). Although organized resistance to the American invasion was brief, large numbers of innocent civilians apparently were killed. With defeat unavoidable, Noriega took refuge in the home of the Papal Nuncio. He surrendered to American authorities in early 1990, after being bombarded around-the-clock by military sound trucks playing high-volume rock music. After his capture, Noriega was carted off to the United States and incarcerated. He was brought to trial in late 1991 and found guilty by a jury in April of 1992. As the trial began, *Newsweek* (Sept. 23, 1991) carried the following report:

> As Panama's "maximum leader," Gen. Manuel Noriega was briefly America's Public Enemy No. 1. Since the December 1989 invasion that brought him to Florida, his trial — due finally to get underway this week in Miami — has blossomed into a three-ring legal circus. At the center are charges of narcotics smuggling and racketeering that could put him in prison for the rest of his life.

Was General Noriega a U.S. resident for 1990? For 1991? For the rest of his life? Do you see any constitutional objections to taxing him on his world-wide income for 1990 and 1991? Would there be any argument that he was a U.S. resident under pre-1984 law?

3. From the perspective of the taxpayer, what are the advantages of the place-of-management test over the place-of-incorporation test? Which test is more certain of application? What are the likely U.S. tax consequences of a change of residence under the two tests? According to some commentators, the objective of the corporate tax, at least in theory, is to impose current tax on corporate shareholders.

Assuming that objective, should the residence of a corporation turn on the residence of its shareholders? What problems do you see with a residence-of-shareholders test?

4. If you were designing a test for residence of individuals, which of the following factors would you take into account: (1) whether the individual is present in the country for a certain number of days (e.g. 183 days); (2) whether the individual has an abode in the country or in another country; (3) whether the individual is a citizen of the country; (4) whether an individual has established residence in another country; (5) whether an individual has a resident visa.

§ 5.02. Planning Problems on Tax Jurisdiction

Jack & Jill Go Abroad

Jack and Jill (J&J) have been happily married for 30 years. They have two adult children. J&J have a home in Columbus, Ohio. They have lived in that home for many years and plan to retire there in about 10 years. Jack is a geologist. He has received an offer from the On-Shore Drilling Corporation, a Country N corporation, to work for five years in Country N. If he takes the job, he and Jill will rent a home in Country N and live there practically full time. They do expect to return to their Ohio home for about a month each year, and they expect that their children will make occasional visits to Country N. The children will not spend more than two months in Country N in any year. One of them is in graduate school and the other is working full-time as a medical researcher in Chicago. Neither Jack nor Jill would be willing to change their planned living arrangements in any significant way to accommodate a tax avoidance plan. They will, of course, remain U.S. citizens and will retain close ties with friends and family in the United States.

Jill is a retired school teacher and a free-lance writer. She earns about $600 per year from her writing. If Jack takes the job in Country N, she will accompany him, but she does not expect to take a salaried job there. She may continue doing some free-lance writing.

Country N has a tax treaty with the United States based on the U.S./Canada model. Jack's salary has not been set, but it is anticipated that it will exceed $200,000 per year. J&J have substantial investment assets, generating $70,000 per year in income. Included in their portfolio are some State of Ohio tax-exempt bonds, paying annual interest of $40,000. The Ohio bonds are held in Jill's name. The rest of the assets are held jointly. J&J currently do not have any foreign income.

The income tax of Country N has a flat rate of 50 percent, with a phased-out exemption to individuals of $20,000. Country N taxes its residents on a worldwide basis. It has an individual filing system. There are relief provisions for dependent spouses and dependent children, but those relief provisions are phased out for incomes over $100,000. The tax base of the Country N income tax is very broad. It includes all investment income, including income from national, state and local bonds. It has controlled foreign corporation (CFC) rules to prevent tax haven abuses, although the rules have little resemblance to the U.S. anti-avoidance rules contained in subpart F of the Internal Revenue Code. Country N adopted its residency rules using the U.S. rules as its model. In particular, Country N generally treats persons residing in Country N for 183 days or more in a year to be residents.

J&J have received some general tax advice from Bill, an employee of Anderson Touche, an international accounting firm retained by On-Shore. Bill suggests that J&J will be treated as residents of Country N and will be taxable there on their worldwide income, including their investment income. He also told them that the income earned on the Ohio bonds will be taxable by Country N.

Feeling a little uneasy about the tax advice they have been getting, J&J come to you for tax advice. They are worried about being subject to double taxation in Country N and the United States. They are also concerned that they will be paying tax in Country N at a very high rate. You may assume that Bill's statements to them regarding Country N's tax law are correct.

What can you tell J&J? In particular, what are the risks of double taxation and what would you suggest to minimize those risks. What questions, if any, would you like to ask J&J. Why?

Miss S, International Skiing Instructor

Miss S is a professional skiing instructor. She is 28 years old. She is a citizen of Country S and no other country. From December 1 to April 1, she lives in Country S, giving skiing instructions at a famous resort in that country. The resort provides her with free lodgings at the resort and a guaranteed salary of $10,000 for giving group lessons to guests at the hotel. The lodgings have a fair market value of $20,000. With tips and fees from private lessons, Miss S usually earns an additional $50,000 in Country S.

In addition, Miss S owns shares in a Country S mutual fund. From the mutual fund, she receives annual dividends of $20,000, which she reinvests in the fund. Although she owns the mutual fund and is liable for taxes on its income, she holds it jointly with her mother, who lives in Country S. When she is living in Country S, Miss S visits her mother frequently, and the mother occasionally goes to visit her daughter at the ski lodge. The mother was a member of the Country S skiing team in the 1975 Olympics. Aside from her mother, Miss S has no close family. She has an active social life but no steady boy friend.

After the skiing season in Country S ends, Miss S goes to Country B, an island tourist destination, to relax on the beautiful beaches of that country. She stays there from April 1 to August 1. During that time, she lives in a small bungalow that she owns jointly with a girl friend who lives full-time in Country B. The bungalow is located just off one of Country B¡|s nicest beaches. It is valued at $100,000. Miss S is an expert swimmer and does a lot of snorkeling around the coral reefs of the island. On several occasions, Miss S has been offered a job by one of the local resorts to give tourists a guided tour of the coral reefs, but she has always declined the offers. The job would pay $30,000 for the summer season.

At the beginning of August, Miss S travels to Country Z, located in the southern hemisphere. There she stays at a large resort and gives skiing instructions. The resort provides her with free lodgings and meals at the resort and pays her a guaranteed $6.000 to give skiing instructions to guests at the hotel. The meals and lodgings have a fair market value of $10,000. With tips and fees from private lessons, Miss S earns an additional $24,000 in Country Z. Miss S stays in Country Z from August 1 to November 1. She then returns to Country B for the month of November, before returning to Country S at the beginning of December.

Domestic tax rules. Miss S is treated as a resident under the domestic laws of County S, Country B, and Country Z. Country S and Country Z tax their residents on their worldwide income. They give relief from double taxation using the credit method and only through their tax treaties. Both countries tax nonresident individuals only on income having a source in their country. Country B does not tax its residents with respect to their foreign earned income but does tax them on their foreign investment income. Under the tax rules of all three countries, earned income has its source where the services are provided, and dividends have their source in the country where the entity paying the dividends is located. Country Z includes in income the value of food and lodgings provided to employees. Country S and Country B do not tax such food and lodgings if they are provided on the business premises of the employer. All three countries tax income at a flat rate of 30 percent. They allow no deductions that are relevant to this planning problem.

Tax treaty rules. Country S has a tax treaty with Country Z but does not have a tax treaty with Country B. Country Z has a tax treaty with both countries. All of the treaties are based on the OECD Model Convention.

Questions

(1) In which country is Miss S a resident under the Country S/Country Z tax treaty? Explain. If you believe there is some doubt as to Miss S's country of residence, explain how that doubt would be resolved.

(2) In which country is Miss S a resident under the Country B/Country Z tax treaty? Explain. If you believe there is some doubt as to Miss S's country of residence, explain how that doubt would be resolved.

(3) For purposes of this question only, assume that Miss S is a resident of Country S under the Country S/Country Z treaty and a resident of Country B under the Country B/Country Z treaty. How will Miss S be taxed by each of the three countries? In giving your answer, specify the relief from double taxation that she would be entitled to receive and discuss whether she will be subject to double taxation that is not relieved under the treaties.

(4) For purposes of this question only, assume that Miss S is a resident of Country Z under the Country S/Country Z treaty and a resident of Country Z under the Country B/Country Z treaty. How will Miss S be taxed by each of the three countries? In giving your answer, specify the relief from double taxation that she would be entitled to receive and discuss whether she will be subject to double taxation that is not relieved under the treaties.