Part 2

U.S. Taxation of Foreigners

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Chapter 6
Introduction to Taxation of Foreign Persons

§ 6.01. Overview of U.S. Taxation of Foreigners

Foreign persons generally are taxable by the United States only with respect to that portion of their income derived from economic activities having some nexus with the United States. That is, they are subject to U.S. source jurisdiction, not to U.S. residence jurisdiction. The highly technical rules that the United States has developed for exercising its source jurisdiction are discussed in this chapter. The operation of those rules depends, in substantial part, on the U.S. source rules. The source rules are presented in Part 3. They are modified in important ways by tax treaties. Tax treaty rules are addressed systematically in Part 4.

This chapter does not examine the issues that arise from the use of foreign entities by U.S. persons to defer or avoid U.S. tax on income earned outside the United States. Those issues are addressed in later Parts. Nor does this chapter describe the U.S. tax system, as it applies to taxpayers without reference to their foreign or domestic status.

The general rule is that the United States taxes foreign persons under the Code only on their U.S. source income.[1] There is an exception to that rule for certain foreign source income earned through a U.S. office.[2] The Code provides that a foreign person may earn U.S. source income under some circumstances without becoming subject to taxation by the United States. The Code exemptions are expanded in many cases by treaty. In general, a taxpayer is not taxable on U.S. source income from business operations unless the taxpayer is engaged in a trade or business within the United States.

Under the Code, foreign corporations and nonresident aliens are taxable on two categories of income, described by the Code in highly technical language. The first category is "taxable income which is effectively connected with a trade or business within the United States."[3] As a shorthand, such income is referred to in this book as "effectively connected income." Effectively connected income is computed by determining the gross income that is effectively connected with a U.S. trade or business and subtracting therefrom the deductions properly allocable to it.

In general, effectively connected income is U.S. source gross income, reduced by properly allocable deductions, that has been derived from business activities or the performance of personal services carried on by a foreign taxpayer in the United States. Certain foreign source taxable income earned through a U.S. office is also characterized as effectively connected income.

The second category of income subject to taxation by the United States is what is popularly referred to as investment income. The Code definition is more complicated and more precise. Investment income taxable to foreign persons is defined by Code sections 871(a) (relating to the taxation of nonresident aliens)

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[1] See IRC §§ 872(a) and 882(b).

[2] IRC §§ 864(c)(4), 872(a)(2), and 882(b).

[3] See IRC §§ 871(b)(1) (relating to the taxation of nonresident alien individuals) and 882(a)(1) (relating to the taxation of foreign corporations).

and 881 (relating to the taxation of foreign corporations).[4] These Code sections impose a 30-percent withholding tax on certain specified items of gross income. Deductions against this gross income are not permitted.

The items of gross income specified in Code sections 871(a) and 881 must be sourced within the United States, and they must *not* be effectively connected income. The specified items of gross income (whether or not effectively connected income) are referred to in this book as "periodical, etc., income."[5]

Typical examples of periodical, etc., income subject to the 30-percent withholding tax are U.S. source dividends, interest,[6] rentals, and royalties.[7] The residual type of periodical, etc., income is "other fixed or determinable annual or periodical gains, profits, and income."[8] U.S. source periodical, etc., income also includes certain U.S. source gains derived from transactions in property. For example, it includes U.S. source capital gains derived by a nonresident alien who is present in the United States during the taxable year for at least 183 days.[9]

U.S. source periodical, etc., income that is not effectively connected income is subject to taxation under the Code at the rate of 30 percent. The tax is collected through withholding. No deductions from gross income are allowable in computing the tax due. The taxation of periodical, etc., income is discussed in Chapter 8.

The Code contains many special provisions applicable to foreign taxpayers. One such provision, added by the 1986 tax act, is the branch profits tax. Another is the earnings-stripping provisions, which typically limit the allowable deduction for interest payments made by a U.S. corporation to its foreign parent.

Compliance issues are addressed briefly in Chapter 10. That chapter outlines the filing, withholding, and reporting requirements of the Code that are applicable to various categories of income derived by foreigners from investment or business activities within the United States.

The general statutory pattern described in this chapter is modified by numerous tax treaties. Some treaty issues are presented briefly throughout Part 2. A more systematic discussion of treaty rules is provided in Part 4. All U.S. tax treaties limit U.S. source jurisdiction over the business income of foreign nationals of treaty partners. Tax treaties also provide an exemption from U.S. tax for certain foreign persons, such as diplomats and exchange students. Almost all U.S. tax treaties provide for a reduction in the U.S. withholding rate on certain U.S. source investment income. Many treaties reduce the withholding rate to zero on interest, royalties, and some other categories of investment income. Tax treaties are relieving only—that is, they may provide relief from taxes imposed by the Code but do not impose taxes.

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[4] The items of gross income taxable under those two Code provisions are similar but not identical.

[5] This shorthand is taken from the heading of IRC § 864(c)(2).

[6] Certain interest income otherwise taxable under IRC §§ 871(a) or 881(a) is exempt from taxation under IRC §§ 871(h) and (i) and 881(c) and (d). For example, interest earned by a foreigner from a deposit in a U.S. bank is a type of periodical income, but it is exempt from tax under IRC § 871(i) in order to encourage foreigners to use U.S. banking facilities.

[7] IRC §§ 871(a)(1)(A) (applicable to dividends, interest, and rentals derived by nonresident alien individuals) and 881(a)(1) (applicable to dividends, interest, and rentals derived by foreign corporations). Royalties are included in periodical income by regulation. See Reg. § 1.871-7(b)(1) (1997) (nonresident alien individuals); Reg. § 1.881-2(b)(1) (1997) (foreign corporations).

[8] Id. Tax specialists sometimes refer to Fixed, Determinable, Annual, or Periodical income as FDAP income.

[9] IRC § 871(a)(2). Foreign corporations generally are not taxable on capital gains under IRC § 881. In most cases, an individual present in the United States for 183 days would qualify as a U.S. resident. All days present in the U.S. count in applying the 183-day test of § 871(a)(2), including days that would not count in determining residency.

§ 6.02. Scope of U.S. Activities of Foreign and Foreign-Controlled Taxpayers

Foreign investment in the United States is characterized either as direct investment or portfolio (indirect) investment. A direct investment takes place when a foreign-controlled corporation or foreign individual directly runs a U.S. business or owns a substantial interest in a U.S. corporation engaged in business in the United States. A U.S. portfolio investment is an investment in U.S. stocks, bonds, or other intangible property of a U.S. business that does not give the investor any significant role in the management of that business. The line between portfolio investment and direct investment is not always a bright one. An investor holding more than 50 percent of the voting stock of a company would clearly be a direct investor in that company, whereas an investor holding no more than 10 percent of the voting stock would typically be considered a portfolio investor. An investor holding between 10 percent and 50 percent may be treated as a direct investor for some purposes and as a portfolio investor for other purposes.

Most income earned by foreign persons in the United States is not subject to tax. For 2009, the total of the reported U.S. source income paid to foreign individuals or legal entities was $555.8 billion, whereas only $65.4 billion of this amount (11.8%) was subject to tax.[10] The effective tax rate on the income subject to tax was around 16 percent.[11]

Some types of income are far more likely to be taxed than others. The taxes paid on interest income typically are light or nonexistent, whereas dividends typically are subject to significant tax. Interest represents around 48 percent of total U.S. source income earned by foreign persons in 2009. Of that amount, only around 16 percent is subject to tax by the United States. Notional principal contract income accounted for almost 20 percent of U.S.-source income paid to foreign persons in 2009. Such income typically is not subject to U.S. withholding tax or any other U.S. tax.[12]

Most foreign corporations engaging in business activity in the United States elect to do so through a controlled domestic subsidiary rather than through a branch. A domestic subsidiary controlled by foreign persons (FCDC) is subject to tax on its worldwide income under the same rules that are applicable to domestic subsidiaries controlled by U.S. persons. A U.S. branch of a foreign corporation is subject to the tax rules addressed in this chapter. In general, it is taxable only on certain income having a nexus with the United States. The Internal Revenue Service periodically publishes reports showing the amount of income and taxes paid by branches and subsidiaries of foreign corporations.

Foreign-controlled domestic corporations (FCDCs) are engaged in a wide range of activities in the United States. For 2008, more than two-third of the FCDCs had primary business activities in one of the following four industrial sectors: (1) wholesale trade; (2) real estate and rental and leasing; (3) professional, scientific, and technical services; and (4) manufacturing.[13] Relatively few FCDCs were primarily involved in utilities, health care and social assistance, and educational services.[14] Manufacturing represented around 46 percent of the gross receipts generated by FCDC in 2008 and around the same percentage of income taxes

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[10] Scott Luttrell, "Foreign Recipients of U.S. Income, 2009," SOI BULLETIN 105-127 (Spring 2012) at 110 (Figure C) .

[11] Id.

[12] Id.

[13] James R. Hobbes, "Foreign-Controlled Domestic Corporations, 2008," SOI BULLETIN 71-115 (Summer 2011) at 74.

[14] Id.

paid. The following table provides some data on the assets, receipts, deductions, and taxes paid of FCDCs for 2008 and for some prior years.

Foreign-Controlled Domestic Corporations (In Billions of Dollars)			
Year	**1971**	**2000**	**2008**
Total assets	$ 36.7	$ 6,072	$ 10,887
Total receipts	39.2	2,612	4,367
Total deductions	38.0	2,550	4,352
Total receipts less total deductions	1.1	62	16
Income subject to tax	1.3	98	140
Total income tax paid	0.6	28	38
Tax paid as % of receipts	1.6%	1.1%	0.9%
Source: James R. Hobbes, "Foreign-Controlled Domestic Corporations, 2008," SOI Bulletin (Summer 2011).			

Chapter 7
Taxation of Business Income of Foreign Persons

§ 7.01. Statutory Scheme

Under Code section 871(b)(1), a nonresident alien individual is taxable "on his taxable income which is effectively connected with the conduct of a trade or business within the United States." Similar language in Code section 882(a)(1) imposes a tax on foreign corporations with respect to their effectively connected income.

In general, a foreign person must be engaged in a trade or business within the United States during the taxable year to have effectively connected income. This rule allows foreigners with minimal economic contacts with the United States to escape taxation on their U.S. source business income. The engaged-in-business requirement serves a function similar to the function served by the permanent establishment article in U.S. tax treaties.[15]

Section 7.01.1, below, explains how tax is actually imposed on the effectively connected income of foreign persons. Section 7.01.2 describes the deductions allowable in computing effectively connected income and the credits allowable in computing tax due on such income.

§ 7.01.1. Imposition of Tax

The effectively connected income of a foreign person is taxable under rules that are roughly comparable to the rules that would apply if that income were the worldwide income of a U.S. person. Nonresident alien individuals who are engaged in a trade or business within the United States are taxable on their effectively connected income at graduated rates. They are also subject to the minimum tax on preference income imposed by Code section 55.

The graduated rate schedules applicable to individuals, trusts, and estates are contained in Code section 1. There are five separate rate schedules.[16] A nonresident alien individual who is not married on the last day of the taxable year would be taxable according to rate schedule 1(c).[17]

Married nonresident alien individuals generally are taxable under rate schedule 1(d), applicable to married persons filing separately.[18]

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[15] The permanent establishment concept is explained in Part 4 (Tax Treaties).

[16] IRC § 1(a)-(e). A separate schedule is provided for: (1) married individuals filing joint returns and surviving spouses; (2) heads of households; (3) unmarried individuals (other than surviving spouses and heads of households); (4) married individuals filing separate returns; and (5) estates and trusts.

[17] Nonresident aliens must pay tax according to the rate schedule contained in IRC § 1(c) unless they are a head of household, a surviving spouse, or "a married individual (as defined in section 7703)." IRC § 7703(a) simply provides that marital status for a taxable year is determined, with some exceptions, as of the end of that year.

[18] IRC § 879 generally provides that a married nonresident alien individual is to determine his or her earned income, trade or business income, partnership share of trade or business income, and community income from the separate property of each spouse without reference to community property laws.

Nonresident aliens are not eligible to use the more favorable rate schedule applicable to heads of households.[19] Nor can they file a joint return with their spouse, thereby qualifying for the special rate schedule applicable to married individuals, unless their spouse is a U.S. citizen or resident and they elect to be treated as a resident under either Code section 6013(g) or section 6013(h).[20] The joint return schedule and the head of household schedule have been designed to provide for some income splitting. Congress determined that income splitting was inappropriate unless the taxpayer and the person with whom he is presumably splitting his income are both taxable under the Code on their worldwide income.[21]

Foreign corporations engaged in a trade or business within the United States are taxable on their effectively connected income under Code section 882(a)(1) according to the rate schedule applicable to domestic corporations. That rate schedule is contained in Code section 11. Foreign corporations are also subject to the minimum tax. Under some circumstances, a foreign corporation is subject to the personal holding company tax[22] and to the accumulated earnings tax.[23]

Foreign partnerships are not taxable directly on their effectively connected income. Instead the foreign partners of a foreign partnership are taxable on their share of the effectively connected income of the partnership.[24] Partners of a foreign partnership are treated as being engaged in a trade or business within the United States if the foreign partnership is so engaged.[25]

A foreign trust or estate is treated under the Code as a nonresident alien individual for purposes of computing its taxable income.[26] In general, a foreign trust or estate is taxable on its undistributed effectively

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[19] IRC § 2(b)(3)(A). An alien individual with a qualified dependent could use the head of household schedule by becoming a U.S. resident.

[20] IRC § 6013(g) provides that a nonresident alien individual can file a joint return with his or her spouse if both spouses file an election to be taxable on their joint worldwide income. Under IRC § 6013(h), an alien individual who is a nonresident for part of the taxable year and a resident at the end of the taxable year can elect to be treated as a resident for the entire year for the purpose of qualifying to file a joint return with a resident spouse.

[21] Details on filing requirements are contained in the instructions for Form 1040NR, which nonresident alien individuals are required to file, and in IRS Publication 519, U.S. Tax Guide for Aliens, available without charge from the Internal Revenue Service. See also IRS Publication 518, Foreign Workers, Scholars, and Exchange Visitors; IRS Publication 597, Information on the United States-Canada Income Tax Treaty, and IRS Publication 901, U.S. Tax Treaties. These booklets are updated frequently.

[22] The personal holding company (PHC) tax is a tax equal to 15% of the undistributed PHC income of a PHC. See IRC §§ 541 (imposing the tax) and 545(c) (limiting the income of a foreign corporation that is subject to tax to certain personal service income if all of its stock is held, directly or indirectly, by nonresident alien individuals). For foreign corporations, PHC income is limited to U.S. source gross income, and capital gains cannot reduce PHC income unless the gains are effectively connected with a U.S. trade or business. See IRC § 882(a)(2) (defining gross income of a foreign corporation engaged in business within the United States) and IRC § 545(b)(7) (providing that capital gains are taxed only if they are effectively connected with the conduct of a trade or business within the United States and are not exempt from tax by treaty).

[23] The accumulated earnings tax is a tax on the accumulated taxable income of a corporation. The rate is 15% of accumulated taxable income. See IRC § 531. A deduction of no less than $250,000 is allowed in computing accumulated earnings. IRC § 535(c)(2). Foreign corporations generally are subject to the tax with respect to their U.S. source income if any of their shareholders are persons subject to U.S. tax on distributions of the corporation—that is, the shareholders are U.S. citizens or residents, nonresident aliens taxable under IRC § 871, and foreign corporations that are owned in part by U.S. citizens or residents or by nonresident aliens taxable under IRC § 871. Reg. § 1.532-1(c) (1959). The deduction for capital gains, which otherwise is allowable in computing accumulated earnings, is not allowed unless the capital gains qualify as effectively connected income and those gains are not exempt from tax by treaty. IRC § 535(b)(9).

[24] IRC § 701. Income derived by a foreign partner from the disposition of an interest in a foreign partnership is effectively connected income to the extent that the gain (or loss) is attributable to partnership assets used in the conduct of a U.S. trade or business Rev. Rul. 91-32, 1991-1 C.B. 107.

[25] IRC § 875(1).

[26] IRC § 641(b).

connected income,[27] and the beneficiaries of the trust are taxable on their share of the distributed effectively connected income.[28] The beneficiary of a trust or estate is treated as being engaged in business within the United States if the trust or estate is so engaged.[29]

§ 7.01.2. Allowable Deductions and Credits

Foreign persons may claim a deduction for business expenses and depreciation in computing their effectively connected income. Such deductions are allowable under the rules described in Part 3 for reducing U.S. source gross income to U.S. source taxable income. In general, business expense deductions are not allowed unless they are linked to gross income that is effectively connected with a U.S. trade or business.

To claim a deduction, the foreign taxpayer generally must file a "true and accurate" tax return[30] and submit it in a timely fashion.[31] A taxpayer also must file a timely and true return to claim most tax credits.[32]

In general, the regulations under Code sections 874 and 882 provide that foreign taxpayers will not lose their right to claim deductions if they file a true return within 16 months (18 months in the case of corporations) of the due date.[33] The regulations also provide that taxpayers must file a true and timely return to claim deductions allowable under a tax treaty in computing income attributable to a U.S. permanent establishment.[34] Foreigners claiming exemption from U.S. tax under a tax treaty may preserve

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[27] IRC § 641(a).

[28] IRC §§ 651-652. An exception to the general pattern applies to so-called grantor trusts. The income of a grantor trust is taxable to the grantor. Under IRC § 679, a foreign trust having a U.S. beneficiary generally is treated as a grantor trust, to the extent that the property of the trust was obtained by transfer from a U.S. person.

[29] IRC § 875(2).

[30] IRC § 874(a) (individuals) and § 882(c)(2) (corporations). See Brittingham v. Comm'r, 66 T.C. 373 (1976), aff'd, 598 F.2d 1375 (5th Cir. 1979) (holding that a nonresident alien filing a tax return containing major errors cannot claim deductions against his gross income). The failure to file a true and timely tax return would not cause an individual to lose the right to claim personal exemptions otherwise allowable in computing his withholding tax obligations and would not cause a corporation to lose the right to claim a deduction for charitable contributions. Reg. §§ 1.874-1(a) (2003) and 1.882-4(a)(1) (2003).

[31] Reg. §§ 1.874-1(a) (2003) and 1.882-4(a)(2) (2003). See Reg. §§ 1.874-1(b) and 1.882-4(a)(3) (generally allowing a late filing grace period of up to 16 months for individuals and 18 months for corporations). In Anglo-American Direct Tea Trading Co. v. Comm'r, 38 B.T.A. 711 (1938) (nonacq.), the court, in interpreting the predecessor of IRC § 874(a), held that a foreign taxpayer who filed a tax return shortly after the filing deadline and before the Service had determined a deficiency was entitled to claim otherwise allowable deductions. In the court's opinion, a taxpayer who has filed a proper tax return after the filing deadline (with extensions) has met the Code requirement of filing "in the manner prescribed." Although this strained interpretation of the Code was subsequently rejected by the Board of Tax Appeals in Ardbern Company v. Comm'r, 41 B.T.A. 910 (1940), that latter decision was overturned on appeal, 120 F.2d 424 (4th Cir. 1941). More recent cases have read a timing element into the applicable regulation. See Swallows Holding Ltd. v. Comm'r, 515 F.3d 162 (2008), reversing 126 T.C. 96 (2006) (finding that a temporal limitation was consistent with the statute and that the 18 month grace period was reasonable); Espinosa v. Comm'r, 107 T.C. 146 (1996) (holding that a nonresident alien was not entitled to deductions under section 874(a), because he filed his untimely returns only after the IRS issued two filing requests and prepared a substitute return).

[32] IRC § 874(a) (individuals) and § 882(c)(2) (corporations). Notwithstanding their failure to file a timely return, foreign taxpayers may still claim a credit under IRC §§ 31 and 33 (withholding taxes on wages and periodical income), 32 (earned income credit), 34 (credit for certain uses of gasoline and special fuels) and 852(b)(3)(D)(ii) (credit for taxes deemed-paid by shareholders of regulated investment companies). Reg. §§ 1.874-1(a) (2003) and 1.882-4(a)(1) (2003).

[33] Reg. §§ 1.874-1(b) (2003) (individuals) and 1.882-4(a)(3) (2003) (corporations). The 16-month grace period applies in full for taxpayers that filed a return in a prior year or that are required to file for the first time in the current year. For other taxpayers, the Service may shorten the 16-month grace period by giving them notice that they have not filed a required tax return and that they generally will not be allowed to claim deductions or credits.

[34] Reg. §§ 1.874-1(b)(5) (2003) and 1.882-4(a)(3)(v) (2003). This provision of the regulations apparently is intended to forestall claims by residents of a treaty country that their treaty rights override the requirements of IRC §§ 874(a) and 882(c)(2). In general, the

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their rights to deductions should their treaty claim prove illusory by filing a protective tax return—a return that gives identifying information about the taxpayer without giving specifics about the taxpayer's gross income or deductions.[35] The tax authorities may grant a waiver of the timely return requirement if they conclude that the taxpayer acted "reasonably and in good faith" in failing to file a timely return.[36]

Deductions for interest paid by a corporation to a related person are limited under the earnings-stripping rules if the interest is exempt to that person under a tax treaty or otherwise. Limitations also apply to the deduction of interest that constitutes original issue discount (OID).

To prevent related parties from obtaining unwarranted timing benefits, the Code provides that a taxpayer, whether domestic or foreign, cannot take a deduction with respect to an amount owed to a related party until the related party includes that amount in its income.[37] Regulations under Code section 267(a)(3) provide that a taxpayer generally cannot accrue a deduction for an amount owed to a related foreign party if that amount would constitute periodical, etc., income in the hands of the recipient.[38] The deduction would be allowed, however, when the amount is actually paid.

Except for interest deductions, which are governed by the earnings-stripping rules, the requirement of actual payment does not apply if the amount owed would be exempt in the hands of the recipient under a tax treaty. The regulations allow a deduction without actual payment in a number of other situations that are thought not to involve tax avoidance.[39]

In computing the amounts taxable under Code section 871(b)(1), nonresident aliens generally are allowed to claim the itemized deductions available to domestic taxpayers, but only to the extent that the deductions are properly allocable to their effectively connected gross income.[40] Nonresident alien individuals may not claim a standard deduction.[41]

Certain gambling winnings by nonresident aliens are exempt from tax under Code section 871(j) unless the Secretary of the Treasury determines that collection of the tax is feasible. The exemption is limited to winnings from blackjack, baccarat, craps, roulette, and big-6 wheel.[42] A professional gambler (a person engaged in the business of gambling) would be taxable on gambling winnings as effectively connected income and generally would be entitled to a deduction for related expenses under the same terms applicable to U.S. persons. As applies to U.S. persons, gambling losses would be deductible only against

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[34] (...continued)
imposition of reasonable filing deadlines should not be held to violate U.S. income tax treaties.

[35] Reg. §§ 1.874-1(b)(6) (2003) and 1.882-4(a)(3)(vi) (2003). Notice of the treaty claim generally would be required under IRC § 6114.

[36] Reg. §§ 1.874-1(b)(2) (2003) and 1.882-4T(a)(3)(ii) (2003). Detailed guidance is provided on the factors to be taken into account in determining whether a taxpayer has acted reasonably and in good faith. Id.

[37] IRC § 267(a)(2).

[38] Reg. § 1.267(a)-3(b)(1) (1993). The regulation was upheld in Tate & Lyle, Inc. v. Comm'r, 87 F.3d 99 (3d Cir. 1996), rev'g 103 T.C. 656 (1994); Square D Co. v. Comm'r, 118 T.C. 299 (2002) (preventing accrual-basis taxpayer from deducting accrued but unpaid interest, in accordance with the regulation).

[39] Reg. § 1.267(a)-3(c)(4) (1993).

[40] IRC §§ 873(a) and 882(c)(1).

[41] IRC § 63(a)(6)(B).

[42] Big-6 wheel is also known as the wheel of fortune. It is an old carnival game, and the odds of winning are poor. The wheel is about 6 feet in diameter, set vertically. There are symbols on the wheel, such as $1, $10, and joker (which pays 40 times the bet, with a house edge of around 24%). Bets are made on a table in front of the wheel that has spots that replicate the symbols on the wheel.

gambling winnings and only if they occurred in the year in which the gains arose.[43] For all other gambling winnings, the amounts are taxable at a rate of 30 percent as periodical income under Code section 871(a)(1)(A). No deductions, including losses on gambling that occurring in the year of a taxable gain, are allowed.[44]

Foreign corporations and nonresident alien individuals may claim the deduction for charitable contributions provided by Code section 170 whether or not the contributions are related to their U.S. business.[45] Nonresident alien individuals are allowed to claim casualty losses under Code section 165(c)(3) for losses incurred with respect to property located within the United States.[46] They are generally allowed to claim only one personal exemption under Code section 151.[47]

Many of the tax credits, such as the child-care credit and general business credit, that are allowable to domestic taxpayers are allowable to foreign taxpayers as well.[48] A few credits, such as the credit for the elderly and handicapped[49] are not granted to nonresident aliens. Foreign persons may not claim a foreign tax credit, except for the credits granted under Code sections 906 and 877 for foreign taxes paid with respect to foreign source income.

§ 7.02. Business Income: In the Courts

Swallows Holding Ltd. v. Comm'r

515 F.3d 162 (2008), reversing 126 T.C. 96 (2006)

ROTH, Circuit Judge:

I. Factual and Procedural Background

The IRS has appealed a United States Tax Court decision that held Treas. Reg. 1.882-4(a)(3)(i) [limiting deductions of nonresidents who fail to file a tax return] to be invalid. Petitioner appellee Swallows Holdings, Ltd. (Taxpayer) is a Barbados corporation with two principal shareholders, Raimundo Arnaiz-Rosas and Aurora Elsa Arnaiz. On September 14, 1992, Taxpayer filed its first federal income tax return. In its return, Taxpayer reported that it held real property in San Diego, California. Between 1993 and 1996, Taxpayer

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[43] See IRC § 165(d).

[44] See Sang J. Park v. Comm'r, 136 T.C. 569 (2011). In Ismat M. Abeid v. Comm'r, 122 T.C. 404 (2004), the court held that the gambling winnings from a California lottery, payable in installments over a number of years, were not properly classified as an exempt annuity under the U.S./Israel tax treaty and thus were not exempt from U.S. taxation because the treaty required that an annuity, to be exempt, had to be paid for "adequate and full consideration."

[45] IRC §§ 873(b)(2) and 882(c)(1)(B).

[46] IRC § 873(b)(1).

[47] IRC § 873(b)(3). Residents of Mexico and Canada may claim all of the personal exemptions allowable to U.S. residents and citizens under IRC § 151. Id. Under Art. 4(7) of the U.S./Korea tax treaty, residents of Korea living in the United States can claim prorated exemptions with respect to dependents present in the United States during the taxable year. The exemptions are prorated by multiplying the amount of the exemptions by a fraction. The numerator of the fraction is the taxpayer's effectively connected income, and the denominator is the taxpayer's worldwide income.

[48] See, e.g., IRC §§ 21 (allowing child-care credit to individuals without reference to their residence status) and 38 (allowing general business credit to taxpayers without reference to their residence status).

[49] IRC § 22(f).

generated rental income from the San Diego property.[50] It was not until 1999, however, that Taxpayer filed returns for tax years 1993, 1994, 1995 and 1996. * * *

The dispute in this case arises from the filing deadlines set forth in Treas. Reg. 1.882-4(a)(3)(i),[51] which the Secretary of the Treasury promulgated to supplement section 882(c)(2). The regulation requires that a foreign corporation file a return within eighteen months of the filing deadline set in section 6072 in order to claim the real property activity tax deductions. Here, Taxpayer filed the tax returns in question well after the expiration of the eighteen-month filing period. The Commissioner assessed tax deficiencies accordingly.[52]

Taxpayer challenged the Commissioner's findings in the United States Tax Court, arguing that Treas. Reg. 1.882-4(a)(3)(i) was an invalid exercise of the Secretary's rule-making authority. See *Swallows Holdings, Ltd. v. C.I.R.,* 126 T.C. 96 (2006). The Tax Court granted judgment in favor of Taxpayer, focusing its inquiry on the plain meaning of I.R.C. § 882(c)(2). Specifically, the court held that section 882(c)(2) requires that foreign corporations file "in the manner prescribed by subtitle F ." Id. at 107. The Tax Court's interpretation of the statute centered on the meaning of the word "manner" in the absence of any explicit textual reference to "time." The court found it persuasive that Congress did not draft the statute with the familiar phrase "time and manner." The court noted that Congress placed "time" and "manner" together in several Code sections, indicating that when Congress intended a time limit to apply, it did so with the phrase "time and manner." Because the court found that the plain meaning of "manner" did not inherently include an element of time, the court concluded that Congress did not intend section 882(c)(2) to embody a filing deadline. Id. at 134-46. The court found that the meaning of the statutory text was plain and unambiguous. Id. at 135. The court nonetheless continued its analysis and held that the Secretary's interpretation of the statute to include a timely filing requirement in the language of Treas. Reg. 1.882-4(a)(3)(i) was unreasonable. 126 T.C. at 137.

* * *

II. Discussion * * *

1. *Chevron* Step One: Ambiguity of the Statutory Text * * *

Under *Chevron*, if the statutory language is clear and unambiguous, our inquiry ends and the plain meaning of the statute governs the action. 467 U.S. at 842-43. If, however, the statutory provision is ambiguous, such ambiguity is viewed as an implicit congressional delegation of authority to an agency, allowing the agency to fill the gap with a reasonable regulation. *MCI Telecomm. Corp. v. Bell Atlantic-Pa.,* 271 F.3d 491, 515-16 (3d Cir. 2001). The inquiry into the ambiguity of a statutory provision must begin with the text of the statute. The text of I.R.C. § 882(c)(2) reads in pertinent part:

> A foreign corporation shall receive the benefit of the deductions and credits allowed to it in this subtitle only by filing or causing to be filed with the Secretary a true and accurate return, in the manner prescribed in subtitle F, including therein all information which the Secretary may deem necessary for the calculation of such deductions and credits.

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[50] The real property located in San Diego remained vacant during the period of time that is relevant to this appeal. Taxpayer leased the property to an entity that used it as a landing zone for sky-diving adventures. See *Swallows Holdings, Ltd. v. C.I.R.,* 126 T.C. 96, 101 (2006).

[51] Treas. Reg. 1.882-4(a)(3)(i) provides:

> If a return was filed for that immediately preceding taxable year, or if the current taxable year is the first taxable year of the foreign corporation for which a return is required to be filed, the required return for the current taxable year must be filed within 18 months of the due date as set forth in section 6072 and the regulations under that section .

[52] The Secretary determined that Taxpayer owed deficiencies for 1994, 1995, and 1996.

Our inquiry focuses on the requirement that foreign companies file "with the Secretary a true and accurate return, in the manner prescribed in subtitle F." Taxpayer argues that the word "manner" does not by its nature include a timing element, thus indicating that Congress did not intend for a filing deadline to exist. This is an overly narrow interpretation of "manner." Courts that have interpreted "manner" as used in I.R.C. § 882(c)(2) and its predecessors have struggled over whether "manner" includes a timing element, which indicates that the language is not clear and unambiguous. *Compare Anglo-American Tea Trading Co. v. C.I.R.,* 38 B.T.A. 711, 714 (1938) (discussing divergent conclusions and adopting interpretation that excludes a "timing" element), with *Espinosa v. Comm'r,* 107 T.C. 146, 156 (1996) (reasoning that provision embodied some "cut-off" period, even if not expressly stated).

Moreover, Congress uses "manner" without "time" in other sections of the Code, and, in some of these situations, "manner" has been interpreted to implicitly include a timing element. See I.R.C. §§ 179(c), 835(c)(2). In these provisions, Congress did not use the phrase "time and manner," yet the Secretary promulgated valid regulations that include temporal components. See Treas. Reg. §§ 1.179-5(a), 1.826-1(a)(3)(i). Thus, Congress does not uniformly use the phrase "time and manner" when it desires a particular Code provision to embody a timing element. Rather, we find "manner," depending on the context, may be a comprehensive term.

As used in this instance, the word "manner" may be defined as "a characteristic or customary way of acting." Webster's Dictionary 724 (9th Ed. 1986). Under this definition, the provision is not a clear and unambiguous expression of congressional intent, as one's "customary way of acting" may include an element of timeliness. Further, Congress's use of "manner" in I.R.C. § 882(c)(2) prompts contextual ambiguity. We could read "manner" to refer to subtitle F, which itself includes timing elements. Alternatively, we could read this provision as indicating that Congress did not wish the timing requirements of subtitle F to apply. Reading the statute this way would not foreclose the Secretary from promulgating a regulation that sets a filing deadline. Instead, it would only restrict the Secretary from promulgating a regulation that would embody the timing elements of subtitle F.

As a result, we hold that Congress's use of the word "manner" creates ambiguity. Therefore, Congress has not "spoken to the precise question at issue." *Chevron*, 467 U.S. at 843. Rather, because we find I.R.C. § 882(c)(2) to be ambiguous, the Secretary was justified in promulgating a rule that prescribed a filing deadline.

2. *Chevron* Step 2 — Reasonableness of the Secretary's Action

Our inquiry is not yet at its end, as we will only defer to the Secretary's action if it is a permissible construction of I.R.C. § 882(c)(2). See *Woodall,* 432 F.3d at 248 (citing *Chevron*, 467 U.S. at 842-43). We "need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question had arisen in a judicial proceeding." *Chevron*, 467 U.S. at 843 n.11. Often, a promulgated rule is the culmination of intense debate between the agency, Congress, other members of the Executive Branch and the public. Rules represent important policy decisions, and should not be disturbed if "'this choice represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute .'" *Id.* at 845 (quoting *United States v. Shimer,* 367 U.S. 374, 382-83 (1961)). Further, *Chevron* deference is "even more appropriate in cases" that involve a "'complex and highly technical regulatory program.'" *Robert Wood,* 297 F.3d at 282 (quoting *Thomas Jefferson Univ. v. Shalala,* 512 U.S. 504, 512 (1994)). The Code is indisputably complex and technical, and we will adjust our inquiry accordingly.

Chevron deference is even more appropriate in cases that involve a complex and highly technical regulatory program. The Code is indisputably complex and technical.

In this case, the Secretary has promulgated a rule that creates an eighteen-month window within which foreign companies must file a federal tax return in order to claim rental activity tax deductions. Taxpayer argues that previous cases upholding the disallowance of deductions under I.R.C. § 882(c)(2) involved filing deadlines that permitted at least a two year window within which foreign corporations could have filed timely tax returns. From this, Taxpayer draws the conclusion that it is unreasonable for the Secretary to promulgate a rule with a filing period of less than two years. We find Taxpayer's argument to be unpersuasive. The Secretary will, under the current regulation, allow a foreign company to file eighteen months after the filing was originally due. Moreover, because I.R.C. § 6072(c) already provides for a five and one-half month filing period, foreign companies have, in practice, twenty-three and one-half months to submit a "timely" return. It is not unreasonable for the Secretary to impose such a deadline.

Additionally, we believe that drawing this temporal line is a task properly within the powers and expertise of the IRS. *Chevron* recognizes the notion that the IRS is in a superior position to make judgments concerning the administration of the ambiguities in its enabling statute. In this case, the IRS found that eighteen months served as a balance between its desire for compliance with the federal tax laws and a foreign corporation's desire to obtain valuable tax deductions. Therefore, we hold that the eighteen-month filing window created by Treas. Reg. 1.882-4(a)(3)(i) is a reasonable exercise of the Secretary's authority.

III. Conclusion

For the forgoing reasons, we will vacate the judgment of the Tax Court and remand this case for further proceedings in accordance with this opinion.

Frank Handfield v. Comm'r

23 T.C. 633 (1955)

Editor's Summary

The petitioner, Frank Handfield, is a nonresident alien individual residing in Montreal, Quebec, Canada. He was engaged in the manufacture of picture postal cards in Canada during the entire fiscal year ended July 31, 1949. The cards produced by the petitioner sold under the trade name *Folkards*. The business was organized and operated by petitioner as a sole proprietorship. Sales of *Folkards* in the United States were made under a contract between Handfield and the American News Company, Inc., apparently an unrelated party. The *Folkards* were printed in Canada from dies located in Canada.

Handfield managed the business and carried on his activities from his office in Montreal. He visited the United States for a total of 24 days in four trips in pursuit of his business activities during the fiscal year in issue. In addition, he employed R.H. Hawken, now deceased, a resident of the United States, for the entire year involved. Hawken's duties were to check the vendors of the American News Company to insure that the cards were being properly displayed.

Opinion of the Court (Arundell, Judge)

The principal question in this proceeding is whether the petitioner, a nonresident Canadian, was engaged in business in the United States during the year in controversy. The determination of this question depends upon the nature of the arrangement which the petitioner had for selling in this country an item which he manufactured in Canada.

The petitioner manufactures a novelty item called Folkards which is a kind of postal card. He had a contract with the American News Company by which the latter distributed his cards to newsstands in the United States where they were sold to the public. The petitioner contends that the American News Company purchased the cards from him for resale. He further contends that the sale occurred in Canada when the cards were placed in transportation and at that time he surrendered all his right, title, and interest in the cards to the News Company.

The respondent contends that the arrangement between the petitioner and the News Company provided for an agency relationship, and that the News Company was petitioner's exclusive distributor in the United States.

The nature of the contract between petitioner and the News Company is to be determined from the intention of the parties. *Ross v. H. Michaelyan, Inc.*, (C.A. 2, 1932) 57 F. 2d 674. We have an extremely meager record on which to make that determination. At the trial, the parties were cautioned that the record was quite ambiguous for a decision on a question of some importance. Nevertheless, we have been left with only the bare agreement between the petitioner and the News Company and a few stipulated facts from which to determine the nature of the arrangement.

It will be observed that the agreement between the petitioner and the News Company nowhere says that the News Company buys or will buy the petitioner's cards or that the company is or will be obligated for any definite number of cards or in any definite amount. The contract uses the word "sale" twice. In each instance it is clear that the word refers to transactions with the public, not between the petitioner and the News Company. Thus, the contract states, "If * * * the *sale* in any city should be unsatisfactory, we will pick up stock from dealers, and return it to you, * * *." (Emphasis supplied.) And, also, that the News Company "reserves the right to withdraw them [the cards] from *sale* without notice" when copyright or patent infringement is threatened. (Emphasis supplied.) The contract speaks of its purpose as confirmation of "arrangements recently discussed *for the exclusive distribution through our Company*" in the United States where it is "mutually agreed to put these [cards] out." (Emphasis supplied.) The contract specifies the rate at which the News Company will be billed for the cards, the rate at which the cards will be billed to the "trade," and the retail price at which the cards will be sold. But, payments were to be made "on the basis of actual check-ups of dealers' stocks sixty days *after distribution*, and every thirty days thereafter." (Emphasis supplied.) The contract stated that all cards were "fully returnable" and that transportation on shipments to and from the United States was to be paid by the petitioner and that he would allow credit on all unsold cards, regardless of condition.

The contract gave exclusive rights to the News Company "to *distribute* Folkards in the United States" and, as noted above, the News Company could "pick up stock from dealers and return it" after it "mutually agreed to discontinue the *distribution*" in any city. (Emphasis supplied.)

[Handfield] contends that the American News Company purchased the cards from him for resale . . . [and] that the sale occurred in Canada .

The foregoing language raises some doubt whether the News Company actually sells the cards to the public or whether it acts as a distributor to newsdealers who sell to the public. We do not have enough information in the record to make any findings concerning the relationship between the News Company and the dealers. In our view of the case, it is immaterial precisely what that relationship may be because, as will appear below, the important relationship is that between the petitioner and the News Company.

Petitioner visited the United States occasionally to check on his arrangement with the News Company and during the period in issue, he was in the country for a total of 24 days on four dif fer ent vis its. However , he had an employee in the United States whom he paid to visit the various outlets of the News Company checking to insure that the cards were being properly displayed and retailed.

From all the provisions of the contract and all the information on the operations of the petitioner in relation to it that are in this record, we think that the arrangement between the petitioner and the News Company was one in which the News Company was his agent in the United States. We think that the cards were shipped on consignment to the News Company for sale to the public. All the aspects of the agreement point to this interpretation of the contract and none are inconsistent with this interpretation.

The contract stated that all cards were "fully returnable" . . . and that [Handfield] would allow credit on all unsold cards, regardless of condition.

The features of the contract which are particularly persuasive in bringing us to the interpretation we have placed on it are: The News company does not obligate itself to buy any definite amount of merchandise from petitioner and it is obligated only to account for the merchandise which has been sold; all merchandise unsold may be returned; the petitioner will pay the transportation on the cards to and from Canada and give full credit for all cards unsold regardless of their condition; the agreement controls the retail price; and it gives the News Company the right to discontinue merchandising the cards when they move slowly or when they infringe copyright or patent provisions. All these, taken together, we think indicate that the arrangement was an agency relationship in the form of a contract of consignment. *Ludvigh v. American Woolen Co.*, 231 U.S. 522 (1928); *Edgewood Shoe Factories, Etc. v. Stewart*, (C.A. 5, 1939) 107 F. 2d 123; *McCallum v. Bray-Robinson Clothing Co.*, (C.A. 6, 1928) 24 F. 2d 35.

Of such an arrangement, one court has said (*In re Taylor*, (E.D., Mich., 1931) 46 F. 2d 326, 328):

> A contract of consignment * * * imposes no obligation upon the consignor to sell or upon the consignee to buy any property, and it effects no sale or transfer of title, conditional or absolute, from consignor to consignee. It merely creates a bailment between the consignor as bailor and the consignee as bailee, of property of the bailor, with authority in the bailee as his agent to sell such property to third persons and with the duty to account to him for the proceeds of any such sale. On such a sale the title passes, not from the consignor to the consignee as in a contract of conditional sale, but from the consignor as owner, through the consignee as his agent, to the

> purchaser. In the absence of such a sale the consignee may return the property to the consignor without liability for the purchase price thereof.

Article III of the Tax Convention between the United States and Canada subjects the industrial and commercial profits of a Canadian enterprise derived through a "permanent establishment" within the United States to the income taxes of this country. The Protocol implementing the Convention defines an "enterprise" as "every form of undertaking, whether carried on by an individual, partnership, corporation or any other entity," and a "permanent establishment" as follows, in part:

> When an enterprise of one of the contracting States carries on business in the other contracting State through an employee or agent established there, who has general authority to contract for his employer or principal or has a stock of merchandise from which he regularly fills orders which he receives, such enterprise shall be deemed to have a permanent establishment in the latter State. [Paragraph 3(f).]

The News Company, under its contract with petitioner, was an "agent" in the United States with a "stock of merchandise" from which it regularly filled orders for the public. Therefore, within the meaning of the above Protocol, we think the petitioner had a "permanent establishment" in the United States under his arrangement with the News Company. It follows, then, that he was engaged in business within the United States in the year in issue and the income from his operations in this country is subject to taxation under section 211 (b) of the Internal Revenue Code of 1939. . . . [Editor: C.f. sections 871(b)(1) and 864(c).]

Cokes v. Comm'r

91 T.C. 222 (1988)

Findings of Fact (Excerpts)

"Sometime before 1970, petitioner's husband, Hubert Cokes [Cokes] acquired a working interest in seven leases to extract oil from certain real property in Posey County, Indiana. . . . A working interest in an oil field is a leasehold interest granted by the fee simple owner of the land to explore for and extract oil from the land. A unitization agreement combines owners of working interests of separate leases into one unit so that an oil field may be operated as a single unit. . . .

"The owners of a working interest in a unit select someone to operate the unit for them. The unit operating agreement names the operator and states the terms, provisions, and conditions for the operation. . .

> Petitioner contends that her "oil income from the Rogers Unit was passive or investment income similar to income from securities, real estate, or trusts."

"On May 1, 1970, petitioner and Cokes entered into a unitization agreement and a unit operating agreement for the operation of an oil field known as Rogers Unit, Posey County, Indiana. Cokes' interest in the seven Posey County leases became the entire Rogers Unit. The reason petitioner and Cokes entered into the agreements was to drill for and recover oil from the Rogers Unit. By the terms of these agreements, Cokes received a 42.29 percent working interest in the Rogers Unit. These agreements also named T. W. George ("George") as unit operator of the Rogers Unit. . . . George died in 1972,

and all his interests in oil wells were placed in the T. W. George Trust ('the Trust'), which continued to operate the Rogers Unit under the terms of the unitization and unit operating agreements. . . .

"Cokes died on February 13, 1978, and, as a consequence, petitioner became the sole owner of .422900 of the total working interest in the Rogers Unit. . . .

"Petitioner never attended a meeting of the Rogers Unit working interest owners; never voted on any matter in connection with the Rogers Unit; never obtained any oil and gas leases (except for inheriting from Cokes); never drilled any oil wells; never supervised any water flood or secondary recovery operations; and never promoted any 'oil deals' with anyone else. . . . "

Opinion of the Court (Chabot, Judge)

Respondent contends that petitioner's income received from her working interest in the Rogers Unit is subject to self-employment tax because she was carrying on a trade or business either through an agent or as a partner in a partnership.

Petitioner contends that she is not subject to the self-employment tax because she was not engaged in a trade or business. As support for her contention that she was not engaged in a trade or business, petitioner points out that she is not knowledgeable about oil operations, that she did not participate in the activities of the Rogers Unit, that she played no part in the selection of the Rogers Unit operators during the period in issue, that her interest was a minority interest and that the remaining interest-holders had business or family relationships with each other, and that her "oil income from the Rogers Unit was passive or investment income similar to income from securities, real estate, or trusts."

We agree with respondent that petitioner was a partner in a partnership which was engaged in a trade or business. If petitioner's interest in the Rogers Unit in 1980, 1981, and 1982 was a partnership interest, then her distributive share of the partnership's trade or business income, will . . . be subject to the taxes imposed by section 1401 on self-employment income.

Combinations for the purpose of acquiring and exploiting oil and gas properties have been common in the oil industry. Often, the tax status dispute is whether such a combination should be treated as a partnership or as an association taxable as a corporation. See 10 J. Mertens, *Law of Federal Income Taxation*, sec. 38A.23 (1988).

In 1953, in a unanimous Court-reviewed opinion, we held that a taxpayer who held a onequarter interest in an oil and gas lease was a participant in a partnership or joint venture, and so an election to currently deduct or to capitalize certain expenditures could be made only by the partnership or joint venture, and could not be made separately by the taxpayer. *Bentex Oil Corporation v. Commissioner*, 20 T.C. 565 (1953).

We agree with respondent that petitioner was a partner in a partnership which was engaged in a trade or business.

Assertedly, the *Bentex* opinion was the immediate cause for the enactment of section 761(a) . . . under which the members of an unincorporated association may elect out of subchapter K of chapter 1 (sec. 701 et seq.) under Treasury regulations which meet certain restrictive statutory requirements. See 9 J. Mertens, Law of Federal Income Taxation, sec. 35.02 (1988).

Article XVII of the unit operating agreement . . . provides that each working interest owner elects under these regulations to be excluded from subchapter K. However, in our unanimous Court-reviewed opinion in

Bryant v. Commissioner, 46 T.C. 848 (1966), affd. 399 F.2d 800 (CA5 1968), we concluded as follows (46 T.C. at 864):

> When Congress has subtitlized, subchapterized, and sectionized its treatment of a many threaded statutory pattern like the complex Internal Revenue Code, its clear words seem to us a safe guide to meaning. The election under section 761(a) does not operate to change the nature of the entity. A partnership remains a partnership; the exclusion simply prevents the application of subchapter K. The partnership remains intact and other sections of the Code are applicable as if no exclusion existed.

Although *Bryant* involved application of the investment credit to partnerships which had elected out of subchapter K, this Court's above-quoted analysis (which was specifically adopted by the Court of Appeals (399 F.2d at 806-807)) is equally applicable to the self-employment taxes of chapter 2.

Accordingly, . . . the unit operating agreement (1) does not serve to prevent us from agreeing with respondent that the unitization agreement and the unit operating agreement created a partnership for purposes of section 1402(a), and (2) does not serve to insulate petitioner from the self-employment taxes.

In *Bentex Oil Corporation v. Commissioner, supra*, two corporations and an individual had jointly acquired an oil and gas lease. The taxpayer had a one-fourth interest, the other corporation had a five-eighths interest, and the individual had a one-eighth interest. The three owners joined together to operate the lease for profit and shared the income and losses in proportion to their respective interests in the venture. The three owners' agreement was entirely oral. The other corporation (the five-eighths owner) received bills for expenses incurred in the operation and development of the lease and at the end of each month billed the other owners for their shares of the expenses and was reimbursed. The taxpayer kept its own books and records. Each of the owners sold its or his share of the production directly to, and received the proceeds therefor directly from, a purchaser. We concluded in *Bentex* that the taxpayer was a participant in a partnership or joint venture.

Our *Bentex* analysis was specifically approved in *Madison Gas & Electric Co. v. Commissioner*, 633 F.2d at 515-516, affg. 72 T.C. at 562-565.

While the instant case involves less individual initiative and power for petitioner than was the case in *Bentex*, it does involve formal written agreements among the working interest owners while *Bentex* did not. Both the instant case and *Bentex* involve proportional sharing of costs and of proceeds from sales of the produced oil and gas. In both cases, the group carried on a trade or business, even though in the instant case an individual member of the group may not have been active in the conduct of that trade or business.

In the instant case, neither side contends that the Rogers Unit working interest owners should be treated as an association taxable as a corporation.

We conclude, based on section 7701(a)(2) and *Bentex*, that the Rogers Unit working interest owners constituted a partnership, or a joint venture treated as a partnership. We conclude that, under section 1402(a), petitioner's profits from this activity constitute "net earning from selfemployment" and these earnings are subject to the self-employment taxes imposed by these sections 1401(a) and 1401(b). * * *

Petitioner stresses her lack of control of the working interest operations because of the close relationships among the other owners and the operator. The question before us is whether petitioner was a member of a partnership or of a joint venture treated as a partnership, and petitioner's lack of control does not affect that question.

Petitioner contends that "The situation is analogous to a minority interest in a close-held corporation."

The problem is that petitioner (and Cokes) did not put their working interest in a corporation, and, for purposes of the self-employment taxes, the relevant statute makes receipt of distributive share of trade or business income from a partnership (defined expansively in section 7701(a)(2)) generally equivalent to the partner's engagement in a trade or business.

The question before us is whether petitioner was a member of a partnership . . . and petitioner's lack of control does not affect that question.

We note that the concept that the character of trade or business income is retained in the partner's hands is not unique to the self-employment taxes area. The unrelated business income tax provisions (sec. 511 et seq.) generally provide that a tax-exempt organization's distributive share of a partnership's unrelated trade or business income is subject to the unrelated trade or business income tax. . . .

Petitioner relies on *DiPortanova v. United States*, 231 Ct. Cl. 623, 690 F.2d 169 (1982), as support for her contention that she was not a partner in a partnership.

In *DiPortanova*, foreign trusts, which held working interests in United States oil and gas reserves, entered into a unit agreement and a unit operating agreement. The trusts held about a 2.27 percent interest in the agreement. The Court of Claims held that the income from the working interests was not "effectively connected with the conduct of a trade or business" within the United States. Because of this holding, the trusts' beneficiary was not taxable at United States regular graduated tax rates on the income derived from the working interest. . . .

The opinion in *DiPortanova* does not consider the question of whether the trusts therein were partners in a partnership. Accordingly, *DiPortanova* does not assist petitioner in the instant case.[53]

Eugene Higgins v. Comm'r

312 U.S. 212 (1941)
Aff'g 111 F.2d 795 (2nd Cir. 1940) and 39 B.T.A. 1005 (1939)

Opinion of the Court (Reed, Justice)

Petitioner, the taxpayer, with extensive investments in real estate, bonds and stocks, devoted a considerable portion of his time to the oversight of his interests and hired others to assist him in offices rented for that purpose. For the tax years in question, 1932 and 1933, he claimed the salaries and expenses incident to looking after his properties were deductible under [the predecessor of IRC § 162(a)]. The commissioner refused the deductions. The applicable phrases are: "In computing net income there shall be allowed as deductions: (a) Expenses. — All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." There is no dispute over whether the claimed

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[53] In Hendrickson v. Commissioner, T.C. Memo. 1987-566, we relied on DiPortanova v. United States, 231 Ct. Cl. 623, 690 F.2d 169 (1982). As in DiPortanova, it does not appear that the partnership question was dealt with in Hendrickson. Accordingly, Hendrickson is of no assistance to petitioner on the partnership issue which is the critical question in the instant case. . . .

deductions are ordinary and necessary expenses. As the Commissioner also conceded before the Board of Tax Appeals that the real estate activities of the petitioner in renting buildings constituted a business, the Board allowed such portions of the claimed deductions as were fairly allocable to the handling of the real estate. The same offices and staffs handled both real estate and security matters. After this adjustment there remained for the year 1932 over twenty and for the year 1933 over sixteen thousand dollars expended for managing the stocks and bonds.

Petitioner's financial affairs were conducted through his New York office pursuant to his personal detailed instructions. His residence was in Paris, France, where he had a second office. By cable, telephone and mail, petitioner kept a watchful eye over his securities. While he sought permanent investments, changes, redemptions, maturities and accumulations caused limited shiftings in his portfolio. These were made under his own orders. The offices kept records, received securities, interest and dividend checks, made deposits, forwarded weekly and annual reports and undertook generally the care of the investments as instructed by the owner. Purchases were made by a financial institution. Petitioner did not participate directly or indirectly in the management of the corporations in which he held stock or bonds. The method of handling his affairs under examination had been employed by petitioner for more than thirty years. No objection to the deductions had previously been made by the Government.

Petitioner's financial affairs were conducted through his New York office pursuant to his personal detailed instructions.

The Board of Tax Appeals held that these activities did not constitute carrying on a business and that the expenses were capable of apportionment between the real estate and the investments. The Circuit Court of Appeals affirmed, and we granted certiorari because of conflict.

Petitioner urges that the "elements of continuity, constant repetition, regularity and extent" differentiate his activities from the occasional like actions of the small investor. His activity is and the occasional action is not "carrying on business." On the other hand, the respondent urges that "mere personal investment activities never constitute carrying on a trade or business, no matter how much of one's time or of one's employees' time they may occupy."

While the Commissioner has combated views similar to petitioner's in the courts, sometimes successfully and sometimes unsuccessfully, the petitioner urges that the Bureau accepted for years the doctrine that the management of one's own securities might be a business where there was sufficient extent, continuity, variety and regularity. We fail to find such a fixed administrative construction in the examples cited. It is true that the decisions are frequently put on the ground that the taxpayer's activities were sporadic but it does not follow that had those activities been continuous the Commissioner would not have used the argument advanced here, i. e., that no amount of personal investment management would turn those activities into a business. Evidently such was the Government's contention in the *Kales* case, where the things the taxpayer did met petitioner's tests, and in *Foss v. Commissioner* and *Washburn v. Commissioner* where the opinions turned on the extent of the taxpayer's participation in the management of the corporations in which investments were held.

> The petitioner merely kept records and collected interest and dividends from his securities, through managerial attention for his investments.

Petitioner relies strongly on the definition of business in *Flint v. Stone Tracy Company*: "'Business' is a very comprehensive term and embraces everything about which a person can be employed." This definition was given in considering whether certain corporations came under the Corporation Tax law which levies a tax on corporations engaged in business. The immediate issue was whether corporations engaged principally in the "holding and management of real estate" were subject to the act. A definition given for such an issue is not controlling in this dissimilar inquiry.

To determine whether the activities of a taxpayer are "carrying on a business" requires an examination of the facts in each case. As the Circuit Court of Appeals observed, all expenses of every business transaction are not deductible. Only those are deductible which relate to carrying on a business. The Bureau of Internal Revenue has this duty of determining what is carrying on a business, subject to reexamination of the facts by the Board of Tax Appeals and ultimately to review on the law by the courts on which jurisdiction is conferred. The Commissioner and the Board appraised the evidence here as insufficient to establish petitioner's activities as those of carrying on a business. The petitioner merely kept records and collected interest and dividends from his securities, through managerial attention for his investments. No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board. Its conclusion is adequately supported by this record, and rests upon a conception of carrying on business similar to that expressed by this Court for an antecedent section.

The petitioner makes the point that his activities in managing his estate, both realty and personalty, were a unified business. Since it was admittedly a business in so far as the realty is concerned, he urges, there is no statutory authority to sever expenses allocable to the securities. But we see no reason why expenses not attributable, as we have just held these are not, to carrying on business cannot be apportioned. It is not unusual to allocate expenses paid for services partly personal and partly business.

Questions

1. Did Handfield have any U.S. source income? What is the applicable source rule? Why didn't the court discuss the source of his income? Is Handfield a manufacturer within the meaning of Code section 863?

2. How much of Handfield's income was attributable to his U.S. permanent establishment? Would he have a U.S. permanent establishment under Article V of the U.S./Canada tax treaty?

3. Could Handfield have arranged his affairs so as to avoid U.S. taxation? Explain.

4. What are the likely tax consequences to Handfield in Canada? Would Handfield have suffered any adverse tax effects in Canada from restructuring the transaction to avoid or minimize U.S. taxes?

5. Is it appropriate for the United States to tax foreign persons earning income from the operation of a mine or other natural deposit located within the United States? In *DiPortanova*, discussed by the court in the *Cokes* case, the taxpayer objected to being taxed under the effectively connected rule as a result of being a

beneficiary of a trust that owned a working interest in an oil well. What precisely was DiPortanova's complaint?

6. If taxation of income from mineral extraction is proper, should the tax be assessed on net income or on gross receipts? That is, should the income be characterized as effectively connected income or as periodical income?

7. Is the rule of Code section 875(1) — that the business of a partnership is attributed to all of the partners — vindicated or called into question by the *Cokes* case? What is left of *DiPortanova* after *Cokes*? See Code section 875(2) (attributing the business activities of a trust to its beneficiaries). Should it matter that *Cokes* is a self-employment case rather than an income tax case?

8. The Supreme Court in *Higgins* properly notes that the answer to the question of whether a taxpayer is engaged in business varies with the context. Why did it then fail to discuss the context in that case?

9. Is Eugene Higgins engaged in business within the United States for purposes of Code section 871(b)? Does the *Higgins* case itself answer that question? From a policy perspective, what should the answer be? The holding of *Higgins* has now been overturned by Congress with the adoption of the predecessor of Code section 212. Why? Is *Higgins* still good law in interpreting Code section 864(b) and related international tax provisions? Should it be?

10. What is the effect, if any, of the language of Code section 864(b)(2) on the result in *Higgins*?

§ 7.03. Definition of Effectively Connected Income

The definition of effectively connected income is provided by Code section 864(c). Under that provision, there are two categories of effectively connected income: U.S. source effectively connected income and foreign source effectively connected income. The former type of effectively connected income is discussed in § 7.03.1, below. The latter is discussed in § 7.03.2.

§ 7.03.1. U.S. Source Effectively Connected Income

The Code definition of effectively connected income is convoluted. The general rules is that all of the U.S. source gross income of a foreign person is effectively connected gross income if that person is engaged in business within the United States.[54] An exception to the general rule provides that U.S. source gross income classified as periodical, etc., income under Code section 871(a) or 881 is not effectively connected gross income.[55] An exception to that exception provides that periodical, etc., income will be effectively connected gross income under some circumstances.

Section 7.03.1.1, below, discusses the general definition of effectively connected income. The exception to the exception, under which certain periodical, etc., income is treated as effectively connected income, is explained in § 7.03.1.2. Income from the sale of a U.S. real property interest is always classified as effectively connected income. The taxation of gain derived from the sale of a U.S. real property interest is discussed in § 7.03.1.3.

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[54] See IRC § 864(c)(1) and (3).

[55] IRC § 864(c)(2) and (3).

§ 7.03.1.1. Definition of Effectively Connected Income

The U.S. source income of a foreign taxpayer derived from activities causing it to be engaged in business in the United States would be effectively connected income. Assume, for example, that MCo, a foreign corporation, engages in the manufacture of automobiles in Flat Rock, Michigan. Those activities would cause MCo to be engaged in business within the United States. All of the U.S. source income derived from manufacturing those automobiles in the United States would be effectively connected income.

Force-of-Attraction Rule. The U.S. source income of foreigners engaged in a trade or business within the United States is effectively connected income even if the income is derived from activities that are unrelated to that trade or business. Assume, for example, that MCo, the automobile manufacturer described above, makes occasional sales of desk calculators in the United States through independent distributors. Even if MCo's sales activity in the United States with respect to the sale of calculators is insufficient to constitute engaging in business within the United States, the U.S. source income derived from those sales will be effectively connected income.

The rule illustrated by the example above is called the *force-of-attraction* rule. It once had a much broader application. Prior to the adoption of the 1966 tax act, a foreign person engaged in a trade or business within the United States was taxable on its entire U.S. source taxable income, including its periodical, etc., income, under rules similar to the rules now governing the taxation of effectively connected income.

The 1966 act introduced the concept of effectively connected income in order to limit the force-of-attraction rule. That act provided that periodical, etc., income unrelated to a U.S. business would not be "attracted" to a U.S. business. Instead, it would be subject to the 30-percent withholding tax of the Code or to the lower withholding rate applicable under a tax treaty. The change was made to encourage investment in U.S. stocks, securities, and other portfolio assets and to prevent certain foreign persons from avoiding the 30-percent withholding tax.[56]

The vestige of the force-of-attraction rule contained in Code section 864(c)(3) is defensible on two grounds. The first advantage is that it avoids the difficult administrative problems that otherwise would arise in determining whether income of a foreign taxpayer is attributable to a particular business. This problem is particularly acute when a business records some U.S. sales on the books of its U.S. office and records other U.S. sales of the same or similar products on the books of a foreign office.

The second advantage of force of attraction is that it tends to equalize the tax treatment of foreign and domestic taxpayers. The function of the engaged-in-business requirement is to avoid the interference with international commerce that might result from the extension of U.S. tax jurisdiction to foreign persons having only incidental contacts with the United States. Once a foreign person is subject to U.S. tax jurisdiction,

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[56] Prior to the 1966 tax act, investment income classified as business income under the force-of-attraction rule would be subject to marginal tax rates of up to 70%. Deductions allowed against that income, however, could reduce, or even eliminate the tax. For example, a foreign corporation engaged in business within the United States would be eligible for the dividends received deduction under the force-of-attraction rule. A foreign corporation receiving large amount of dividend income from U.S. companies might attempt to have itself engage in business in the United States in order to qualify for the dividends received deduction. See Linen Thread Co. v. Comm'r, 14 T.C. 725 (1950) (arguing, unsuccessfully, that a small number of casual sales of thread to U.S. customers constituted engaging in business in the United States).

however, the inconvenience to the foreign taxpayer of complying with U.S. tax rules is not sufficient to override the goal of tax equity.[57]

§ 7.03.1.2. Effectively Connected Periodical, etc., Income

In some circumstances, U.S. source income of a type that normally would constitute nonbusiness periodical, etc., income may be classified as effectively connected income. Whether the U.S. source periodical, etc., income of a foreign taxpayer is effectively connected with a U.S. trade or business depends on the facts and circumstances of each case. The Treasury regulations under Code section 864(c)(2) provide two tests—the *asset-use* test and the *business activities* test—that are helpful in determining whether periodical, etc., income is effectively connected income.

Under the *asset-use* test, U.S. source periodical, etc., income derived from assets used in a U.S. trade or business will generally be treated as effectively connected income.[58] For example, interest income on a trade receivable acquired in the conduct of a U.S. business would be effectively connected income.[59] Similarly, interest income derived from the temporary investment of funds needed in the taxpayer's U.S. business would be effectively connected income.[60] An investment asset generally will be presumed to be used in a U.S. business if (1) it was acquired from funds generated by that business, (2) the income derived from the use of the asset is retained by the U.S. business, and (3) the persons conducting the U.S. business have control over the asset.[61] Except in the case of foreign insurance companies, stock of a corporation is not treated as an asset held for use in the conduct of a trade or business in the United States.[62]

Under the *business activities* test, U.S. source periodical, etc., income also will be treated as effectively connected income if the activities of the taxpayer in carrying on its U.S. trade or business were a material factor in earning that income.[63] Assume, for example, that a foreign corporation has a branch office in the United States. The branch arranges for the license of patents to U.S. customers for royalties as a regular part of its business. The activities of the branch are sufficient to make the foreign corporation engaged in business within the United States. The royalty income of the foreign corporation is effectively connected income because the activities of its U.S. branch were a material element in earning the income.[64]

In applying the asset-use test and the business activities test, the regulations advise that "due regard shall be given to . . . whether or not the asset, or the income, gain, or loss, is carried on books of account separately kept for the trade or business."[65] Of course, the taxpayer's method of accounting is not

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[57] Under U.S. tax treaties, the force-of-attraction principle generally does not apply. Only income attributable to a U.S. permanent establishment is subject to U.S. tax. To the extent that the foreign person is subject to tax in its country of residence, the fairness problem is solved. The treaty rule creates a serious administrative problem, however, because it requires the IRS to determine whether the U.S. source income of a foreigner is attributable to a permanent establishment.

[58] IRC § 864(c)(2)(A).

[59] See Reg. § 1.864-4(c)(2)(ii)(b) (2005).

[60] Reg. § 1.864-4(c)(2)(v)(Ex. 1) (2005). Stock of a corporation generally is not treated as an asset used in the conduct of a U.S. trade or business. Reg. § 1.864-4(c)(2)(iii)(a) (2005). That rule does not apply to stock held by foreign insurers unless their ownership interests equal or exceed 10 percent by vote or value. Reg. § 1.864-4(c)(2)(iii)(*b*) (2005).

[61] Reg. § 1.864-4(c)(2)(iv)(b) (2005).

[62] Reg. § 1.864-4(c)(2)(iii)(a) (2005).

[63] IRC § 864(c)(2)(B). See Reg. § 1.864-4(c)(3) (2005).

[64] Reg. § 1.864-4(c)(3)(i) (2005). Cf. Reg. § 1.864-4(c)(3)(ii)(Ex. 2) (2005).

[65] Reg. § 1.864-4(c)(4) (2005).

controlling.[66] The weight to be given to an accounting method depends upon its conformity to accepted accounting practices and the consistency of its application by the foreign taxpayer.[67]

§ 7.03.1.3. United States Real Property Interests

Gain or loss derived from the sale or other disposition of a U.S. real property interest is classified as effectively connected income under Code section 897(a)(1). That is, foreign persons are taxable on such dispositions under Code section 871(a) or 882 as if they were engaged in business within the United States and the gain or loss on the dispositions were effectively connected with that business. Whether the foreign taxpayer actually was engaged in business in the United States is irrelevant for taxing its disposition of a U.S. real property interest.

Under the definition contained in Code section 897(c), a U.S. real property interest is (1) any interest in real property located within the United States,[68] and (2) any interest, other than as a creditor, in certain domestic corporations that qualify, or have qualified, as a U.S. real property holding corporation.[69] An interest in real property includes an interest in a mine, well, or other natural deposit.[70] The rules governing dispositions by foreign taxpayers of U.S. real property interests are sufficiently complex to defy easy summary.

The transferee of a U.S. real property interest must withhold 10 percent of the contract price under Code section 1445.[71] The withholding tax, however is not a final tax. The foreign transferor of property must file a tax return and compute tax according to the general rules for foreign persons engaged in business within the United States. Nonresident alien individuals are also subject to the alternative minimum tax on their net gain from the disposition of U.S. real property interests.[72]

In general, a domestic corporation is classified as a U.S. real property holding company if the fair market value of its U.S. real property assets are equal to or greater than the sum of its foreign real property interests and its business-related assets other than real property.[73] For example, if XCo, a domestic corporation, owns land located within the United States worth $1,000, it would be a U.S. real property holding company if the value of its foreign real property and its other business assets were $1,000 or less. Investment assets are not taken into account in determining whether a U.S. corporation is holding sufficient U.S. real property to be classified as a U.S. real property holding company. This rule is designed to prevent foreign taxpayers from avoiding the bite of section 897 by stuffing a U.S. corporation with investment assets.

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[66] Id.

[67] Id.

[68] IRC § 897(c)(1)(A)(i). See Reg. § 1.897-1(b)(1) (2003) for the expansive definition of real property applicable to this section ("The term 'real property' includes the following three categories of property: Land and [unsevered] natural products of the land, improvements, and personal property associated with the use of real property"). For a good example of the operation of this section, see Botai Corporation, N.V. v. Comm'r, TC Memo 1990-475, 60 T.C.M. 681 (1990).

[69] IRC § 897(c)(1)(A)(ii). See Reg. § 1.897-2(b) (2003).

[70] IRC § 897(c)(1)(A)(i).

[71] For discussion of the withholding requirement, see Reg. § 1.1445-1 (2003). Withholding generally is not required on transfers to identified U.S. persons. IRC § 1445(b)(2); Reg. §§ 1.1445-2 (2003) and 1.1445-5 (2003).

[72] IRC § 897(a)(2).

[73] IRC § 897(c)(2) and Reg. § 1.897-2(b) (2003).

In some circumstances, a taxpayer may use the book value rather than the fair market value of the assets of a U.S. corporation in determining whether that corporation is a U.S. real property holding company.[74]

The purpose of section 897 is to require foreign taxpayers that own U.S. real property, directly or through a U.S. holding company, to pay U.S. tax on the sale or other disposition of that real property whether or not that real property was held for use in a U.S. business. The section was thought to be necessary because foreign taxpayers generally are not taxable on their U.S. source capital gains unless the gains are effectively connected with a U.S. business.[75] The rule was extended to include gains from the sale of a U.S. real property holding company to prevent foreign taxpayers from avoiding the rule by transferring the real property tax-free to a U.S. corporation and then selling the shares of that corporation. Foreign holding companies are not covered by the rule because the transfer of U.S. real property to a foreign corporation generally would be a taxable event.

U.S. tax treaties generally provide that residents of a treaty country are not exempt from tax under Code section 897,[76] notwithstanding the general treaty rule that exempts residents of a Contracting State from U.S. taxation on gain derived from the sale of stock.[77] Any tax treaty that would permit taxpayers to avoid taxation under section 897 are overridden in this respect.[78]

§ 7.03.2. Foreign Source Effectively Connected Income

Certain foreign source income of a foreign person engaged in a trade or business within the United States is treated as effectively connected income under Code section 864(c)(4). The foreign taxpayer must have an office or other fixed place of business located within the United States, and the foreign source income must be attributable to that office or other fixed place of business. Prior to the adoption of Code section 865(e)(2) by the 1986 tax act, foreign taxpayers making sales into the United States through a U.S. office would have foreign source income if they passed title to the goods sold outside the United States.[79] Except in some special cases, that income is now characterized as U.S. source income. As a result, the foreign-source effectively connected rule of section 864(c)(4) has diminished importance since 1986.

The following four categories of foreign source income earned through a U.S. office are classified as effectively connected income under Code section 864(c)(4):

(1) Certain rents, royalties, and capital gains or losses derived from the active conduct of a business of licensing or leasing foreign patents, copyrights, brand names, secret processes, and similar intangible property, as defined in Code section 862(a)(4);[80]

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[74] Reg. § 1.897-2(b)(2) (2003).

[75] See IRC §§ 871(a)(2) (taxing capital gains of a nonresident alien as periodical, etc., income only if the nonresident alien has been present during the taxable year for at least 183 days) and 881(a) (not including capital gains of foreign corporations in the definition of periodical, etc., income).

[76] See, e.g., U.S. Model Treaty (2006), Art. 13(2)(b).

[77] See, e.g., U.S. Model Treaty (2006), Art. 13(6).

[78] See Sec. 1125(c) of the Foreign Investment in Real Property Tax Act, P.L. 96-499, 94 Stat. 2682 (1980), as amended, (providing a five-year window during which Treasury was expected to renegotiate treaties inconsistent with IRC § 897, after which conflicting treaties were to be overridden).

[79] See IRC § 861(a)(6).

[80] IRC § 864(c)(4)(B)(i). See also Reg. § 1.864-5(b)(1) (1997).

(2) Certain dividends and interest and gains or losses from the sale or exchange of stock or debt instruments that are derived by a foreign taxpayer engaged in the active conduct of a banking, financing, or similar business within the United States, or that are received by a foreign corporation whose principal business is trading in stocks or securities for its own account;[81]

(3) Certain foreign source income derived from the sale of inventory property (a) for use within the United States or (b) for use without the United States if no foreign office materially participated in the sale of that property;[82]

(4) The foreign source income of a foreign insurance company attributable to the company's U.S. business.[83]

As noted above, the third category of foreign-source effectively connected income—foreign source income derived from the sale of inventory property through a U.S. office—has limited applicability because of the addition of Code section 865(e)(2) to the Code by the 1986 tax act. Under that section, gross income derived by a foreign taxpayer from the sale of inventory property through a U.S. office is generally U.S. source gross income, even if title to the goods sold was passed outside the United States. Such income, therefore, would be effectively connected gross income if earned by a foreign taxpayer engaged in business within the United States.[84] Congress preserved the foreign-source effectively connected rule of Code section 864(c)(4)(A)(iii) because of a concern that certain foreign persons treated as U.S. residents under the source rules would be able to avoid U.S. tax on inventory property sold through a U.S. office.[85] The regulations issued under section 864(c)(4) remain important in interpreting the comparable provisions of section 865(e)(2).

The classification of income falling into one of the four categories set forth above as effectively connected income has two exceptions. The exceptions are for foreign source dividends, interest, and royalties paid by a foreign related corporation[86] and for subpart F income.[87]

Treasury regulations under Code section 864(c) provide that an office or other fixed place of business is "a place, site, structure, or other similar facility, through which a nonresident alien individual or foreign corporation engages in a trade or business."[88] Absent special circumstances, a taxpayer will not be deemed to have a U.S. office because a related party, such as a subsidiary corporation, has such an office.[89] In addition, the occasional use by a foreign taxpayer of a U.S. office of a related party generally is not enough to make that office attributable to the foreign taxpayer.[90]

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[81] IRC § 864(c)(4)(B)(ii). See also Reg. § 1.864-5(b)(2) (1997).

[82] IRC § 864(c)(4)(B)(iii). See also Reg. § 1.864-5(b)(3) (1997).

[83] IRC § 864(c)(4)(C). See also Reg. § 1.864-5(c) (1997).

[84] See IRC § 864(c)(3).

[85] IRC § 864(c)(4)(A)(iii) was actually repealed by the 1986 tax act. It is restored by TAMRA (1988). For discussion of the source of income from sales of inventory property through a U.S. office, see Part 3.

[86] IRC § 864(c)(4)(D)(i). See also Reg. § 1.864-5(d)(1) (1997).

[87] IRC § 964(c)(4)(D)(ii). See also Reg. 1.864-5(d)(2) (1997).

[88] Reg. § 1.864-7(b)(1) (1972).

[89] Reg. § 1.864-7(f) (1972). Of course, the office of the subsidiary may be attributed to the foreign parent corporation if the subsidiary acts as a dependent agent of its parent. See Rev. Rul. 70-424, 1970-2 C.B. 150.

[90] Reg. § 1.864-7(b)(2) (1972).

A foreign person may be treated as having an office or other fixed place of business within the United States on account of an office or other fixed place of business of its agent. An office of an agent will be attributed to its principal under the following two conditions. First, the agent must have the power to conclude contracts for its principal and must regularly exercise that power, or the agent must have a stock of goods belonging to its principal from which it regularly fills orders on behalf of its principal.[91] Second, the agent cannot be an agent having an independent status, such as a general commission agent or broker, acting in the ordinary course of its own business.[92]

Foreign source income will be attributed to a U.S. office (or other fixed place of business) only if the office is a "material factor" in the production of the income and the office regularly carries on the activities from which the income was derived.[93] To be a material factor in the earning of income, the U.S. office "must be an essential economic element" in the realization of the income.[94] A U.S. office would be a material factor in earning royalty income if it actively participates in soliciting or negotiating a license of the intangible property from which the royalty income is derived.[95] It would be a material factor in earning dividends or interest if it actively participated in a transaction resulting in the acquisition of the stocks or debt instruments with respect to which the dividends and interest were paid.[96] A U.S. office that merely collected dividends or interest or performed clerical chores would not be a material factor in earning the dividends or interest.[97]

In general, a foreign taxpayer is not treated as engaged in business in the United States if it merely trades in stocks or securities for its own account, even if the trading is conducted through a U.S. office.[98] As a result, a foreign taxpayer's foreign source income derived from trading in stocks or securities for its own account generally is not foreign source effectively connected income. The general rule does not apply, however, if a foreign taxpayer is engaged in a trade or business in the United States without reference to the office used for trading its stocks or securities. In that situation, the trading income is foreign source effectively connected income as long as the U.S. office was a material factor in earning the income.

To be a material factor in earning income from the sale of inventory property, a U.S. office generally must actively participate "in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale."[99] It generally is enough that the order was received by a U.S. office for the office to materially participate in the sale, even if the order was unsolicited, as long as the office is held out to customers as a place where orders may be sent. The following activities are generally not sufficient for an office to be considered a material factor in earning income from the sale of goods: (1) performing mere clerical functions incident to the sale of goods; (2) giving final approval for a sale; (3) holding a supply of the goods from which orders are filled; and (4) displaying samples of the goods sold.

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[91] IRC § 864(c)(5)(A)(i) and Reg. § 1.864-7(d)(1) (1972).

[92] IRC § 864(c)(5)(A)(ii) and Reg. § 1.864-7(d)(2) and (3) (1972).

[93] IRC § 864(c)(5)(B).

[94] Reg. § 1.864-6(b)(1) (1972).

[95] Reg. § 1.864-6(b)(2)(i) (1972).

[96] Reg. § 1.864-6(b)(2)(ii) (1972).

[97] Id.

[98] IRC § 864(b)(2)(A)(ii). For discussion of this anomalous result, see Robert P. Rothman and David M. Hryvk, "Ten commandments Repeal Leaves a Trap for the Unwary," 22 *Tax Notes Int'l* 2871-2873 (June 4, 2001).

[99] Reg. § 1.864-6(b)(2)(iii) (1972).

The foreign source effectively connected rules were enacted by Congress in 1966 for two independent reasons.[100] The first reason was to provide equity between domestic taxpayers and foreign taxpayers earning income through a U.S. office or other fixed place of business. To the extent the rules serve this purpose, they are best understood as an indirect modification of the source of income rules applicable to foreign taxpayers. The second reason was to prevent the United States from serving as a tax haven for residents of countries that relinquish their jurisdiction to tax income earned by their residents through a foreign office.[101]

§ 7.04. Engaged in Trade or Business

§ 7.04.1. General Criteria for Engaging in Business

Neither the Code nor the Treasury regulations define the phrase "engaged in trade or business within the United States." The definition of that phrase must be gleaned from a reading of court cases and administrative determinations and from the practices of the Internal Revenue Service.[102] The Code adds a gloss to the understanding of that phrase by specifying that a taxpayer performing services within the United States generally is engaged in trade or business within the United States.[103] A few other Code rules, discussed below, give additional content to that phrase.

Some commentators have thought it useful to determine whether a taxpayer is engaged in business, and then to determine whether that business is conducted within the United States. That approach has support in the case law and thus has some practical utility to tax specialists. It has two drawbacks. First, the vague tests developed under Code section 162 (relating to the deduction for business expenses) are not appropriate for determining whether foreign persons should be taxable by the United States. Those tests were developed primarily to distinguish personal consumption from profit-seeking activities and, secondarily, to distinguish investment costs, subject to capitalization rules, from current expenses. They are not necessarily applicable, even by analogy, to the question of whether the United States should exercise its source jurisdiction.[104]

Second, a foreign person's business does not have to be conducted within the United States, despite the language of the Code, for the taxpayer to be engaged in a trade or business within the United States. Indeed, most of the interesting cases arise when the foreign person is engaging in transnational transactions, with only a part of its business being conducted within the United States. The United States has a legitimate claim to some tax revenue in such circumstances as long as significant economic activity relating to the business was conducted within the United States.

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[100] See Stanley Ross, "United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments," 22 *Tax Law Review* 279, 328 (1967).

[101] France, for example, exempts French residents from tax on foreign business income earned through a foreign permanent establishment, presumably on the theory that the income will be taxed by the source country.

[102] The Service ordinarily will not inform a taxpayer through its ruling procedures as to whether the taxpayer is engaged in trade or business within the United States. Rev. Proc. 2012-7, 2012-1 I.R.B. 232 at § 4.01(3).

[103] IRC § 864(b).

[104] The Supreme Court has noted that the terms "carrying on a trade or business" and "engaged in a trade or business" are used no less than 60 times in the Code and that the meaning given to those phrases in one section does not necessarily carry over to other sections. See Comm'r v. Groetzinger, 480 U.S. 23, 26 (1987), 107 S.Ct. 980, 983, aff'g 82 T.C. 793 (1984).

A taxpayer may be engaged in a trade or business within the United States on account of its own activities or on account of the activities conducted on its behalf by employees or agents. The activities of a taxpayer's employee are routinely attributed to the taxpayer. Whether the activities of an agent are attributable to its principal depends upon the nature of the agent's business and the control that the principal exercises over the agent. The activities within the United States of an independent agent, such as a freight forwarder, generally would not be attributed to its principal. The activities of an agent generally would be attributed to its principal if the agent has no independent status or has very limited powers to act without approval. A U.S. subsidiary of a foreign corporation will not be treated as the agent of its parent unless it performs the functions of an agent.[105]

A taxpayer apparently cannot be engaged in a trade or business during a taxable year unless it engages during that year in some economically significant conduct in the United States, directly or through an employee or agent. A taxpayer who is engaged in a trade or business within the United States at any time during a taxable year is treated as engaged in that trade or business for the entire taxable year.[106] Activities of one taxable year do not carry over to make a taxpayer engaged in a trade or business in another taxable year.[107]

The foreign partners of a partnership are treated as engaged in a trade or business within the United States if the partnership is so engaged.[108] Similarly, a nonresident alien or foreign corporation that is the beneficiary of a trust that is engaged in a trade or business within the United States is treated as being engaged in such trade or business within the United States.[109] These rules are necessary because partnerships, and certain trusts and estates that distribute their income to their beneficiaries, are not themselves taxable with respect to their effectively connected income under either Code sections 871(b) and 882.

§ 7.04.2. Types of Activities Constituting a U.S. Business

Sections 7.04.2.1 through 7.04.2.4, below, discuss whether engaging in some common activities within the United States would cause a foreign person to be engaged in a trade or business within the United States. In most instances, those activities would give rise to U.S. source gross income under the source rules described in part 3. For convenience, the discussion of those activities below generally follows the order in which the source rules are discussed.

§ 7.04.2.1. Investment Activities

A foreign person may engage in certain limited investment activities in the United States without engaging in business within the United States.[110] For example, a person who held stocks, bonds, and other portfolio assets for investment and made occasional sales of those assets would not be engaged in a trade

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[105] See Rev. Rul. 70-424, 1970-2 C.B. 150 (holding that a subsidiary corporation, acting as agent for its foreign parent, caused the parent to be engaged in business within the United States).

[106] Reg. § 1.881-1(b)(2) (2008).

[107] The taxation of deferred payments, however, does depend on the status of the taxpayer in the year the activities giving rise to the payments were conducted. IRC § 864(c)(6) and (7).

[108] IRC § 875(1).

[109] IRC § 875(2).

[110] IRC § 864(b)(2).

business in the United States as a result of those activities.[111] That rule applies even if the property held is the stock of a wholly owned U.S. corporation that is engaged in business within the United States.[112] Foreign persons receiving interest, dividends, royalties, rental income, or other investment income generally would be taxable under Code sections 871(a) or 881 at a flat rate of 30 percent, or at such lower rate as is provided in an applicable tax treaty.[113]

Some taxpayers earning interest, dividends, royalties, or rental income may be engaged in business within the United States. For example, the renting of automobiles to customers on a regular basis would be an activity that would cause a taxpayer to be engaged in business. Similarly, a taxpayer earning interest income from operating a bank in the United States would be engaged in business within the United States.

Some problems have arisen in determining whether a foreign taxpayer who rents real estate located within the United States is engaged in business within the United States. Mere receipt of rents and payment of incidental administrative expenses probably does not constitute a business.[114] Similarly, a foreign taxpayer that enters into a net lease of a U.S. apartment building would not be engaged in business within the United States.[115] Active management of real property, directly or through an agent, does constitute engaging in business.[116] Minimal and irregular management has been held not to constitute engaging in business.[117] Foreign persons can avoid uncertainty as to the status of their income derived from an interest in real property located within the United States by electing under Code section 871(d) or 882(d) to treat such income as effectively connected income.[118] This election does not cause the taxpayer to be engaged in a trade or business for other purposes, such as the force-of-attraction rule.[119] Gain or loss on the disposition of

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[111] See, e.g., Higgins v. Comm'r, 312 U.S. 212 (1941) (distinguishing between buying and selling of stock to maintain the value of an investment portfolio, which would not constitute engaging in business, and trading in securities and commodities for short-term profit, which would constitute engaging in business). The result in Higgins is codified in IRC § 864(b)(2). See also Chang Hsiao Liang v. Comm'r, 23 T.C. 1040 (1955), acq. (holding that extensive trading of portfolio assets by a nonresident alien through a U.S. agent did not constitute engaging in business within the United States); Reg. § 1.864-3(b)(Ex. 2) (1972) (foreign holding company not engaged in business in the U.S. on account of U.S. office used by chief executive officer for supervising the foreign corporation's investments in U.S. subsidiaries).

[112] Linen Thread Co. v. Comm'r, 14 T.C. 725 (1950) (holding that a foreign corporation was not engaged in business within the United States, and thus not eligible for a dividends received deduction on dividends paid to it by its wholly owned domestic subsidiary, even though its subsidiary was so engaged, it maintained an office in the United States that performed certain clerical duties, and it made some casual sales in the United States).

[113] Investment income would be effectively connected income if it was derived from the normal operations of a business. For example, the interest income earned on a taxpayer's bank account would be effectively connected income if the bank account was opened for reasons relating to the conduct of a U.S. business..

[114] G.C.M. 18835, 1937-2 C.B. 141; Neill v. Comm'r, 46 B.T.A. 197 (1942).

[115] Rev. Rul. 73-522, 1973-1 C.B. 226.

[116] G.C.M. 18835, 1937-2 C.B. 141; Pinchot v. Comm'r, 113 F.2d 718 (2d Cir. 1940) (management of real estate requires "regular and continuous activity" to constitute engaging in business); Lewenhaupt v. Comm'r, 20 T.C. 151 (1953) (gain derived from sale of rental property managed by the taxpayer's resident agent was effectively connected income because the agent engaged in significant management activities).

[117] See, e.g., Herbert v. Comm'r, 30 T.C. 26 (1958), acq.

[118] For details on making the elections, see Reg. § 1.871-10 (2005). According to the tax authorities, a taxpayer must have income from real property to make the election. Thus, a taxpayer having expenses but no income cannot either deduct or capitalize the expenses. Reg. § 1.871-10(a) (2005); Rev. Rul. 91-7, 1991-1 C.B. 110. The effect of this rule is to prevent foreigners participating in a U.S. real estate tax shelter from using that shelter to avoid U.S. tax on business income. Losses derived from the disposition of a U.S. real property interest that qualifies as a capital asset generally cannot be used to offset ordinary income. See Rev. Rul. 92-74, 1992-2 C.B. 156.

[119] Reg. § 1.871-10(c)(1) (2005).

a U.S. real property interest is taxable as effectively connected income whether or not the taxpayer has made an election to so treat it.[120]

A taxpayer holding oil rights or other mineral rights that entitled it merely to a royalty payment generally would not be engaged in a trade or business within the United States.[121] In contrast, holders of working interests in mineral deposits generally would be engaged in business.[122]

Under some circumstances, a taxpayer engaged in the sale within the United States of investment property would be treated as engaged in a trade or business within the United States. The tax status of foreign taxpayers engaged in the sale of investment property is discussed below in the next section.

§ 7.04.2.2. Purchase and Sale of Property

By statute, a foreign taxpayer that derives income from the sale of real property located in the United States or from the sale of certain other U.S. real property interests is treated as being engaged in a trade or business in the United States. The definition of a U.S. real property interest is discussed above.

A foreign taxpayer deriving income from the sale of inventory property through regular and sustained activities conducted within the United States is engaged in a trade or business within the United States.[123] Inventory property is generally defined to be property sold by the taxpayer in the ordinary course of its business.[124] Casual sales of inventory property would not constitute engaging in a trade or business, absent special circumstances.[125] The threshold of sales activity necessary to be engaged in a trade or business, however, is low.[126]

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[120] See IRC §§ 871(d) or 882(d).

[121] Rev. Rul. 69-355, 1969-1 C.B. 65 (net operating loss denied to holder of royalty interest in oil and gas lease).

[122] Rev. Rul. 58-166, 1958-1 C.B. 324 (holder of fractional working interest in oil and gas lease has earnings for purposes of self-employment tax). But see Di Portanova v. U.S., 690 F.2d 169 (Ct. Cl. 1982) (treating a beneficiary of a trust that held a working interest in mineral deposits as not engaged in business because the working interest represented a small share of the total working interests in the deposits and the taxpayer had no effective control over the operation or management of the drilling or mining activities conducted by the operating company.) Di Portanova was distinguished in Cokes v. Comm'r, 91 T.C. 222 (1988) (holding that the owners of a working interest in an oil and gas lease generally were partners in the mining activity and thus each owner was engaged in business in the United States under IRC § 875(1), notwithstanding a particular owner's lack of control over the mining activities). The logic of Cokes would seem to apply to Di Portanova, assuming that the holders of the working interests in that case are "partners" within the meaning of IRC § 7701(a)(2). Under IRC § 875(1), the trust, as one of the partners, would be engaged in business, and that status would be attributed to its beneficiaries under IRC 875(2).

[123] See, e.g., Handfield v. Comm'r, 23 T.C. 633 (1955).

[124] IRC § 865(i)(1).

[125] See Linen Thread Co. v. Comm'r, 14 T.C. 725 (1950) (holding that two unplanned and unsolicited sales by a foreign corporation resulting in a profit of about $150 did not constitute engaging in a trade or business). See also European Naval Stores Co. v. Comm'r, 11 T.C. 127 (1948) (holding that an isolated sale outside the normal course of the taxpayer's business did not constitute engaging in a trade or business); Spermacet Whaling & Shipping Co. v. Comm'r, 30 T.C. 618 (1958), 281 F.2d 646 (6th Cir. 1960) (holding that extensive whaling activities on the high seas, coupled with largely ministerial activities in the United States, were not enough to cause the company to be engaged in business in the United States).

[126] See Rev. Rul. 56-165, 1956-1 C.B. 849 (declaring that a foreign taxpayer present in the United States to demonstrate its products and to solicit orders is engaged in business within the United States, despite the absence of a U.S. office or other U.S. fixed place of business). See also Rev. Rul. 55-617, 1955-2 C.B. 774 (declaring that the extensive marketing activity of the taxpayer in the United States constituted engaging in business within the United States, although the actual sales made by the taxpayer were arranged through independent commission agents).

Purchasing activity can also constitute engaging in a trade or business.[127] The purchasing activities apparently must be extensive, and they must be conducted within the United States.[128] Mere ordering of supplies by a foreign purchaser, without a significant U.S. presence, would not be sufficient to make the purchaser engaged in business within the United States.[129]

Foreign taxpayers that regularly purchase and sell investment assets, such as stocks and securities, or that trade in commodities would be engaged in a trade or business within the United States under some conditions.[130] The case law has not developed clear tests, but generally a taxpayer engaging in multiple transactions for short-term gains is likely to be treated as engaged in business unless one of the statutory exceptions for trading in securities or commodities is applicable. For example, a foreign corporation was treated as engaged in a trade or business in the United States when it regularly purchased certificates of deposit in the United States for its customers through a dependent agent that acted on its behalf as a resident broker.[131]

Code section 864(b)(2) provides the following specific exceptions to the general rule that regular trading in stock, securities, or commodities within the United States constitutes a U.S. trade or business:

(1) A foreign taxpayer trading in stocks, securities, or commodities through an independent resident broker, commission agent, custodian, or other independent agent is not engaged in a trade or business within the United States unless the transactions are made through an office of the taxpayer located within the United States.[132] This exception does not apply to traders of commodities unless the commodities are of a type customarily traded on an organized commodities exchange.[133]

(2) Trading in stocks and securities for one's own account generally does not constitute a trade or business within the United States even if the transactions are made by the taxpayer or by the taxpayer's dependent agent.[134] This exception is inapplicable if the taxpayer is a dealer in stocks or securities.[135]

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[127] Income derived by foreign taxpayers from the purchase of goods within the United States and their sale outside the United States would be foreign source income under IRC § 862(a)(6). Thus the income from exports would not be taxable by the United States whether or not the taxpayer was engaged in business in the United States. In addition, most U.S. tax treaties provide an exception for business income derived from purchasing activities within the United States. See U.S. Model Treaty (1996), Art. 5(4)(d). As a result, few cases are presented to the courts on whether purchasing for export constitutes a trade or business.

[128] U.S. v. Israel Balanovski, 236 F.2d 298 (2d Cir. 1956), cert. denied, 352 U.S. 968. But the law is unclear. Compare T.D. 3111, 4 C.B. 280 (1921) (holding that mere buying of goods within the United States for sale abroad does not constitute engaging in business within the United States) with I.T. 1406, 1-2 C.B. 151 (1922) (holding that customary, regular, and systematic purchasing activities conducted within the United States constitute engaging in business within the United States).

[129] See Amalgamated Dental Co. v. Comm'r, 6 T.C. 1009 (1946) (holding that extensive purchasing activities made without employees or agents located within the United States is not enough to make the taxpayer engaged in business within the United States).

[130] See, e.g., Comm'r v. Nubar, 185 F.2d 584 (4th Cir. 1950), cert. denied, 341 U.S. 925 (195 1) (holding that a nonresident alien who earned large sums from investment activities while present in the United States during World War II was engaged in business); Chang Hsiao Liang v. Comm'r, 23 T.C. 1040 (1955) (holding that a nonresident alien who managed an active investment portfolio through a U.S. agent was not engaged in business within the United States).

[131] Inverworld, Inc. v. Comm'r, TC Memo 1996-301 (1996), TC Memo 1997-226 (1997) (supplemental opinion aff'g prior opinion and denying rehearing).

[132] See IRC § 864(b)(2)(A)(i) and (B)(i), as modified by IRC § 864(b)(2)(C).

[133] IRC § 864(b)(2)(B)(iii).

[134] IRC § 864(b)(2)(A)(ii).

[135] Id. Reg. § 1.471-5 (1993) offers a definition of a dealer in securities. The 1997 tax act amended IRC § 864(b)(2)(A)(ii) to extend this exemption to corporations having their principal office in the United States, apparently in response to the Tax Court's decision in Inverworld. That case, interpreting the prior version of IRC § 864(b)(2)(A)(ii), held that a Cayman Islands corporation investing in the

(continued...)

(3) Trading for one's own account in commodities of a type customarily traded on an organized commodities exchange does not constitute a trade or business within the United States.[136] This exception is inapplicable to dealers in commodities.[137]

§ 7.04.2.3. Manufacture or Other Production of Goods

The uncontested practice of the Service is to treat foreign taxpayers that manufacture, mine, farm, or cut timber within the geographical boundaries of the United States as being engaged in a trade or business within the United States. More generally, any conduct of the taxpayer within the United States resulting in the production of goods within the United States is likely to cause the taxpayer to be engaged in a trade or business within the United States. That production of goods within the United States constitutes a U.S. trade or business has apparently been so obvious to everyone that the issue has never been tested in the courts or specifically addressed by Congress.[138]

§ 7.04.2.4. Performance of Services

Code section 864(b) sets forth the general rule that a foreign taxpayer who performs services within the United States is engaged in a trade or business within the United States. Any activity that would cause a foreign taxpayer to have U.S. source income from the performance of services is likely to also cause that taxpayer to be engaged in trade or business within the United States.[139]Thus activities carried on in the United States for a wage or other payment for services generally would cause a taxpayer to be engaged in business within the United States.

As an exception to the general rule, Code section 864(b)(1) provides that certain nonresident alien individuals temporarily working within the United States are not engaged in business within the United States if their stay in the United States is limited and the compensation they receive is limited. The exception, sometimes called the commercial-traveler's exception, has an exact analog in the rules determining the source of income from the performance of personal services.[140]

The commercial-traveler's exception applies only if the taxpayer is present in the United States during a taxable year for 90 days or less and the total compensation attributable to services performed within the United States during that taxable year does not exceed $3,000.[141] In addition, the compensation must have

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[135] (...continued)
United States on behalf of its Mexican customers did not qualify for the statutory safe harbor because its principal place of business was the United States.

[136] IRC § 864(b)(2)(B)(ii) and (iii).

[137] Id.

[138] Although no administrative or court decisions directly hold that production of goods within the United States constitutes engaging in a trade or business, countless cases and revenue rulings take that position by implication.

[139] Some activities resulting in U.S. source transportation income or U.S. source international communications income also would cause a foreign taxpayer to be engaged in business within the United States.

[140] Having an exemption under the engaging-in-business rules and under the source rules was once quite important, due to the old force-of-attraction rule. A commercial traveler otherwise engaged in business would not need to worry that his services income would be taxed because it was U.S. source income. More importantly, he would not need to worry that his periodical, etc., income would be taxed because his services activities caused him to be engaged in business. With the partial abandonment of the force-of-attraction rule in 1966, the significance of having an exemption under both the source rules and the engaged in business rules is reduced.

[141] IRC § 864(b)(1) and Reg. § 1.864-2(b) (1975). Reimbursement for legitimate travel expenses does not count toward the $3,000 cap. Reg. § 1.864-2(b)(4) (1975).

been paid either by a foreign taxpayer not engaged in business in the United States[142] or by a foreign branch of a domestic taxpayer for services performed on behalf of the foreign branch.[143]

Solely for purposes of applying the commercial-traveler's exception, a foreign taxpayer having an employee temporarily in the United States will not be treated as being engaged in a trade or business in the United States on account of the activities of that employee.[144] Assume, for example, that CT is employed by FCo, a foreign corporation, and received $2,000 for two weeks of work in the United States on behalf of FCo. Assume also that FCo has no other dealings with the United States and that the activities of CT in the United States are sufficient to cause FCo to be engaged in business within the United States. The commercial-traveler's exception will apply to CT, notwithstanding the fact that his compensation is paid by a corporation that is engaged in business in the United States, because FCo is so engaged only on account of CT's activities. The fact that CT qualifies for the commercial-traveler's exception, however, would not prevent FCo from being taxable on the income that it derived from the conduct of a trade or business in the United States. Thus if FCo charged a U.S. customer $6,000 for the services performed by CT, FCo would have $6,000 of effectively connected income, taxable to it under Code section 882(a).

The $3,000 exemption, once significant in amount, has become less and less important, due to inflation and economic growth. As a result, the comparable exemption provided by tax treaty has become increasingly important. Under the typical U.S. tax treaty, the cap on the exempt amount is increased substantially[145] or eliminated entirely[146] and the number of days that the commercial traveler is permitted to say in the United States without attracting tax is increased to 183 days.[147]

Presumably the United States has declined to update the Code rule for inflation and economic growth in order to improve its bargaining position in treaty negotiations.

§ 7.05. Planning Problem

Mr. Doe, the Bread Maker

Mr. Doe is a Canadian resident and national living in Windsor, Ontario (a city in Canada). Doe bakes bread and related products which he sells in Windsor at his bakery. He also makes bulk sales of bread products to Detroit restaurants. He has five employees, all Canadian nationals. One of the employees, Ms. C, travels to Detroit early each morning, seven days a week, to make deliveries of bread products to the Detroit restaurants. It takes her about two hours a day to cross the border into the United States, make her deliveries, and return to Canada. Regular customers typically tell C how much bread to deliver the next day, and C passes the word on to T. On Mondays, Tuesdays, and Thursdays, C also works for six hours a day at the Windsor bakery. C earns $40,000 in salary and has no other income.

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[142] IRC § 864(b)(1)(A).

[143] IRC § 864(b)(1)(B).

[144] See Reg. § 1.864-2(b)(2)(ii) (1975).

[145] See, e.g., U.S./Canada tax treaty, Art. 15(2)(a) (increasing cap to $10,000 in U.S. or Canadian dollars, as the case may be).

[146] See, e.g., U.S./Spain tax treaty, Art. 16(2) (not providing any cap).

[147] See, e.g., U.S./Canada tax treaty, Art. 15(2)(b) and U.S./Spain tax treaty, Art. 16(2)(a).

About once a month Doe enters the United States on business. He very occasionally goes across the border on personal matters. He frequently talks with his U.S. customers by telephone and often receives U.S. orders by fax. He sometimes obtains bread recipes by surfing the internet, mostly at U.S.-based computer bulletin boards.

Doe's Detroit sales are very profitable, but business in Windsor is not so good. Indeed, for the most recent tax year, the Windsor bakery operated at a loss of $10,000, whereas the U.S. sales have produced a profit of $90,000. The net income of $80,000 all goes to Mr. Doe. He also earns $20,000 of interest income on a CD account in a Canadian bank.

How is Mr. Doe taxed by the United States? How is Ms. C taxed? What suggestions do you have for modifying Mr. Doe's method of doing business in the United States to reduce his taxes. You should assume a U.S. tax rate of 35 percent and a Canada rate of 40 percent. Also consider the possibility that Doe might be eligible for tax incentives in Canada. In preparing your answer, consider the following questions:

(1) Is Doe engaged in business in the United States? What about C?

(2) Does Doe or C have income effectively connected with a U.S. business?

(3) Is Doe or C taxable by the U.S.? If so, compute the amount of the tax. If not, explain why not. Are they subject to withholding?

(4) Assume that Doe is taxable on some portion of his income by the United States and Canada. Will he be entitled to a foreign tax credit in Canada for some (or all) of the U.S. income taxes paid? Same for C.

(5) Is C a resident of the United States under the rules of Code § 7701(b)? Under the U.S./Canada tax treaty? How about Doe?

§ 7.06. Engaging in Business through U.S. Financial Activities

The following case applies the source rules, the effectively-connected rules, and the doing business rules to determine whether foreign persons operating in the United States through a foreign tax haven are subject to tax in the United States. The Code was amended after this case was decided to expand a safe-harbor rule for foreign investors engaging in investment activities in the United States.[148] The portions of the case produced below relate to the court's discussion of the case law relating to engaging in a trade or business inthe United States and the application of the effectively-connected concept to management fees. These aspects of the case are unaffected by the 1997 amendment.

[148] See IRC § 864(b)(2)(A)(ii) (removing language that limited the safe harbor to foreign taxpayers that did not have their principal office in the U.S.).

Inverworld, Inc. v. Comm'r

T.C. Memo 1996-301 (June 27, 1996); 71 TCM ¶3231

Editor's Summary of Facts, with Excerpts from the Court's Findings.

Inverworld Ltd (LTD) is an investment management and financial services company that was organized pursuant to the laws of the Cayman Islands on November 27, 1981. Inverworld Inc. (INC) is a corporation that was organized pursuant to the laws of the State of Delaware on December 22, 1982. INC's principal office was at 1250 N.E. Loop 410, Suite 1030, San Antonio, Texas 78209. During the years in issue, LTD owned, either directly or indirectly, all of the outstanding stock of INC. On November 15, 1985, INC was registered with the SEC as an investment adviser pursuant to section 203 of the Investment Advisers Act of 1940. * * *

"LTD was created by principals of InverMexico, S.A. de C.V., Casa de Bolsa, which was a securities brokerage firm that was registered in Mexico and headquartered in Mexico City, Mexico. On November 27, 1981, LTD was incorporated as an exempted company pursuant to the laws of the Cayman Islands. To maintain its registration as an exempted company in the Cayman Islands, LTD submitted . . . an 'Annual Return and Declaration' stating, inter alia, that its operations since its last return have been mainly outside the Cayman Islands."

"LTD was a 'sister company' of InverMexico; i.e., LTD and InverMexico were owned by the same persons or entities. During the years in issue, no client of LTD was a citizen or resident of the United States."

"The principals of InverMexico managed a diverse group of financial services companies in the name of InverMexico and other entities; such companies were called 'Grupo Inver,' or the 'Inver Group.' During the late 1970's and early 1980's, in the face of Mexico's declining oil revenues, the massive devaluation of the peso, and a growing sense of political instability, wealthy Mexicans increasingly sought opportunities outside Mexico's borders for investments that were considered safer than domestic investment opportunities. In response to such 'capital flight,' during those years the Mexican Government placed increasing restrictions on the operations of Mexican financial institutions, having already closed its borders to non-Mexican financial institutions. The culmination of Mexico's restrictive investment regime was the imposition of exchange controls by presidential decree during September 1982 and the nationalization of the country's private banks. From that date onward, no Mexican-chartered bank or financial institution was permitted to handle foreign-currency-denominated accounts. Peso-based investments lost value. During 1982, many of the accounts managed by InverMexico were diminished as a result of the capital flight. Clients of InverMexico were sending their money to Merrill Lynch in the United States and to Swiss and Japanese banks."

"From its inception through its taxable year ended June 30, 1990, LTD did not file any registration statement, reporting statement, or any other statement with any governmental entity in Mexico. During each of its taxable years ended June 30, 1984 through 1990, LTD was not registered to do business in Mexico."

INC was incorporated to perform the research, bookkeeping, and administrative services that LTD has previously obtained from an unrelated U.S. investment firm. The original INC office was established in New York City by George Fahey, president and a director of INC. "Jose Zollino, treasurer and a director of INC, and Raymundo Leal, chairman of the board of directors of INC, moved to San Antonio, Texas, in August 1983. By November 1983, INC had leased space and opened an office in San Antonio. By the end of that year, Mr. Zollino informed Mr. Fahey that INC's management wanted to close the New York office and to

have Mr. Fahey move to San Antonio." Mr. Fahey agreed to do so. "For its office, INC purchased an office copier, computer equipment and software, and office equipment and furniture."

"As conceived by LTD's founders, LTD's business was to provide U.S. and foreign investment opportunities to InverMexico clients. As a foreign (i.e., non-Mexican) financial institution, however, LTD was restricted by Mexican law in the manner by which it could advise clients in Mexico. Accordingly, LTD chose not to establish a direct corporate presence in Mexico. When LTD was first established, its clients were on the client roster of InverMexico. Additionally, clients were referred to LTD by the principals of InverMexico (including principals of InverMexico who were directors, officers, or shareholders of LTD) and by InverMexico account executives and employees. Accordingly, LTD depended upon referrals rather than direct marketing."

"The account executives of InverMexico (known in Mexico as promotores and in the United States as promoters) were trained to sell in Mexico the services of the companies within the Inver Group, including LTD. For clients who were interested in Mexican, peso-based investments, an account would be opened at InverMexico. For clients who were interested in dollar deposits or other investments outside Mexico, an account would be opened at LTD. The number of client accounts at LTD was approximately 70 during 1984, 257 during 1985, 434 during 1986, 557 during 1987, 870 during 1988, and 1,131 during 1989. Not all client accounts were actively traded. For those years, the total amounts of client assets placed with LTD were $42,627,253 during 1984; $82,808,357 during 1985; $135,861,724 during 1986; $166,544,045 during 1987; $291,002,145 during 1988; and $285,621,179 during 1989."

"Once the account was opened, the promoter directed the client to wire funds to a bank account opened in Texas in the name of LTD. LTD called this bank account the client clearing account or clearing account. Pursuant to its consulting agreement with LTD, INC had the authority to invest the "cash, securities, and other properties comprising the assets" of LTD's clients as instructed by LTD. During each of the years in issue, one or more employees or officers of INC had signatory authority for LTD's bank accounts."

LTD and INC entered into an agreement dated February 1, 1983 (the Agreement). Under the Agreement, INC was to furnish LTD "with such factual information, research reports and investment recommendations relating to securities of issuers or other investments designated by * * * [LTD]." INC also kept the books for LTD and performed a variety of additional functions described in the opinion below.

"LTD's receipts during the years in issue fall into four basic categories: (1) Management fees, (2) interest income, (3) currency transactions, and (4) sales commissions and fees. . . ." Only the management fees are addressed in the excerpt below. * * *

Opinion of the Court (Wells, Judge)

[Engaged in U.S. Trade or Business]

A. Whether LTD Was Engaged in Trade or Business Within the United States

The first issue we must decide is whether LTD was engaged in trade or business within the United States pursuant to section 864(b). If we decide that LTD was engaged in trade or business within the United States, then we must decide the character and the source of each item of LTD's income and whether each such item was effectively connected with the conduct of such trade or business pursuant to section 864(c).

* * *

Respondent [IRS] contends that, pursuant to the facts and circumstances test of section 1.864-2(e), Income Tax Regs., LTD was engaged in trade or business within the United States. Respondent contends that the test for determining if a taxpayer is engaged in "trade or business within the United States" is whether substantial profit-oriented activities regularly and continuously occur in the United States whether carried on directly by the taxpayer or through agents.

Petitioners [LTD] rely on a line of cases holding that the mere maintenance of records and collection of rents, interest, or dividends through managerial attention to securities does not constitute trade or business. See, e.g., *Higgins v. Commissioner*, 312 U.S. 212, 218 (1941); *Continental Trading, Inc. v. Commissioner*, 265 F.2d 40 (9th Cir. 1959); *DeKrause v. Commissioner*, T.C. Memo. 1974- 291. The taxpayer in each of those cases managed only personal investments and/or personal investment income. Because those cases did not address taxpayers who managed the investments of others, as did LTD, we conclude that they are not dispositive of the instant case.

Petitioners also cite several cases which are distinguishable on their facts, to wit: *Piedras Negras Broadcasting Co. v. Commissioner*, 127 F.2d 260 (8th Cir. 1942), affg. 43 B.T.A. 297 (1941); *Abegg v. Commissioner*, 50 T.C. 145 (1968), affd. 429 F.2d 1209 (2d Cir. 1970), and *Amalgamated Dental Co. v. Commissioner*, 6 T.C. 1009 (1946). In *Piedras Negras*, the court held that none of the taxpayer's income was derived from sources within the United States. *Piedras Negras Broadcasting Co. v. Commissioner*, supra at 261. In the instant case, we conclude that the main situs of LTD's income- producing activities was the San Antonio office. Consequently, we conclude that *Piedras Negras* does not support petitioners, position in the instant case. * * *

Petitioners also rely heavily on *Spermacet Whaling & Shipping Co. S/A v. Commissioner*, 30 T.C. 618 (1958). In *Spermacet*, this Court addressed the issue of whether the taxpayer was "engaged in trade or business within the United States" within the meaning of section 231(b) of the 1939 Code, as amended. The taxpayer entered into a contract to provide management services for whaling boats. The Court held that the "business in which * * * [the taxpayer] was engaged was that of managing the [whaling] expedition" and that the taxpayer's "activities which produced the income in question took place almost entirely on the high seas or in Norway." Id. at 633. Additionally, the Court held that the activities that the taxpayer performed within the United States were "without substance." Id. The Court stated:

> * * * [the actions in the United States of the taxpayer's forty percent shareholder] in receiving monthly statements or correspondence involving * * * [the taxpayer], or in paying a limited number of obligations requiring payment in American dollars out of a bank account * * * maintained by * * * [the taxpayer], were ministerial and clerical in nature, involving very little exercise of discretion or business judgment necessary to the production of the income in question. * * *

[Id. at 633-634.]

Finally, "The holding of the directors' meetings in New York City solely for the personal convenience of the directors was of no particular consequence." Id at 634. Accordingly, the Court stated that "we are convinced that * * * [the taxpayer] was not engaged in any substantial, regular, or continuous ordinary business activity in the United States." Id. at 634.

We conclude that the facts in the instant case are distinguishable from those in *Spermacet*. LTD's activities in the United States, as conducted by LTD directly and through INC, exceeded the mere receipt of LTD's own monthly statements or correspondence and limited payments of bills from a bank account. LTD

received clients' funds and placed such funds with third parties. Additionally, LTD's activities in the United States were more extensive than the taxpayer's "ministerial and clerical" activities in *Spermacet*. LTD traded in stocks or securities in the United States. A substantial part of the activities that produced LTD's income took place in San Antonio. In sum, we conclude that *Spermacet Whaling & Shipping Co. S/A v. Commissioner*, supra, is not dispositive of the instant case.

* * *

One final inquiry into the issue of whether LTD was engaged in "trade or business within the United States" remains. Although LTD's trading activities are not eligible for exclusion from "the performance of personal services" for purposes of section 864(b), LTD is not automatically deemed to be engaged in "trade or business within the United States." Sec. 1.864-2(e), Income Tax Regs. The fact that a party "is not determined by reason of this section to be not engaged in trade or business within the United States is not to be considered a determination that such person is engaged in trade or business within the United States." Id. Whether such a person is engaged in trade or business within the United States "shall be determined on the basis of the facts and circumstances in each case." Id.

Accordingly, pursuant to section 1.864-2(e), Income Tax Regs., we apply the relevant case law, which provides tests regarding the amount of activity that is required for a conclusion that a taxpayer is engaged in "trade or business within the United States" pursuant to section 864(b). Finding no cases addressing the term "trade or business within the United States" as used in section 864(b), we turn to the cases interpreting the statutory precursors of section 864 and section 882(a).

In *European Naval Stores Co., S.A. v. Commissioner*, 11 T.C. 127 (1948), the Court addressed whether the taxpayer, a foreign corporation, was "engaged in trade or business within the United States" within the meaning of section 231(b) of the 1939 Code, as amended. In interpreting former section 231(b), the Court held that the "question as to what activities of a taxpayer constitute the carrying on of a business is one of fact." Id. at 132 (citing *Higgins v. Commissioner*, 312 U.S. 212 (1941), which interpreted the phrase "carrying on any trade or business" within the meaning of section 23(a) of the Revenue Act of 1932 (a precursor of section 162(a))). The Court in *European Naval Stores* indicated that the phrase "engaged in trade or business within the United States" refers to profit- seeking activities that are sufficiently regular, continuous, and extensive to constitute "carrying on a trade or business" within the meaning of section 162. The Court added:

> The meaning of the phrases "engaged in business," "carrying on business," and "doing business" were defined by the Circuit Court of Appeals for the Third Circuit in *Lewellyn v. Pittsburgh, B. & L.E.R. Co.*, 222 Fed. 177. It was stated therein that, "The three expressions, either separately, or connectedly, convey the idea of progression, continuity, or sustained activity. 'Engaged in business' means occupied in business; employed in business. 'Carrying on business' does not mean the performance of a single disconnected business act. It means conducting, prosecuting, and continuing business by performing progressively all the acts normally incident thereto, and likewise the expression 'doing business', when employed as descriptive of an occupation, conveys the idea of business being done, not from time to time, but all the time. * * *".

[Id. at 133.]

* * *

Petitioners contend that LTD's "real business" was "to render investment advice to clients in Mexico." Accordingly, petitioners argue that all of the activities relating to LTD's business occurred in Mexico: LTD's clients were solicited and advised by Mexican-based promoters in Mexico, their accounts were opened and approved in Mexico, clients changed their investment portfolios in consultation with their Mexican promoter, and the spread (where applicable) was negotiated in Mexico. Petitioners contend that INC performed merely ministerial activities in the United States and did not render any investment advice to clients in Mexico. On those premises, petitioners conclude that LTD's "real business" — even if INC's activities were imputed to LTD — did not occur in the United States.

"We [the court] believe that the 'real business' of LTD, the doing of what LTD was 'principally organized to do in order to realize profit', was to enable Mexican nationals to invest their capital in non-Mexican financial markets.

We disagree. Contrary to petitioners' argument, we believe that the term "performance of personal services within the United States" for purposes of section 864(b) does not require that LTD itself perform such "personal services" in order to be engaged in "trade or business within the United States."

We first look to the "real business" of the taxpayers, the "doing of what * * * [the taxpayers] were principally organized to do in order to profit", *Scottish Am. Inv. Co. v. Commissioner*. . . . LTD is a corporation organized pursuant to the laws of the Cayman Islands. Based on the record, we believe that the "real business" of LTD, the doing of what LTD was "principally organized to do in order to realize profit", was to enable Mexican nationals to invest their capital in non-Mexican financial markets. LTD's "real business" was not merely to render investment advice to clients in Mexico, as petitioners contend. During each of the years in issue, LTD's income consisted of four major categories: Management fees, interest income, currency transactions fees, and other fees and commissions. LTD's income, therefore, was derived from effecting, primarily in the United States, transactions in financial markets. Accordingly, we conclude that LTD's "real business" was providing Mexican nationals with access to non-Mexican financial markets and that such business was conducted primarily in the United States.

* * *

In sum, we conclude that LTD "engaged in * * * substantial, regular, or continuous ordinary business activity in the United States." *Spermacet Whaling & Shipping Co. S/A v. Commissioner*. . . . We find that LTD's activities in the United States, conducted directly or through agents, included: Receiving client funds, monitoring interest rates, effecting trades, collecting and disbursing dividends and interest, maintaining customer account information, and valuing portfolios. Accordingly, we conclude that, during the years in issue, LTD was "engaged in business in the United States" within the meaning of section 1.864-4(c)(5)(i), Income Tax Regs. Consequently, we hold that LTD was "engaged in the active conduct of a banking, financing, or similar business in the United States" pursuant to section 1.864-4(c)(5)(i), Income Tax Regs. A fortiori, we hold that LTD was engaged in "trade or business within the United States" pursuant to section 864(b) for its taxable years June 30, 1985 through 1989.

* * *

[Effectively Connected Income]

[*Editor*: the Court found that most of the contested items of income were U.S. source income. It then went on to determine whether the various items of income were effectively connected with a U.S. trade or business. It found that all of the items of U.S. source income were ECI and that one item of foreign source income was also ECI. The introductory discussion of the effectively connected concept and the application of the regulatory rules to management fees are reproduced below.]

* * *

4. Application of the Effectively Connected Income Rules

We have held . . . that LTD was "engaged in the active conduct of a banking, financing, or similar business in the United States" within the meaning of section 1.864-4(c)(5)(i), Income Tax Regs. Because section 1.864-5(b)(2)(i), Income Tax Regs., applies the test articulated in section 1.864-4(c)(5)(i), Income Tax Regs, we also hold that LTD was "engaged in the active conduct of a banking, financing, or similar business in the United States" within the meaning of section 1.864-5(b)(2)(i), Income Tax Regs. Accordingly, we apply the special effectively connected income rules for a foreign corporation considered to be so engaged.

a. Management Fees

Petitioners contend that the management fee is income from sources without the United States. Petitioners contend that such fee is not effectively connected income because it is not one of the types of foreign source income that is deemed effectively connected income pursuant to section 864(c)(4)(B) or (C).

Respondent contends that the management fee is income from sources within the United States. Respondent applies the business-activities test only by implication and contends that the fee is effectively connected income.

We have held . . . that the management fee is characterized as compensation for personal services and is treated as income from sources within the United States. Accordingly, as petitioners' effectively connected income argument presumes foreign source income, we find that argument to have no merit. Although respondent applies the business-activities test only by implication, we are convinced that the test is properly applied to the management fee.

"We have held . . . that the management fee is characterized as compensation for personal services and is treated as income from sources within the United States."

LTD's management fee is any "income, gain, or loss from sources within the United States" not already described in the first two categories of U.S. source income and, therefore, falls under the third category of U.S. source income of a foreign corporation engaged in the active conduct of a banking, financing, or similar business. Sec. 1.864-4(c)(5)(vi)(b), Income Tax Regs. Accordingly, we analyze LTD's management fee pursuant to either the asset-use or business- activities test. id.

The business-activities test is of primary significance under circumstances, inter alia, where "service fees are derived in the active conduct of a servicing business". Sec. 1.864-4(c)(3)(i), Income Tax Regs. LTD's management fee is a service fee derived in the active conduct of a servicing business. Consequently, we apply the business-activities test to decide whether such fee is effectively connected income.

Before applying the business-activities test, however, we must address the exception for activities relating to the management of investment portfolios provided in section 1.864-4(c)(3)(i), Income Tax Regs. We hold that such exception is inapplicable because the maintenance of investments constitutes the principal activity of LTD's trade or business within the meaning of section 1.864-4(c)(3)(i), Income Tax Regs. Although regulations do not define "principal activity" for the purposes of section 1.864-4(c)(3)(i), Income Tax Regs., in interpreting such words, we look to their "ordinary, everyday senses." *Soliman v. Commissioner*, 506 U.S. 168, 174 (1993), and the cases cited therein. The term "principal" has been defined to mean "most important, consequential, or influential." Id. at 174 (quoting Webster's *Third New International Dictionary* 1802 (1971) and defining "principal place of business" for purposes of the home office deduction pursuant to section 280A(c)(1)).

In the instant case, the "maintenance" of investments, which is equated in section 1.8644(c)(3)(i), Income Tax Regs., to the "management" of investments, constitutes the "most important, consequential, or influential" activity of LTD's trade or business as seen by both its total activities and total income. Accordingly, we conclude that the "maintenance" of investments constitutes the principal activity of LTD's trade or business within the meaning of section 1.864-4(c)(3)(i), Income Tax Regs. Consequently, we hold that LTD's activities relating to the management of investment portfolios shall be treated as activities of LTD's trade or business conducted in the United States for purposes of applying the business-activities test.

In applying the business-activities test to decide whether the management fee is effectively connected income, we must consider whether "the activities of such trade or business were a material factor in the realization of the income". Sec. 864(c)(2)(B). We have held . . . that LTD was engaged in "trade or business within the United States" pursuant to section 864(b) during its taxable years in issue. The activities of LTD's trade or business relating to the management fee included instructing banks on the disposition of client assets, working with brokers on the disposition of client assets, applying client deposits with LTD to client investments, and paying bills for clients. We conclude that such activities of LTD's trade or business were "a material factor in the realization of the income" within the meaning of section 864(c)(2)(B). We have given due regard to the question of whether such income was accounted for through such trade or business, and we find LTD's management fee to have been accounted for through LTD's trade or business. Sec. 864(c)(2). Consequently, we hold that LTD's management fee is effectively connected income pursuant to section 1.864-4(c)(5)(vi)(b), Income Tax Regs., and section 864(c)(2)(B).

[*Editor*: The Court went on to uphold the Service's position that LTD was not entitled to any deductions in computing its taxable income because of its failure to file a tax return and that LTD and/or INC were subject to penalties for failure to file tax returns, for negligence and substantial understatement of income, and for failure to make timely deposits of tax.]

Questions

1. Is the decision in *Inverworld* likely to discourage foreign investment in the United States? Why or why not? Is that result good or bad?

2. How would this case be decided after the amendment to Code section 864(b)(2) by the 1997 tax act? The amendment eliminated the requirement that a foreign taxpayer have its principle office outside the United States in order to qualify for the safe harbor provided in that section?

3. Would the case have come out the same way if the offshore business was located in a country with a tax treaty with the United States?

4. What do you think of the Code rule denying deductions to nonresident taxpayers who fail to file a tax return? Is the penalty a rationale one? A fair one?

§ 7.07. Special Rules Relating to Effectively Connected Income

Section. 7.07.1 describes anti-avoidance timing rules designed to prevent foreign taxpayers from avoiding U.S. tax on business income earned in the United States by postponing receipt or realization of the income until they no longer are engaged in business in the United States. Section 7.07.2 deals with the problem that arises when a foreign taxpayer brings property into the United States for use in a U.S. business and seeks to take depreciation deductions on that property.

§ 7.07.1. Timing Rules

The general rule is that a foreign person must be engaged in a trade or business in the year in which income is received in order for the income to be classified as effectively connected income. To prevent foreign taxpayers from avoiding U.S. tax by postponing receipt of income until they are no longer engaged in business within the United States, two special timing rules were adopted by the 1986 tax act, as amended by the *Technical and Miscellaneous Revenue Act* (TAMRA) of 1988. Under both of these timing rules, income that was earned when the taxpayer was engaged in business in the United States will be treated as effectively connected income even though the taxpayer is not engaged in business within the United States during the year the income is received.

§ 7.07.1.1. Deferred-Income Rule

The first of the two special timing rules—the *deferred-income* rule—treats as effectively connected income certain deferred income received or otherwise taken into account by a foreign person in a year in which that person is not engaged in business within the United States. The rule would apply, for example, if a person performed personal services in year one, left the United States before the end of that year, and was paid for the year-one services in year two or thereafter.

For this deferred income rule to apply, two conditions must be met. First, the deferred income received in the current taxable year must be attributable to activities conducted in another taxable year. Second, the income must be income that would have been effectively connected income if it had been taken into account in that other year.[149] The example below illustrates the operation of the deferred-income rule.

Example 7.1: Receipt of Deferred Payments

FCo, a foreign corporation, is engaged in the sale of widgets in the United States during year 1. Its sales activities are sufficient to cause FCo to be engaged in business in the United States. FCo also makes some casual sales of hookums during that year. The hookums are sold to customers in the United States directly from FCo's foreign office. The sales activity with respect to hookums is not sufficient, in and of itself, to cause FCo to be engaged in business in the United States. FCo has an

[149] IRC § 864(c)(6) (as amended by TAMRA, 1988).

employee, A, who is located in the United States and who manages the U.S. sales of widgets. A is a nonresident alien individual.

FCo sells some widgets and some hookums in the United States during year 1 on the installment plan.[150] *At the end of year 1, FCo ceases all business operations in the United States. A departs from the United States before the end of year 1. During year 2, FCo receives payments for widgets and hookums sold in year 1 under its installment contracts. FCo also pays compensation to A of $10,000 in year 2 for her sales activities during year 1. A has business expenses of $1,000 properly allocable to that compensation*

But for the deferred-income rule, the payments received by FCo in year 2 on the sale of widgets and hookums would be exempt from U.S. tax because the payments would not constitute either effectively connected income or periodical, etc., income. The deferredincome rule provides, however, that those payments will be characterized according to the activities of the taxpayer within the United States during the year in which the transactions giving rise to the payments were conducted. The deferred payments from sale of widgets will be effectively connected income because FCo was engaged in business within the United States in year 1 and its income received on the installment contracts in year 2 is U.S. source income.[151]

FCo's deferred income from the sale of hookums also will be effectively connected income. Under the force-of-attraction principle, the income received from the hookum sales in year 2 would have been effectively connected income if received in year 1 because of FCo's widget business.[152] *Consequently, that income will be effectively connected income in the year 2 under the deferred-income rule.*

If FCo is a resident of Country F and the U.S. has a tax treaty with Country F, then FCo would be taxable on the income derived from the sale of widgets if the sales were made their a PE located in the United States.[153] *It would not be taxable on the income derived from the sale of hookums because the sales are not make through a PE located within the United States. A will also be taxable on her net wage income of $9,000 ($10,000 gross wages minus the allocable deduction of $1,000) as effectively connected income under the deferred-income rule. But for that rule, her gross wage income of $10,000 would have been characterized as periodical, etc., income, subject to the 30-percent withholding tax of Code section 871(a).*

The impact on the U.S. taxation of wages from the adoption of Code section 864(c)(6) is not discussed in its legislative history. Prior to the adoption of that provision, wage payments received in a year in which the earner was no longer engaged in business in the United States would be taxable as periodical income under Code section 871(a)(1). Under section 864(c)(6), however, those payments are now taxable as effectively connected income.

There are two potential advantages to a nonresident alien of having wages taxed as effectively connected income. First, some deductions are allowable against effectively connected income, whereas

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[150] The 1999 tax act eliminated the installment method of reporting for taxpayers keeping the books on an accrual basis. Congress then reversed field and reinstated the installment method for accrual taxpayers.

[151] Reg. § 1.864-4(b)(Ex. 2) (2005), reversing result of Reg. § 1.864-3(b)(Ex. 1) (1972).

[152] Reg. § 1.864-4(b)(Ex. 3) (2005).

[153] U.S. Model Treaty (2006), Art. 7(8).

periodical, etc., income is taxable on a gross basis. Second, the average tax rate applicable to an individual with respect to effectively connected income might be lower than the 30-percent withholding rate applicable under section 871(a). High-income individuals, however, might benefit from being taxed at a flat 30-percent rate.

The language of Code section 864(c)(6), and sound tax policy, would seem to require that pension income be taxable as effectively connected income, to the extent that the amount paid under a pension is a deferred payment for services previously performed within the United States.[154] The legislative history of that provision does not address pension issues. Under prior law, pension income was classified as periodical, etc., income, taxable at a 30-percent rate under Code section 871(a).

§ 7.07.1.2. Disposition of Business Assets

The second of the special effectively connected timing rules—the *property-transactions* rule—is contained in Code section 864(c)(7). It applies to gains or income derived from the sale or other disposition of property used by a foreign person in its U.S. trade or business during a year that the taxpayer is not conducting business in the United States. Under prior law, a foreign person could avoid being taxable on such gains if it ceased using the property in its U.S. business in one year and then sold the property in a subsequent year. The new rule blocks that tax-avoidance route.

Under the property-transactions rule, gains or income derived from the sale of property previously used in a U.S. business are characterized as effectively connected income by treating the sale as if it had occurred just prior to the time that the property ceases to be used in the U.S. business. For example, assume that FCo has a branch in the United States that uses certain property to manufacture telephones. In year 2, FCo ceases to use that property in its business. In year 3, FCo is no longer engaged in business in the United States. It then sells the property it used to manufacture telephones. The gain on that sale will be effectively connected income.

The property-transactions rule only applies if the sale or disposition of the property used in the United States is disposed of within ten years of the time that the taxpayer ceased using that property in its U.S. trade or business.[155] For example, if FCo, in the example above, used its U.S. property in a foreign business for at least 10 years before disposing of that property, the gain on the disposition would not be treated as effectively connected income.

§ 7.07.2. Depreciation of Used Equipment

Foreign persons bringing used equipment into the United States are allowed to claim a depreciation deduction on that equipment if the equipment is employed to produce effectively connected income.[156] The tax basis that a foreign person should use in computing its depreciation deduction is unclear under current law. To provide for comparable treatment of U.S. and foreign persons, the tax basis should be determined by subtracting from the original cost basis of the equipment the amount of depreciation that

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[154] This result is now reached explicitly in Reg. § 1-864-4(c)(6)(ii) (2005).

[155] IRC § 864(c)(7) (as amended by TAMRA, 1988). For discussion, see General Explanation of the Tax Reform Act of 1986 (1987) at 1047-1049.

[156] IRC § 167 and 882(c)(1)(A).

would have been allowable under Code sections 167 and 168 if the equipment had been held by a U.S. person and had been used outside the United States.[157]

Consider, for example, a foreign person, F, that brings a used construction crane into the United States in year 2 for the purpose of erecting office buildings. The crane was purchased in year 1 for $500,000 and had been used outside the United States during that year to earn foreign source income that was not taxable by the United States. If that crane had been purchased by a U.S. person, the U.S. person would have been allowed a depreciation deduction of $50,000 in year one. Under these circumstances, F should be given a basis of $450,000 in the crane for purposes of computing its depreciation deduction in year 2.

Code section 167 provides a deduction for depreciation for qualifying property, including property used outside the United States. That section generally applies, by its terms, to all domestic and foreign persons, whether or not they are taxable under the Code. Code section 1012(a)(2) provides that the cost basis of an asset should be reduced by the greater of the depreciation deductions allowed or allowable under section 167. Thus a straightforward interpretation of sections 167 and 1012 yields the appropriate policy result. Under this reading, the anti-churning rules of section 168(i)(7) are applicable to prevent foreign persons from getting a stepped-up basis through transfers made prior to the entry of their equipment into the United States.

The interpretative problem under current law arises due to the language of Code sections 873(a) (applicable to individuals) and 882(c)(1) (applicable to corporations). Those sections prohibit foreign persons from claiming a deduction in computing effectively connected taxable income unless the deduction is properly allocable to effectively connected gross income.

In effect, the depreciation on assets used outside the United States is being allowed to a foreign person under Code section 167 in computing that person's worldwide taxable income. The deduction is being disallowed only for purposes of computing the foreign person's taxable income subject to U.S. tax. The reading given here is consistent with the principles underlying the deduction allocation rules applicable to foreign persons under section 882.[158]

An alternative to the rule suggested above would be to allow the taxpayer to take a basis equal to the fair market value of the equipment at the time of its entry into the United States. That rule would unfairly penalize foreign taxpayers whenever their used property had fallen in value faster than the rate of decline anticipated in the depreciation schedules. Conversely, foreign persons would obtain an unfair benefit whenever their property appreciated in value or declined less rapidly than the depreciation schedules anticipated. A rule that depends on the determination of the fair market value of property creates administrative problems for the tax authorities and the taxpayer.

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[157] The depreciation schedule for property used outside the United States is typically less favorable than the schedule for property used within the United States. See IRC § 168(g)(1)(A).

[158] See Reg. § 1.882-4(b) (2003). See also Reg. § 1.861-8T(d)(2)(iii)(A) (2009) (holding that the income of a foreign person that is not effectively connected income is not to be treated as "exempt" income for purposes of allocating deductions, including depreciation deductions).

Chapter 8
Taxation of Periodical Income

CODE SECTION 871(A)(1) imposes a tax of 30 percent on certain amounts received from sources within the United States by a nonresident alien individual. The 30-percent tax is imposed on foreign corporations under Code section 881(a) To be taxable under these sections, the amounts received must constitute gross income satisfying the definition of periodical, etc., income, and the gross income must not be effectively connected with the conduct of a trade or business within the United States. No deductions against amounts received are allowable in computing the tax due. Periodical, etc., income is subject to the 30-percent tax whether or not the foreign taxpayer is engaged in a trade or business within the United States. It typically is collected through withholding at source.

§ 8.01. General Rules for Taxing Periodical Income

Code section 871(a) and its counterpart, section 881, provide that an amount received by a foreign person is subject to the 30-percent withholding tax if the following five conditions are met:

(1) The amount received is periodical, etc., income. That term is a shorthand used to describe the items of gross income that may be taxable under Code sections 871(a) and 881. Section 8.02, below, discusses the definition of periodical, etc., income. One type of income characterized under some circumstances as periodical, etc., income is original issue discount (OID). In general, OID is treated like interest income. The complex rules applicable to OID are discussed below.

(2) The amount received constitutes gross income of the taxpayer. Receipts that are excluded from gross income under some Code provision would not be taxable as an amount received. For example, employee fringe benefits excluded from gross income under Code section 132 or state and local bond interest excluded from gross income under Code section 103 would not be taxable to foreign persons as amounts received. Some special exclusions from gross income apply only to foreign taxpayers. For example, certain shipping income is excluded from the income of certain residents of foreign countries that provide an equivalent exclusion to U.S. citizens and domestic corporations.[159] Those special exclusions are discussed below.

(3) The periodical, etc., income is derived from sources within the United States.

(4) The gross income is not effectively connected with the conduct of a trade or business within the United States, under the rules described above.

(5) The gross income is not exempt from the 30-percent tax under some provision of the Code.

Exemptions for amounts included in the gross income of foreigners apply to two broad categories of interest income—bank deposit interest and portfolio interest—and to certain other, narrowly defined, categories of interest income. The exemptions applicable to interest income are discussed in § 8.04. Commentary on the U.S. system for taxing foreigners is provided in section § 8.05.

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[159] See IRC § 872(b)(1).

Prior to 2010, an exemption applied to certain dividends and interest from so-called 80-20 companies.[160] An 80-20 company is a U.S. corporation receiving at least 80 percent of its income from active foreign business income.[161] The rule was changed in 2010 to limit the special treatment to existing 80/20 companies that have not added a substantial line of business after the effective date of the new legislation.[162] The 80-20 company and all its subsidiaries are treated as a single corporation for purposes of computing the portion of the income of the 80-20 company that is exempt from tax.[163] The exempt portion is the amount of the dividend or interest multiplied by the ratio of the active foreign business income of the 80-20 company to its worldwide gross income.[164]

In general, the 30-percent tax is collected through withholding at source.[165] The withholding rules and other compliance matters are discussed in chapter 10, below.

On its face, Code section 871(a) applies only to nonresident alien individuals, and section 881 applies only to foreign corporations. Foreign trusts and foreign estates are taxable, nevertheless, on their undistributed periodical, etc., income under section 871(a) because those entities are treated as individuals under the Code.[166] Periodical, etc., income distributed by a foreign trust to a foreign beneficiary is taxable to the beneficiary under Code section 871(a) or 881.

Foreign partnerships are not formally taxable under Code section 871(a) or section 881. The foreign partners of such partnerships, however, are subject to the 30-percent tax. The 30-percent tax is imposed on foreign partners whether or not the income of their partnership is actually distributed to them. That is, foreign partners are deemed to have an amount received, for purposes of section 871(a) or 881, if an amount is received by the partnership in which they participate. Amounts paid to a foreign partnership are subject to withholding.[167]

Some tax credits may be taken against the 30-percent tax. The allowable credits include the credits granted under Code sections 31 and 33 for amounts withheld at source and the credit granted by section 34 for certain fuel taxes paid on the purchase of fuels used for nontaxable purposes.[168] Other credits, such as the foreign tax credit, cannot be claimed.[169]

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[160] IRC §§ 871(l) and (i)(2)(B) and 881(d).

[161] IRC § 871(l)(1)(B).

[162] IRC § 871(l)(1)(A).

[163] IRC § 871(l)(3).

[164] IRC § 871(l)(2).

[165] IRC § 1441.

[166] IRC § 641(b).

[167] IRC § 1441(a).

[168] See IRC § 874(a); see also Reg. § 1.871-8(d) (1974) (this regulation has not been updated to reflect renumbering of some Code sections).

[169] See IRC § 874(c).

§ 8.02. Definition of Periodical, etc., Income

Periodical, etc., income is comprised of two categories of gross income specified in Code sections 871(a) and 881. The first category is what the Code refers to as "fixed or determinable annual or periodical gains, profits, and income." As a shorthand, income in this category is referred to in this book as "periodical income." The second category of periodical, etc., income is made up of a list of unrelated items of income specifically subjected to the 30-percent tax by Code sections 871(a)(1)(B)-(D), 871(a)(2), and 881(a)(2)-(4). The items of income on that list are referred to in this book as "other periodical, etc., income."

Specifically included by the Code in the definition of periodical income are the following items of gross income: interest (other than original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments.[170] Interest that is characterized as original issue discount (OID) is included, with some exceptions, in the category of other periodical, etc., income under Code sections 871(a)(1)(C) and 881(a)(3). OID that is classified as portfolio interest would be exempt from tax.

In addition to interest characterized as original issue discount, the category of other periodical, etc., income includes gain from the sale or exchange of patents, copyrights, and other intangible property, and gain from the sale of an interest in such property, but only to the extent that the gain is "contingent on the productivity, use, or disposition of the property or interest sold or exchanged."[171] Income included in that category also includes gain from the disposal of certain interests in timber, coal, and iron ore, as defined in Code section 631(b) or (c).[172]

The definition of other periodical, etc., income includes the U.S. source capital gains of nonresident alien individuals present in the United States for 183 or more days during the taxable year in which the gains are recognized.[173] U.S. tax treaties generally exempt capital gains of residents of treaty countries from the 30-percent tax.[174] Capital gains taxable as effectively connected income are not subject to the 30-percent tax. Foreign corporations are not taxable on capital gains unless the gains constitute effectively connected income.[175]

Code section 871(a)(3) provides that 85 percent of any social security benefits will be taxable as periodical income.[176] Although such benefits are akin to other benefits taxable as periodical income, they had been exempt from taxation to both domestic and foreign taxpayers for many years.[177]

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170 IRC §§ 871(a)(1)(A) and 881(a)(1).

171 IRC §§ 871(a)(1)(D) and 881(a)(4). The sale or exchange must have occurred after October 4, 1966.

172 IRC §§ 871(a)(1)(B) and 881(a)(2). Also taxable to nonresident alien individuals as other periodical, etc., are income described in IRC § 402(a)(2) (relating to the treatment of total distributions from certain employee trusts) and income described in IRC § 403(a)(2) (relating to treatment of certain payments under certain employee annuity plans). Both of those sections are now repealed. Periodical, etc., income also includes gains derived by a nonresident alien individual on transfers, before October 4, 1966, of patents described in IRC § 1235.

173 IRC § 871(a)(2).

174 See U.S. Model Treaty (2006), Art. 13(6). No exemption is provided for gains from the sale of U.S. real property interests. Id. at Art.13(2)(b).

175 See IRC § 881(a) (omitting capital gains, other than gains from the disposition of certain mineral interests, from list of taxable items).

176 Social security benefits are defined by IRC § 86(d) to include monthly benefits, including retirement pensions, paid under Title 11 of the Social Security Act and certain railroad retirement benefits.

177 IRC § 871(a)(3) was adopted in 1982. At that time, it required nonresident aliens to include 50% of their social security benefits in income. The 1982 tax act also subjected U.S. citizens and residents to taxation on one-half of their social security benefits, but only to

(continued...)

To a very substantial degree, the 30-percent tax is a tax on investment income derived from U.S. sources. Most forms of U.S. source investment income are subject to the 30-percent tax, unless a special exemption is applicable. Interest, dividends, and rents are specifically included within the Code definition of periodical income, although bank deposit interest and portfolio interest are exempted from the 30-percent tax and a narrow exception applies to dividends from an 80-20 company. A foreign taxpayer may elect to have rents derived from ownership of real property classified as effectively connected income under Code section 871(d) or 882(d), thereby avoiding the 30-percent tax on such income.

Royalties are included within the definition of periodical income by regulation.[178] As explained above, gain from the sale of intangible property that is functionally equivalent to royalty payments is treated as other periodical, etc., income.[179]

Included in the definition of periodical income are wages, salaries, and other compensation for services. In virtually all cases, however, such income would be classified as effectively connected income under current law. Before the amendments to the definition of effectively connected income made by the 1986 tax act, income from the performance of services would not have been effectively connected income if the payments for those services were received after the year in which the services were performed and the taxpayer was not engaged in business in the United States in that year.[180] The post-1986 rule, however, would characterize payments for services performed within the United States as effectively connected income without reference to the status of the taxpayer in the year the payments are received.

The denial of deductions properly allocable to periodical, etc., income has been justified on the ground that investment income and other types of periodical income typically are earned without incurring substantial expenses. There is merit to this position, but only if the word “typically” is stressed. Some taxpayers incur substantial costs in earning periodical income. A common example would be a nonresident alien individual who borrows money to acquire U.S. investment assets.

Prior to the reduction in U.S. tax rates during the 1980s, a denial of properly allocable deductions could be justified, at least in part, on the ground that the 30-percent tax on gross income was a rough proxy for the tax that would have been imposed if the foreign taxpayer had been taxable on a net basis under the tax rates applicable to U.S. persons. That justification lost much of its force when the top marginal rates dropped to around 28 percent in 1986. It regained some limited force as the top marginal rates moved toward 40 percent in the 1990s, but it again lost explanatory power when the top marginal rates dropped in 2001.

Under current law, a major function of the 30-percent tax is to provide foreign governments with an inducement to enter into a tax treaty with the United States. The typical tax treaty provides for a mutual

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177 (...continued)
the extent those benefits exceed a base amount. The 1993 tax act required domestic taxpayers with income above a somewhat higher base amount to include 85 percent of their social security benefits in income. Foreign persons were denied the benefit of the base amount, and their inclusion percentage continued to be limited to 50 percent of benefits received. The 1994 tax act raised the inclusion percentage to 85 percent for foreigners without changing the base amount rule. The 85% rule was adopted on the ground that the typical recipient of social security payments had paid social security taxes equal to only 15% of social security payments. Current retirees typically have paid much high social security taxes than implied by the the 85% rule.

178 Reg. § 1.871-7(b) (1997).

179 IRC §§ 871(a)(1)(D) and 881(a)(4). This treatment of the gain from the sale of intangible property was adopted by the 1986 tax act.

180 See Reg. § 1.864-3(a) (1972). This regulation is now superseded by Reg. § 1.864-4(b) (2005).

reduction by the treaty partners in the tax rates applicable to investment income. Most treaties provide that some categories of income are exempt from tax in the source country.

§ 8.03. Taxation of Original Issue Discount (OID)

Amounts received by a foreign taxpayer that are characterized as original issue discount (OID), within the meaning of Code section 1273, are taxable to nonresident alien individuals under Code section 871(a)(1)(C) and to foreign corporations under Code section 881(a)(3). The method of taxing OID to foreigners, which differs in some important respects from the method of taxing domestic taxpayers with respect to OID is explained below. OID is defined, for purposes of Code sections 871 and 881, in Code section 871(g). That provision generally incorporates by reference the general definition of OID contained in Code section 1273, with exceptions for certain short-term obligations and tax-exempt obligations.

§ 8.03.1. General Treatment of OID

In general, original issue discount (OID) is the difference between the stated redemption price for a debt instrument at maturity and the price paid for the debt instrument at the time it was issued.[181] The redemption price is the price that the person issuing the instrument (the borrower) is obligated to pay when the instrument is mature—that is, when it becomes due and must be paid off. The OID on a bond or other debt instrument is sometimes referred to as the "premium".

> *Example*. PCo borrows $100 in year 1 and promises to repay $150 in year 5. As evidence of its debt, it issues a debt instrument with a redemption price (sometimes called "face amount") of $150. The *original issue discount* with respect to the corporate debt instrument is $50 ($150 redemption price minus $100 price when issued).

A debt instrument may have some stated interest and also some OID. The extreme case of an OID bond is a bond issued for less than the redemption price with no stated interest at all.

OID is a substitute for periodical interest payments. When an OID bond or other debt instrument is issued, the premium due at the end of the term of the bond—that is, the OID—must compensate the holder of the bond for lending the issue price of the bond and also for lending the interest that was accruing annually on the bond.

> Example. A issues a bond, with a two-year term, for $100 at a time when the annual market rate of interest is 6 percent. No stated interest is payable on the bond. To make the bond attractive to prospective holders, A must agree to compensate the holder of the bond, by way of a redemption premium, not only for the $12 of interest due on the issue price, but also for the delay in paying the $6 of interest that would accrue in the first year. At a 6-percent annual rate, the charge for the year's delay in making the $6 interest payment accruing in year 1 would be $0.36 (6% of $6). Thus the redemption price of A's bond would have to be $112.36 for it to be marketable.

During periods of high interest rates, the OID for a bond with an extended term would have to be very high relative to the issue price in order to be competitive in the marketplace with a bond paying periodical interest.

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[181] IRC § 1273(a) and (b).

Example. An OID bond paying no periodical interest is issued for $100, redeemable after 25 years, at a time when the market interest rate is 15 percent. In the first year, the return on the OID bond would have to be 15 percent of the issue price, or $15, in order to be competitive with a bond paying periodical interest of 15 percent. In the second year, the return would have to be $17.25, which is 15 percent of the sum of the issue price of $100 and the deferred interest of $15. In the third year, the return would have to be $19.84 (15% of ($100 + $15 + $17.25)).

The deferred annual return in the example above would have to grow exponentially. In the 25th year, the deferred return on the issue price and the deferred interest would be $429. The sum of the accrued interest due for all 25 periods plus the issue price would amount to $3,292. That is, for an OID bond with an issue price of $100 and redeemable in 25 years to be competitive in the marketplace with a bond paying periodical interest of 15 percent, its promised redemption price would need to be almost 33 times its issue price.[182]

An investor considering the purchase of an OID bond should calculate the implicit interest rate payable on that bond. That implicit rate is called the yield, or the yield to maturity. A presentworth formula can be used to compute the yield to maturity.

For a bond having no stated interest, the yield to maturity, *r*, expressed as an annual interest rate, can be determined by solving the following equation:

$$I = R/(1 + r)^N$$

where *I* is the issue price, *R* is the redemption price, and *N* is the term of the bond, expressed in years. If the interest is to be compounded over some accrual period other than a year, then *r* would be the interest rate per accrual period and *N* would be the number of accrual periods over the term of the bond. A somewhat more complicated formula must be used to compute the yield to maturity for OID bonds that pay some periodical interest and also pay a premium at redemption.[183]

The United States has developed detailed rules for determining the tax consequences resulting from the issuance of debts instruments at a discount. A full discussion of those rules, contained in Code sections 1271 to 1275, is beyond the scope of this book. The OID rules provide a formula for allocating the original issue discount attributable to a bond (or other debt instrument) over the expected term of the bond. The objective of the formula is to amortize original issue discount in a manner that approximates the manner in which interest would accrue on a bond that was issued for its face amount and paid a market interest rate.

The formula for allocating original issue discount to particular taxable periods is contained in Code section 1272(a)(3) and is explained in further detail in the two dozen odd pages of Treasury regulations under that section.[184] The statutory formula provides a method for spreading the total OID attributable to a bond over the term of that bond. Some portion of the OID is allocated to each day of that term. The Code refers to the OID allocated to a particular day as the “daily portion” of the OID. The OID allocated to a particular taxable year is referred to as the “accrued OID” for that year. The accrued OID for any year would be the sum of the daily portions for that year. With some exceptions, a holder of an OID bond is taxable

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[182] If the bond were redeemable after 30 years, the redemption price would have to be $6,621 for the bond to be competitive with a $100 bond paying periodical interest of 15%. See General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (1982) at 159.

[183] That formula would provide that the issue price would equal the sum of the present worth of the periodical interest payments due on the bond and the present worth of the redemption price.

[184] See, in particular, Reg. § 1.1272-1 (1996).

each year on the OID allocated to that year, unless the holder is a related foreign person.[185] The issuer of an OID bond generally can deduct each year the accrued OID for that year.[186]

The daily portion of OID is determined by ratably spreading the OID allocated to an "accrual period" over the days in that period. An accrual period is a year or other period over which interest is being compounded. The term of a bond is divided into accrual periods, starting backward from the redemption date. All of the accrual periods are of equal duration, except perhaps for the first accrual period. The accrual period generally may be selected by the taxpayer but may be no longer than one year.[187]

The OID allocable to the first accrual period is calculated by multiplying the issue price of the bond by the yield to maturity and subtracting the interest actually paid on the bond.

> *Example*. A bond is issued for $100. Its yield to maturity is 15 percent, its accrual period is one year, and the annual interest actually paid is $8. Under these conditions, the OID allocable to the first year would be $7 (15% of $100 minus $8).[188]

OID allocable to subsequent accrual periods is calculated in a similar manner, except that the yield to maturity is multiplied by the "adjusted issue price" of the bond. The adjusted issue price is the sum of the issue price and the OID allocated to prior accrual periods. In the example above, the adjusted issue price for the bond in the second accrual period would be $107 ($100 + $7). The OID allocated to the second period would be $8.05 (15% of $107 minus $8). For the third accrual period, the adjusted issue price would be $115.05 ($100 + $7 + $8.05), and the OID allocated to that period would be $9.23 (15% of $115.05 minus $8).

In the examples above, the OID bond was issued for cash. More complicated rules apply for bonds issued for property other than cash.[189]

In some cases, the taxpayer may sell an OID bond before its maturity date. In that event, it is taxable on the OID that has accrued up to the time of the sale. The buyer is responsible for paying tax on OID accruing after the sale.

§ 8.03.2. Taxation of Foreign Persons on OID

A foreign holder of an OID bond would compute the OID allocable to its taxable year following the rules explained above. That amount is taxable to the foreign holder if the OID is effectively connected income and the holder is engaged in a trade or business within the United States.[190]

If OID accruing on a bond held by a nonresident alien individual or foreign corporation is not effectively connected income, it is taxable to the foreign holder under the provisions of Code sections 871(a)(1)(C) (individuals) and 881(a)(3) (corporations). Under those provisions, the foreign holder of an OID

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[185] IRC § 1272(a)(1). Exceptions to the general rule apply for tax exempt obligations, for U.S. savings bonds, for bonds with a maturity date one year or less from the date of issuance, for obligations issued by a natural person before March 2, 1984, and for certain loans of less than $10,000 between natural persons. IRC § 1272(a)(2).

[186] IRC § 163(e)(1).

[187] See Reg. § 1.1272-1(b)(1)(ii) and (j)(ex.1)(iii) (1996).

[188] If the first accrual period is less than a year, the yield to maturity would be adjusted to reflect the yield on the bond for that shorter period.

[189] IRC § 1274.

[190] OID would be treated as interest for purposes of determining whether it is effectively connected income. It also would be treated as interest for purposes of determining its source. IRC § 871(g)(3).

bond is not taxable until there is an amount received from U.S. sources that represents OID that accrued during the period that the bond was held by that person.

On the sale or exchange of an OID bond, the foreign holder is generally taxable on the entire amount of the previously untaxed OID that accrued during the period that the bond was held by that person.[191] A holder receiving a payment with respect to an OID bond is generally taxable on OID that accrued during the period it held the bond, up to the amount of the payment received.[192]

The tax on accrued OID cannot exceed the amount of the payment, less any U.S. withholding tax imposed on that payment. OID that has previously been taxed to a foreign holder would not be taxed again, either on receipt of an additional payment or on the sale or exchange of the OID bond.

Example. FCo is a foreign corporation not engaged in business in the United States. FCo is the original holder of a bond paying 5 percent annual interest that was issued for $100 and is redeemable after four years at $113.50. A present worth calculation would show that the yield to maturity on the bond is 8 percent.[193] At the end of year one, FCo receives an interest payment of $5 on the bond. That payment is taxable as interest under Code section 881(a)(1) at a 30-percent rate. The amount of that tax is $1.50.

FCo also has accrued OID on the bond. The amount of the OID is $3, computed by multiplying the issue price by the yield to maturity and subtracting from the amount so determined the actual interest payment (8% of $100 minus $5). The tax attributable to the $3 of OID is $0.90 (30% of $3). That amount is less than the $5 interest payment minus the $1.50 withholding tax on the interest payment. Thus the entire tax on the accrued OID must be withheld by the payer of the interest under Code section 881(a)(3). FCo would receive a net payment after withholding of $2.60 ($5 minus $1.50 minus $0.90).

In the example above, FCo was taxable on the accrued OID because it was receiving interest payments on the bond. A foreign taxpayer holding a zero-interest bond would be able to defer tax on the accrued OID until the bond was sold or redeemed.

Because foreign holders of OID bonds may be able to defer tax on their accrued OID under the rules described above, the general rule of Code section 163(e), allowing the issuer of an OID bond to deduct accrued OID, is subject to a limitation. The limitation generally provides that the issuer of an OID bond cannot deduct accrued OID prior to its payment if the holder of the bond is a related foreign person.[194] A related person is defined by reference to Code section 267(b). Under that section, corporations that are members of a control group would be related persons.[195] A foreign related person is any related person other than a U.S. person. The limitation for OID bonds held by related foreign persons generally does not

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[191] IRC §§ 871(a)(1)(C)(i) and 881(a)(1)(3)(A).

[192] IRC §§ 871(a)(1)(C)(ii) and 881(a)(1)(3)(B).

[193] At an 8% discount rate, the present worth of the $113.50 redemption price is $83.43. The present worth of the $5 annual interest payments are, respectively, $4.63, $4.29, $3.97, and $3.68, for a total of $16.57. The sum of those amounts is the issue price of $100.

[194] IRC § 163(e)(3)(A). See Reg. § 1.163-12 (1993).

[195] IRC § 163(e)(3)(B). A control group is defined to include parent and subsidiary corporations and corporations under the common control of another corporation, with more-than-50%-stock-ownership the test of control. IRC § 163(f).

apply if accrued OID is taxable to the holder as effectively connected income[196] or if the accrued OID is actually paid.[197]

Another limitation on the deductibility of accrued OID is contained in Code section 163(e)(5). It prohibits corporations from deducting any unpaid accrued OID attributable to certain "high yield" OID bonds and makes a portion of accrued OID—the disqualified portion—permanently nondeductible.[198] High yield bonds are commonly called junk bonds, due to the substantial risk of forfeiture associated with them. The limitation on interest attributable to OID junk bonds was adopted in 1989 primarily to deal with the tax and economic problems associated with the use of junk bonds in financing corporate takeovers.

The disqualified portion of OID on a junk bond is the portion attributable to the issuance of the bond at a yield to maturity more than six percentage points above the "applicable federal rate" (AFR). In general, the AFR for a bond would be the market interest rate on federal government bonds having a comparable term.[199] Congress determined that this portion of the return on an OID junk bond typically constitutes a return on equity rather than genuine interest. A corporation may be eligible for a dividends-received deduction on receipt of the disqualified portion of OID.[200]

Foreign corporations taxable on their effectively connected income under Code section 882(a) are eligible for the dividends received deduction if the dividend constitutes effectively connected income.[201]

The remaining portion of OID (total OID minus the disqualified portion) is deductible by the issuing corporation when it is paid.[202] Payment must be in cash or in property other than the debt instrument or stock of either the issuing corporation or a related person.[203] This payment requirement applies whether the holder of the junk bond is foreign or domestic, related or unrelated. Thus, the distinction that Code section 163(e)(3) makes in the deductibility of interest on OID bonds held by foreign related persons and foreign unrelated persons is substantially reduced by Code section 163(e)(5) for high-yield OID bonds.

§ 8.04. Exemptions for Interest

Two broad categories of U.S. source interest income otherwise taxable under Code sections 871(a) and 881 are exempt from the 30-percent tax. One exempt category is "interest on deposits."[204] The other

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196 IRC § 163(c)(3)(A). For the effectively connected exception to the foreign holder limitation to apply, the accrued OID cannot be exempt from tax or subject to a reduced rate of tax under a tax treaty.

197 An amount is treated as paid if it is so treated for withholding tax purposes under IRC §§ 1441 or 1442. See Reg. § 1.163-12(a)(1) (1993).

198 IRC § 163(e)(5)(A). For the high yield limitation to apply, the amount of OID must be "substantial" (within the meaning of IRC § 163(i)(2)), the term of the bond must run more than 5 years, and the yield to maturity must be at least 5 percentage points above the "applicable federal rate" (AFR), as determined by IRC § 1274(d).

199 See IRC §§ 163(e)(5)(C) and 163(i).

200 See IRC § 163(e)(5)(B).

201 See IRC §§ 243(a) and 882(c)(1)(A).

202 See IRC § 163(e)(5)(A)(ii).

203 See IRC § 163(i)(3)(B).

204 IRC §§ 871(i)(2)(A) and 881(d) (exempting amounts described in § 871(i)(2)).

exempt category is "portfolio interest."[205] These exemptions are discussed below. The policy implications of the exemptions are also discussed below.

There are two additional exemptions for interest income. Code sections 871(i)(2)(C) and 881(d) provide that interest or other income derived by a foreign central bank from issuing bankers acceptances is exempt from the 30-percent tax.[206] Code section 895 provides that foreign central banks of issue[207] are exempt from U.S. tax on interest paid with respect to obligations of the United States. This exemption does not apply if the interest was earned from commercial banking operations.

Most categories of U.S. source interest income are exempt from tax. Indeed, the only major categories of U.S. source interest income earned by foreign persons that are subject to tax, other than effectively connected interest income, are interest paid to a foreign person by a related party and certain interest paid with respect to privately negotiated loans.

Even those categories of interest taxable under the Code may be exempt, or subject to a reduced tax rate, under a tax treaty. Except in its negotiations with some developing countries, the negotiating goal of the U.S. Treasury Department is to reduce the treaty withholding rate on interest in the source country to zero.[208] It is often successful in achieving this goal.[209]

§ 8.04.1. Interest on Deposits

Interest on deposits is interest paid to foreign persons on a deposit held by a bank or similar commercial enterprise,[210] plus interest paid to foreign persons under a contract with an insurance company.[211] For example, a foreign person holding a savings account in a U.S. bank would be exempt from the 30-percent tax on the interest paid on that account. Interest classified as effectively connected income is not eligible for the exemption.[212] Interest classified as original-issue discount (OID) is eligible for the exemption to the extent that it is not effectively connected income.[213]

Prior to the adoption of the 1986 tax act, interest on deposits was classified under the source rules as foreign source income, even if the interest was paid by a domestic bank or other domestic borrower.[214] The 1986 tax act reformed the source rules to provide that interest paid by U.S. obligors is generally U.S. source income. That act preserved the exemption for deposit interest by granting an explicit exemption under Code sections 871(i) and 881(d). The change in form simply made the point that deposit interest is viewed by Congress as subject to U.S. tax jurisdiction and is exempt for policy reasons.

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[205] IRC § 871(h)(1).

[206] See IRC § 871(i)(2)(C).

[207] A foreign central bank of issue is an institution analogous to the Federal Reserve banks. It generally is a bank charged by the government with the responsibility for issuing instruments intended to circulate as currency.

[208] See U.S. Model Treaty (2006), Art. 11(1).

[209] See, e.g., U.S. tax treaties with Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Luxembourg, Netherlands, Norway, Poland, Russia, Slovak Republic, South Africa, Sweden, Switzerland, Ukraine, and United Kingdom.

[210] IRC § 871(i)(3)(A) and (B). An exemption for bank interest paid to foreign persons dates from the 1936 tax act, although the form and the scope of the exemption have been modified from time to time.

[211] IRC § 871(i)(3)(C).

[212] IRC § 871(i) exempts interest on deposits from the tax imposed by § 871(a) (periodical, etc., income) but not from the tax imposed by § 871(b) (effectively connected income). Similarly, the exemption of IRC § 881(d) is limited to the tax imposed by § 881.

[213] See IRC § 871(i)(1), which extends the exemption to amounts received described in IRC § 871(a)(1)(C) (original issue discount).

[214] See former IRC § 861(a)(1)(A) and (c) (1985).

To deter U.S. taxpayers from claiming the exemption for bank deposit interest, the Internal Revenue Service requires persons claiming the exemption to file a form with the financial institution making the interest payments showing their foreign address. The enforcement mechanism may not be effective, however, because of the possibility that a U.S. person willing to make a false claim that he is a foreigner also would be willing to falsely claim a foreign address.

In early 2001, the Clinton administration issues proposed regulations that would require the U.S. office of financial institutions to report the amount of interest paid to nonresident alien individuals on their U.S. bank deposits.[215] The objective of this proposed regulation was to reduce fraud by U.S. taxpayers falsely claiming foreign status and to assist U.S. treaty partners in collecting taxes properly due to them from their residents. The announcement of the proposed regulation states that "several countries that have tax treaties or other agreements that provide for the exchange of tax information with the United States have requested information concerning bank deposits of individual residents of their countries."[216] Because of the exchange-of-information implications of the proposed regulation, it attracted criticism from banks in Florida, Texas, and elsewhere that cater to nonresident aliens who are evading taxes in their home country.[217]

In 2002, the Bush administration responded to the tax-fraud lobby and withdrew the proposed regulations issued by the Clinton administration. Revised proposed regulations of limited applicability were issued in their place. The proposed regulations never were made final and never went into effect. The revision of the proposed regulations was made in response to heavy criticism by U.S. banks that have substantial deposits from foreign persons. It was feared that the foreign persons resident in Mexico and other developing countries would withdraw their deposits and place them in some tax-haven country other than the United States if the United States assisted their home countries in collecting the taxes due in those countries.[218]

In a letter dated February 9, 2009, Mexican Finance Secretary Agustin Carstens wrote to U.S. Treasury Secretary Timothy Geithner, asking the Treasury to consider a proposal for the automatic sharing of information regarding interest paid by banks of one country to residents of the other.[219] According to Carsten, the goal of the automatic exchange would be to help detect and prevent tax evasion, money laundering, terrorist financing, drug trafficking, and organized crime.[220]

Effective April 19, 2012, regulations under Code section 6049 provide that the United States will collect information on the deposits in U.S. banks of nonresident aliens residing in a country having a full income tax treaty with the United States. The new reporting, according to the preamble to the regulations, is essential to the government's efforts to combat offshore tax evasion. In addition, by offering to exchange information with its allies, the United States will be positioned to request similar information on the foreign

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[215] Prop. Reg. § 1.6049-4(b)(5) (2001).

[216] See REG-126100-00 (Jan. 17, 2001, as amended on March 21, 2001 and May 14, 2001).

[217] For discussion of the proposed regulation and a prediction that its implementation would result in much of the $1 trillion held in U.S. bank deposits by foreigners being moved to countries without an effective exchange of information system, see Marshall Langer, "New EU, U.K., and U.S. Reporting Rules on Bank Deposit Interest Paid to Nonresidents," 25 *Tax Notes Int'l* 403-411 (January 28, 2002).

[218] For a discussion of U.S. complicity with foreign tax cheats, see Lucy Komisar, "After Dirty Air, Dirty Money'," *The Nation*, June 18, 2001.

[219] See Tax Analysts, Doc 2009-5928, 2009 WTD 51-15. A copy of the letter is available at http://faculty.law.wayne.edu/tad/Documents/Country/mexico-carstens_letter.pdf.

[220] For discussion of the significance of the Carsten letter, see Michael J. McIntyre, "How to End the Charade of Information Exchange," 56 *Tax Notes Int'l* 255, 258-59 (October 26, 2009).

bank depposits of U.S. citizens and residents. The reporting requirements also will facilitate intergovernmental cooperation on implementation of the Foreign Account Tax Compliance Act (FATCA). Regrettably, the United States has agreed to provide an automatic exchange of information only with Canada.[221]

§ 8.04.2. Portfolio Interest

The exemption for portfolio interest was added to the Code by the 1984 tax act. Under that exemption, nonresident alien individuals and foreign corporations receiving interest paid on qualifying bonds issued by U.S. persons are not subject to the 30-percent tax under Code section 871(a).[222] The bonds initially could be in bearer form or in registered form. As amended in 2010, qualifying bonds must be issued in registered form and in a fashion that makes it likely to be held by foreign persons.[223] Effectively connected income is not eligible for the exemption. Nor are certain contingent interest payments made with respect to participatory debt.[224]

Congress enacted the exemption for portfolio interest to expand access of U.S. borrowers to the Eurobond market and other international capital markets. Interest rates on bonds traded in the Eurobond market have tended to be lower than U.S. interest rates.[225] The Treasury Department was particularly keen to gain access to the Eurobond market in order to reduce the apparent costs of financing the large federal deficits that were incurred during the 1980s.[226]

The Eurobond market is not an organized bond exchange. It has been described as "a network of underwriters and financial institutions that market bonds issued by private corporations (including but not limited to finance subsidiaries of U.S. companies), foreign governments and government agencies, and other borrowers."[227] A significant portion of the debt instruments traded on the Eurobond market are issued in bearer form. Registered debt is also traded. For example, the U.S. government bonds sold by the Treasury Department on the Eurobond market since 1984 have been in registered form.

Prior to the adoption of the 1984 act, U.S. borrowers had indirect access to the Eurobond market through the use of finance subsidiaries organized in the Netherlands Antilles, a tax-haven country that had, at the time, a tax treaty with the United States. A typical arrangement was for the Antilles subsidiary to sell bearer bonds through European underwriters, with the proceeds of those bonds relent by the Antilles subsidiary to its U.S. parent. To be marketable, the bonds issued by the Antilles subsidiary had to be guaranteed by the U.S. parent. The parent company contemplated that its interest payments to the Antilles subsidiary would be exempt from the 30-percent tax under the U.S./ Netherlands tax treaty, as extended to

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[221] See Rev. Proc. 2012-24, 20 I.R.B. 913 (2012)

[222] IRC § 871(h) and Reg. § 1.871-14 (2007).

[223] IRC § 871(h)(2)(B)(ii).

[224] IRC §§ 871(h)(4) and 881(c)(4). A grandfather clause exempts debt obligations arising on or before April 7, 1993. IRC §§ 871(h)(4)(D) and 881(c)(4)(D).

[225] See Marilyn Doskey Franson, "The Repeal of the Thirty Percent Withholding Tax on Portfolio Interest Paid for Foreign Investors," 6 *Northwestern Journal of International Law & Business* 930 at n.3 (1984) (citing statement made to the Ways and Means Committee that the cost savings in the 1983 Eurobond market were as high as 119 basis points). The 1984 volume of U.S. borrowing in the Eurobond market was more than $21 billion, up from $5.2 billion in 1983. Id. at 930-932.

[226] Although the Treasury Department obtained lower interest rates by issuing tax-free bonds to foreigners, the overall borrowing costs for the U.S. government may not have been reduced because the lower interest rates were offset, in whole or in part, by the loss of tax revenue otherwise obtained through the 30% tax.

[227] General Explanation of the Tax Reform Act of 1984 at 388.

the Netherlands Antilles. The validity of arrangements of this type has been challenged by the Internal Revenue Service.[228]

In 1987, the Treasury Department gave notice of an intent to revoke the Netherlands Antilles treaty. This action would have closed the back door to the Eurobond market for subsequent years. In an attempt to avoid unsettling the legal status of outstanding Antilles loans, however, Treasury allowed the treaty to continue in modified form. Questions about the legal status of that *de facto* amendment of the treaty were laid to rest with the signing and ratification of a protocol between the United States and the Netherlands (on behalf of the Netherlands Antilles).[229] The protocol extends the interest exemption for certain related-party bonds outstanding before October 15, 1984.

The Treasury Department is given the authority to impose the 30-percent tax on the residents of a foreign country after a publicly noticed determination that the exchange of information arrangements with that country are inadequate to prevent the evasion of U.S. taxes by U.S. persons.[230] The exemption for portfolio interest is not available to persons receiving interest from a U.S. corporation if they own 10 percent or more of the voting stock of the corporation.[231] A similar rule prevents persons holding a 10-percent interest in a partnership from qualifying for the exemption with respect to interest paid on bonds issued by that partnership.[232] Attribution rules limit the ability of taxpayers to avoid the 10-percent ownership rules by transferring ownership to family members or to legal entities under their control.[233]

Interest received by a controlled foreign corporation from a related person is also excluded from the exemption.[234] Interest received by a bank from an extension of credit in the ordinary course of its business generally does not qualify as portfolio interest.[235] The purpose of this latter exception is to prevent foreign banks making loans to U.S. persons outside the United States from gaining a competitive advantage over U.S. banks.

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[228] The Service had a strong position. It could argue, with support from established precedents, that the debts incurred by the typical Antilles subsidiary were in substance the debts of its parent. In addition, the Service could contend that a principal purpose of establishing the Antilles subsidiary was to avoid taxes, within the meaning of IRC § 269, thereby making the parent obligated to withhold taxes under IRC § 1461. See General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (1984) at 390. Some of the challenges otherwise available to the Service were mooted by § 127(g) of the 1984 tax act (not codified), which provided that certain loans made by U.S. corporations through a foreign affiliate before June 22, 1984, would be treated as the bona fide loans of the foreign subsidiary. It does not appear that the Service challenged the Antilles arrangements in court.

[229] By note dated June 29, 1987, the U.S. Secretary of State gave notice to the Netherlands of its intent to terminate the U.S./Netherlands tax treaty, as it applied to the Netherlands Antilles, effective January 1, 1988. By note of July 10, 1987, the United States modified that termination to allow Article VIII, relating to the reduced tax rate on interest, to continue to apply. The U.S. position was accepted by the Kingdom of The Netherlands, on behalf of the Netherlands Antilles, by note dated October 2, 1987. Article VIII was amended by a protocol that was signed by the United States and the Netherlands on October 10, 1995, and entered into force on December 30, 1996. The protocol amended Article VIII by adding to it the following: "The exemption provided by this paragraph shall apply only to interest paid with respect to debt instruments issued on or before October 15, 1984 by a U.S. person to a related controlled foreign corporation that was in existence before October 15, 1984, the principal purpose of which consisted of the issuing of debt obligations or the holding of short-term obligations and lending the proceeds of such obligations to affiliates."

[230] IRC § 871(h)(6). Many tax haven jurisdictions have entered into exchange of information agreements with the United States. These agreements are not likely to be effective in practice and give the tax haven treaty partners an undeserved aura of respectability.

[231] IRC §§ 871(h)(3) and 881(c)(3)(B) (incorporating by reference the rules of § 871(h)(3)).

[232] Id.

[233] IRC § 871(h)(3)(C).

[234] IRC § 881(c)(3)(C). A number of special rules affecting portfolio interest received by a controlled foreign corporation are contained in IRC § 881(c)(5).

[235] IRC § 881(c)(3)(A). Banks are exempt, however, on interest paid on a U.S. government obligation.

The exemption for portfolio interest provided in 1984 created a major disparity in the withholding tax applicable to foreign persons receiving interest and foreign persons receiving dividends and other returns on equity investments. Foreign taxpayers making equity investments in the United States sought to exploit that disparity by acquiring hybrid securities that were debt in form but possessed some of the traditional attributes of equity. The Internal Revenue Service has some authority under common law substance-over-form doctrines to challenge a taxpayer's claim that its payments on a hybrid security qualify as portfolio interest. The extent of that authority was unclear, however, and the Service took little formal action to exercise it. Since 1984, foreigners have increasingly invested in the United States so as to receive interest income rather than dividends.

In 1993, Congress took some action to limit the ability of foreigners to exploit the portfolio exemption by using hybrid securities. The 1993 tax act clarifies the tax treatment of contingent interest under the portfolio interest exemption. As amended by that act, the Code generally provides that a payment will not qualify as portfolio interest if the amount of the payment is determined by reference to the gross or net income or profits of the borrower or of certain persons related to the borrower.[236] For example, the receipt by a foreign person of 10 percent of a borrower's profits will not be exempt from withholding tax under the portfolio interest exemption even if the payment is characterized as interest under a loan agreement. The same result would be reached if the amount of the payment was measured by the profits of the borrower's affiliated company. The statutory term "related person" is defined broadly. It includes close family members and legal entities with common stock ownership links. It also includes any person who is a party to any arrangement undertaken for purposes of avoiding the contingent interest rules.[237]

In addition to payments related to the profits of the borrower, certain other types of contingent interest payments are prevented from qualifying as tax-free portfolio interest. The Code provides that a payment will be characterized as nonqualifying contingent interest if the amount of the payment is determined by reference to: (1) the receipts, sales, or other cash flow of the borrower or a related person; (2) a change in the value of the borrower's property (or the property of a related person); or (3) the payment by the borrower (or a related person) of a dividend, a partnership distribution, or similar equity return.[238] Broad regulatory authority is granted to the tax authorities to fine tune the definition of nonqualifying contingent interest.[239]

The characterization of interest keyed to appreciation in the value of a borrower's property prevents foreign investors from using the portfolio interest exemption to avoid the bite of the FIRPTA rules that impose tax on gains derived by foreign persons on the disposition of U.S. real property. Under prior law, interest payable on a note that was contingent on the appreciation of U.S. real property would be exempt under Code section 871(h), whereas a sale of the note would be taxable under Code section 897 and the regulations thereunder.[240]

The 1993 act also makes clear that certain contingencies commonly associated with genuine debt will not prevent an interest payment from qualifying as portfolio interest. Acceptable contingencies include those relating solely to the timing of an interest or principal payment, to the nonrecourse nature of the debt,

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[236] IRC § 871(h)(4)(A)(i)(II) (applicable to individuals, trusts, and estates). The provisions of IRC § 871(h)(4) are applied to corporations by IRC § 881(c)(4).

[237] IRC § 871(h)(4)(B), incorporating by reference the related person rules of IRC §§ 267(b) and 707(b)(1).

[238] See IRC § 871(h)(4)(A)(i)(I), (III), and (IV).

[239] IRC § 871(h)(4)(A)(ii).

[240] See Reg. § 1.897-1(d)(3)(ii)(B) (1996).

or to the uncertainties implicit in a genuine hedging contract.[241] Regulatory authority is given to the Treasury Department to expand the list of acceptable contingencies.

On its face, the exclusion of certain contingent interest from the definition of portfolio interest has no effect on taxpayers that obtain full or partial exemption from tax on interest income through a tax treaty. The legislative history of the 1993 tax act, moreover, indicates that Congress did not intend to override existing tax treaties in enacting the restrictions on portfolio interest.[242] Thus the tax treatment of contingent interest payments under U.S. tax treaties remains unsettled. A treaty beneficiary receiving payments with respect to participatory debt must continue to rely on vague common law concepts in distinguishing genuine interest from returns on equity. It seems likely, however, that the concepts applicable to contingent interest under the portfolio interest rules will influence the development of the common law rules.

§ 8.04.3. Policy Implications of Interest Exemptions

The traditional policy of the United States has been to avoid serving as a tax haven for foreigners. The exemptions for interest on deposits and the exemption for portfolio interest are obviously exceptions to that policy. Commentators have sought to defend the interest exemptions on the ground that foreigners have many opportunities, other than the opportunities provided by the United States, to avoid or evade tax on their interest income. Whatever the merits of that defense, its basic premise—that many governments are willing to exempt foreigners on domestic source interest income—is certainly correct.

The costs and benefits of the exemptions for interest are difficult to assess. On the plus side, the exemptions encourage foreigners to make use of U.S. financial institutions rather than financial institutions located in foreign countries. That effect is presumably good for U.S. financial institutions and their employees. The effect on the general welfare of Americans, however, is not necessarily positive.

On the minus side, the exemptions for interest reduce U.S. tax revenues, resulting in an increase in the federal deficit or an increase in taxes levied against U.S. citizens and residents. It also promotes international tax evasion and tempts U.S. financial institutions to service criminal elements. By serving as a tax haven for tax cheats, the United States undermines its moral authority to develop effective cooperative measures to combat international tax evasion.

Commentators simply do not know the extent to which U.S. taxpayers are posing as foreigners in order to exploit the exemptions for interest. If such a practice is widespread, as seems likely from the UBS case, then the possible benefits obtained from granting the exemption are minuscule in comparison to the costs.

The stated goal of the exemption for portfolio interest is to increase access by U.S. borrowers to the Eurobond market. A goal of the exemption for deposit interest is to encourage foreigners to lend money to U.S. banks. Achievement of those goals is obviously beneficial to U.S. borrowers, but the gain to the U.S. economy is less obvious.

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[241] IRC § 871(h)(4)(C).

[242] See Conference Report to Accompany H.R. 2264, 103d Cong., 1st Sess. at 183. Most tax treaties provide that a treaty partner generally should determine the scope of a concessional withholding rate on interest payments by reference to the definition of interest provided in its domestic laws. Consequently, the U.S. would not violate its tax treaty obligations by classifying contingent interest as a dividend or some other return on equity as long as the definitional rule was applied in a nondiscriminatory fashion. Most U.S. tax treaties treat interest payments more favorably than dividends.

By exempting foreign lenders from the tax on U.S. source interest, the United States encourages foreign holders of dollars to invest in U.S. bonds or in U.S. bank deposits rather than using those dollars for other purposes. That result is generally assumed to be desirable, but it may not be.

Foreigners ultimately have only two uses for dollars: purchasing U.S. assets, such as land, financial assets, or other accumulated wealth, or purchasing U.S. goods and services produced during the current period. Because of the large U.S. trade deficits in recent years, the United States probably would benefit from making the purchase of U.S. goods and services relatively more attractive to foreigners than the purchase of U.S. assets. To achieve that result, Congress could raise the tax on income derived by foreigners from holding the U.S. assets to the level of the tax currently imposed on U.S. persons. A step in that direction would be to end the tax preference for foreigners holding U.S. bonds and other debt instruments.

§ 8.05. Commentary on U.S. Taxation of Foreigners

The United States makes a sharp distinction in its taxation of foreigners between business income and investment income. In general, gross investment income derived from the United States is taxable at a flat rate, and the tax applies no matter how small the amount of the income or how trivial the activities conducted in the United States that generated it. In contrast, the United States does not tax business income at all unless the foreign taxpayer has met some threshold of activity, and then the income is taxable on a net basis at graduated rates. This disparity of treatment of business and investment income is difficult to defend on grounds of fairness or efficiency, given the inescapable fact that a dollar of income in either category provides the taxpayer with the same economic benefit.

The distinction in the treatment of investment income and business income can be explained and perhaps justified on grounds of administrative economy. Investment income is almost certainly taxed on a gross basis so as to simplify withholding. No minimum threshold is provided for the same reason—a threshold level complicates withholding. These administrative concerns almost certainly were the historical reason for the disparate treatment provided in the Code for investment and business income. In more recent years, the United States may have continued the current treatment of investment income in order to conform to international practices, as exemplified by the treatment of investment income in tax treaties, and to encourage portfolio investment in the United States.[243]

The application of the normal statutory rates to business income earned by foreign persons is easy to justify. It simply puts them on equal footing with U.S. taxpayers, thereby promoting fairness and efficiency. It may also provide some administrative advantage to have the tax rules applicable to domestic taxpayers do double duty by applying also to foreign persons. Allowing foreign persons to take appropriate business deductions also serves the twin goals of fairness and efficiency. Although some legitimate questions can arise about the details, there can be little question of the general principle that foreign persons and domestic persons earning U.S. business income should face comparable tax burdens.

Some interesting tax policy issues do arise, however, in determining the minimum threshold level that foreign persons must reach before being taxable on their U.S. source business income. For comparable treatment of domestic taxpayers and foreign taxpayers, a threshold is unnecessary. From the beginning of

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[243] It should not be assumed without proof that encouraging foreign investment in the United States is always desirable. In some cases, foreign investment simply crowds out U.S. exports, resulting in a loss of U.S. jobs. If investment by foreigners is not taxed and investment by Americans is taxed, the result may be that foreigners end up holding an inappropriate share of U.S. assets.

the modern income tax, nevertheless, the United States has exempted foreign persons from taxation on their U.S. source business income if they are not engaged in a trade or business in the United States. In evaluating the merits of this threshold, it would be useful to understand the function that it is intended to serve.

One function of the engaged-in-business rules is to define the reach of U.S. source jurisdiction. Good jurisdictional rules should be as precise as possible. Instead of desirable bright lines, however, the engaged-in-business rules draw some of the fuzziest lines in the Code. The direction of reform of these rules should be to adopt clear, objective rules that specify what constitutes engaging in business within the United States and that minimize opportunities for tax avoidance. Those rules should be designed to exempt foreign persons with minor economic ties to the United States and to tax those who go beyond some minimum level of activity in the United States. That is, foreign firms with gross sales (or other receipts) from U.S. sources over some reasonable threshold should be taxable on their U.S. source income. And once a foreign person has engaged in business in the United States, it should remain taxable on its U.S. source income for some reasonable period.

There are two good reasons for wanting to tax foreign persons that have penetrated the U.S. market to a significant degree on their business income. First, imposition of an income tax on those persons would provide revenue for the U.S. fisc. Second, and most importantly, it would provide for parity with their U.S. competitors. Producers of goods and services in the United States suffer an unfair competitive disadvantage when their foreign competitors are able to sell into the U.S. market on a tax-free basis.[244]

To a large extent, the jurisdictional function of the engaged-in-business rules has been supplanted by the permanent establishment clause of U.S. tax treaties. For residents of a treaty country, the important jurisdictional rule is the permanent establishment clause because virtually any taxpayer having a permanent establishment in the United States also would be engaged in a trade or business within the United States.[245] In theory, the treaty exemption does not produce a competitive inequity because the foreign person importing into the U.S. market is presumed to be taxable in its home country. As a practical matter, however, some treaty partners of the United States do not tax income derived outside their borders. In addition, various tax avoidance techniques are available to allow taxpayers to import goods and services into the United States without attracting tax in their country of residence.

Despite the protection against U.S. taxation they obtain under the permanent establishment clause, residents of a treaty country still may be concerned about their engaged-in-business status. To obtain the benefit of the permanent establishment clause, a taxpayer must disclose to the U.S. tax authorities, in accordance with the provisions of Code section 6114, its treaty claim. Such disclosure is likely to bring the U.S. operations of a foreign taxpayer to the attention of the U.S. tax authorities. Indeed, that is the precise purpose of the reporting requirement. The taxpayer would be able to avoid making disclosure under section 6114, however, if it can avoid being engaged in business within the United States. In that event, it would not be availing itself of a treaty benefit.

Foreign taxpayers ought to be exempt from the reporting requirements of section 6114 if their economic ties to the United States are truly minimal. They should be required to report, however, if they have made a major penetration of the U.S. market. Reform of the engaged-in-business rules along the lines suggested above would improve the operation of the reporting rules of section 6114 in two ways. First, the

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[244] Many foreign entities importing goods into the United States are controlled by U.S.-based multinationals. Exempting those companies on sales into the United States produces a competitive disadvantage for U.S. companies that are purely domestic.

[245] See U.S. Model Treaty (1996), Art. 5.

adoption of clearer engaged-in-business rules would let taxpayers know whether they need to rely on the permanent establishment clause of a treaty to avoid U.S. taxation, and it would prevent aggressive taxpayers from avoiding penalties for failure to report by exploiting the lack of clarity of the current rules. Second, the extension of the engaged-in-business rules to include foreign persons with a major presence in the U.S. market would cause those taxpayers to bring their U.S. activities to the attention of the U.S. tax authorities.

A second function of the engaged-in-business rules is to determine whether a foreign taxpayer deriving periodical, etc., income from U.S. sources will be taxed on its net income under the graduated rate schedules or on its gross income at a flat rate of 30 percent. Taxpayers earning U.S. source periodical income clearly are subject to U.S. tax jurisdiction whatever their engaged-in-business status. Thus, this feature of U.S. law is not a jurisdictional rule. Its intent is to simplify administration of the tax laws. It relieves U.S. tax authorities of the need to verify the claims for deductions of foreign taxpayers with insubstantial ties to the United States, and it allows the tax on those persons to be collected exclusively through a withholding mechanism.

At one time in U.S. tax history, the imposition of a flat tax of 30 percent on gross income may have achieved rough justice. Foreigners lost their right to deductions, to which they had a legitimate fairness claim, but they received the benefit of what typically was a favorable tax rate. The trade off is no longer fair. With the reduction of the top marginal tax rates from 70 percent or more to approximately 40 percent, foreign taxpayers not engaged in business in the United States lose their deductions with modest or nonexistent compensating rate benefits. Indeed, for moderate-income taxpayers, a significant rate penalty is suffered in addition to the loss of their deductions.

There are two possible directions of reform. One direction would be to reduce significantly the statutory withholding rate applicable on periodical income, thereby reinstating the old trade off. For example, the rate might be reduced to 20 percent. This approach has two drawbacks. It does not do enough for taxpayers that incur large deductions in earning their investment income. Second, by reducing withholding rates unilaterally, it may undercut the U.S. position in tax treaty negotiations.[246]

A second approach would be to allow foreign persons to elect to be taxed on a net basis in the United States in a wider range of circumstances. Current law grants such an election only to persons engaged in the rental of real property.[247] A reformed election ought to be made available whenever taxpayers earned gross income that likely would have significant associated deductions. Taxpayers making this election would claim a tax refund for amounts withheld in excess of their tax liability. To reduce the number of persons making that election, the reform might be coupled with a modest reduction in the withholding rate.

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[246] This latter disadvantage may in fact be a disguised advantage in that the United States probably does not serve the national interest (in contrast to the interests of U.S. investors seeking low foreign withholding rates) by negotiating away its ability and the ability of its treaty partners to tax investment income at the source.

[247] IRC §§ 871(d) or 882(d).

Chapter 9
Miscellaneous Special Rules

A major feature of the U.S. system of taxing foreign corporations is the 30-percent branch profits tax imposed by Code section 884. That tax is described in section 9.01, below. The limitation on the deduction for excessive interest payments (earnings stripping) to tax-exempt related persons is described in section 9.02. Certain statutory exemptions available to foreigners are described in section 9.03. Section 9.04.1 describes the 4-percent gross profits tax imposed on transportation income. Certain penalty taxes authorized by Congress in order to facilitate treaty negotiations are described in section 9.04.2.

§ 9.01. Branch Profits Tax

Code section 884, adopted as part of the 1986 tax act, imposed a tax of 30 percent on the repatriated profits of a U.S. branch of a foreign corporation. Certain interest payments made by a foreign corporation through a U.S. branch are also subjected to a 30-percent tax. Section 9.01.1, below, discusses the treatment of repatriated profits under the branch profits tax. The taxation of certain interest paid by a U.S. branch of a foreign corporation is discussed in section 9.01.2.

§ 9.01.1. The 30-Percent Tax on Repatriated Profits

Foreign corporations conducting business within the United States through a branch operation are subject to a tax of 30 percent under Code section 884(a) when the profits attributable to the branch are withdrawn from the branch. The amount subject to the 30-percent tax is referred to as the "dividend equivalent amount." In imposing that tax, Congress sought to equalize, to the extent feasible, the tax treatment of foreign corporations operating within the United States through a wholly owned domestic subsidiary and foreign corporations operating through a U.S. branch.[248] The highly simplified example below illustrates the operation of the tax on repatriated profits.

Consider a foreign corporation, FCo, that is engaged in business within the United States and has earned taxable income of $10,000 from that business. A U.S. tax of $3,500 is paid with respect to that income (35% of $10,000) and the earnings and profits of the U.S. business after payment of that tax are $6,500. That amount is then repatriated to F's head office, located outside the United States. Under these conditions, the dividend equivalent amount would be $6,500, and a branch profits tax of $1,950 (30% of $6,500) would be imposed on F by Code section 884(a). The after-tax amount received by F would be $4,550 ($6,500 minus $1,950).

In the example above, F would have borne the same tax burden if it had conducted its U.S. business through a U.S. subsidiary and received the after-tax income of the subsidiary as a dividend. The U.S. subsidiary would have had taxable income of $10,000 at a rate of 35 percent, and it would have paid a U.S.

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[248] See *General Explanation of the Tax Reform Act of 1986* (1987) at 1036. International organizations are exempt from the branch profits tax. IRC § 884(e)(5).

tax of $3,500. When the remaining $6,500 was distributed as a dividend to F, it would have been subject to the 30-percent tax under Code section 881 ($1,950). Thus F would have received the same after-tax amount of $4,550.

Under Code section 884(b), the dividend equivalent amount of a foreign corporation engaged in business through a U.S. branch is the foreign corporation's effectively-connected earnings and profits, adjusted for changes in the amount of profits retained by the U.S. branch. In general, the effectively-connected earnings and profits (ECEP) of a foreign corporation are its earnings and profits, unadjusted for distributions made during the year, that are attributable to income which is effectively connected, or treated as effectively connected, with the conduct of a U.S. trade or business.[249]

In general, earnings and profits (e&p) of a corporation would be determined under the provisions of Code section 312, after adjustment for the items listed in Code section 884(d)(2). The starting point in computing e&p is the corporation's taxable income for the year. In general, an addition would be made to taxable income for gains excluded from taxable income, such as interest on state and local bonds and income exempt by treaty. A subtraction would be made for nondeductible costs, such as federal income taxes paid. These rules can be applied only by analogy in computing the effectively connected e&p of a foreign corporation.

The earnings and profits of a foreign corporation retained by its U.S. branch are referred to in the Code as "U.S. net equity."[250] A change in U.S. net equity for a taxable year is determined by subtracting the U.S. net equity as of the end of that year from the U.S. net equity at the start of that year.[251] U.S. net equity is the net assets associated with the U.S. branch ("U.S. assets"), reduced (including below zero) by the net liabilities of the branch ("U.S. liabilities").[252] The example below illustrates the application of the branch profits tax to repatriated profits of a U.S. branch.

Example 9.1: The Branch Profits Tax on Repatriated Profits

GCo, a foreign corporation, operates a U.S. business through a branch, B. At the start of year 1, B has assets used in its business of $30,000, computed by taking the sum of its cash in the amount of $10,000 and the adjusted basis of its other property in the amount of $20,000. its liabilities are $12,000. During year 1, GCo has income effectively connected with B of $4,000. It pays U.S. corporate tax with respect to that income of $1,400. GCo has e&p effectively connected with B for the year of $2,600.[253] At the end of year 1, the branch, B, has net assets of $32,000 and liabilities of $12,000.

During year 2, GCo again has e&p effectively connected with B of $2,600. At the end of year 2, B has net assets of $29,000 and liabilities of $12,000. Under these facts, GCo must pay a branch profits tax of $180 in year 1 and a branch profits tax of $1,380 in year 2. Those amounts are determined as follows.

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[249] IRC § 884(d)(1). See Reg. § 1.884-1(f) (2009).

[250] IRC § 884(c).

[251] IRC § 884(b). A foreign corporation is not taxable with respect to a decrease in U.S. net equity unless that decrease represents profits that were not taxed under the branch profits tax because of an increase in U.S. net equity. Thus a foreign corporation would not be taxable on a withdrawal of capital contributed to its U.S. branch. See IRC § 884(b)(2)(B).

[252] IRC § 884(c) and Reg. § 1.884-1(c) (2009).

[253] For simplicity, the example assumes that no adjustment need be made to taxable income in computing earnings and profits other than a subtraction for federal income taxes paid.

Year 1

(1)	*Income effectively connected with B*	*$4,000*
(2)	*Adjustments to line (1), for taxes paid, in computing e&p effectively connected with B*	*1,400*
(3)	*E&p effectively connected with B line (1) minus line (2))*	*2,600*
(4)	*U.S. assets of B at start of year*	*30,000*
(5)	*U.S. liabilities of B at start of year*	*12,000*
(6)	*U.S. net equity of B at start of year (line (4) minus line (5))*	*18,000*
(7)	*U.S. assets of B at end of year*	*32,000*
(8)	*U.S. liabilities of B at end of year*	*12,000*
(9)	*U.S. net equity of B at end of year (line (7) minus line (8))*	*20,000*
(10)	*Change in U.S. net equity of B (line (9) minus line (6))*	*2,000*
(11)	*Dividend equivalent amount (line (3) minus line (10))*	*600*
(12)	*Branch profits tax (30% of line (11))*	*180*

Year 2

(13)	*E&p effectively connected with B*	*$2,600*
(14)	*U.S. net equity of B at end of preceding year (from line (9))*	*20,000*
(15)	*U.S. assets of B at end of year*	*29,000*
(16)	*U.S. liabilities of B at end of year*	*12,000*
(17)	*U.S. net equity of B at end of year (line (15) minus line (16))*	*17,000*
(18)	*Change in U.S. net equity of B (line (17) minus line (14))*	*3,000*
(19)	*Aggregate previous reductions in dividend equivalent amount for increases in U.S. net equity of B (from line (10))*	*2,000*
(20)	*Dividend equivalent amount (line (13) + lesser of line (18) and line (19))*	*4,600*
(21)	*Branch profits tax (30% of line (20))*	*1,380*

The branch profits tax on the repatriated branch profits of a foreign corporation is a substitute for a dividend tax imposed under pre-1986 law on distributions by certain foreign corporations out of profits derived from the active conduct of a U.S. business.[254] Under prior law, such dividends were considered to be U.S. source income, subject to a 30-percent tax under Code section 871(a) or 881. This so-called second-tier dividend tax applied to a foreign corporation only if that corporation derived 50 percent or more of its income for a three-year measurement period from the active conduct of a U.S. business. Under current law,

[254] IRC § 884(e)(3).

the second-tier dividend tax applies to distributions of pre-1987 profits and to certain foreign corporations exempt by treaty from the branch profits tax.[255] To be subject to the second-tier dividends tax, a corporation must have derived 25 percent or more of its income from the active conduct of a U.S. business.

§ 9.01.2. Branch Profits Tax on Interest

Code section 884(f) provides that interest paid or deemed paid by a U.S. branch of a foreign corporation will be treated under certain circumstances as U.S. source income, subject to a 30-percent tax under Code section 871(a) or 881 and subject to withholding under Section 1441.[256] Such interest income may be exempt from tax, nevertheless, as portfolio interest or as deposit interest, and it may be exempt from tax or subject to a reduced rate under a tax treaty.

The branch profits tax as applied to the repatriation of profits of a U.S. branch is an imposition rule. That is, Code section 884(a) actually imposes the tax on the foreign corporation having a U.S. branch. Section 884(f), in contrast, is a source rule. In the typical case, interest paid by a foreign corporation is foreign source income under the residence-of-the-obligor rule of Code section 862(a)(1). Section 884(f) reverses that result by characterizing interest paid by the U.S. branch of a foreign corporation as U.S. source income if the branch has taken a deduction for that interest payments against its U.S. effectively connected income. Whether an interest payment is attributable to a U.S. branch is determined under the deduction allocation rules of Treasury regulation 1. 882-5.

Assume, for example, that FCo, a foreign corporation, conducts business within the United States through a branch. The branch borrows $1,000 from GCo, an unrelated foreign corporation, for use in its U.S. business and pays $50 to GCo as interest on the loan. The interest payment reduces FCo's effectively connected income by $50. But for the branch profits tax provisions, however, the $50 interest payment would not be taxable to GCo under IRC section 881 because the payment would be foreign source income under the Code.[257] Under the branch profits tax provisions, however, the interest payment is characterized as U.S. source income. GCo would be taxable at 30-percent tax under Code section 881, and the interest payment would be subject to withholding under section 1441, absent some provision to the contrary in the Code or in a tax treaty.[258]

Code sections 871(a) and 881 apply to amounts paid as interest or other periodical, etc., income. Some interest attributed to a U.S. branch of a foreign corporation under the allocation formula of Treasury regulation 1.882-5 might not be paid by that branch. Instead, the foreign corporation may have paid the interest from its head office without making any entry on the books of its U.S. branch. To deal with such situations, Code section 884(f)(1)(B) provides that an amount of interest attributed to a U.S. branch by formula will be treated as an amount paid to the extent that it exceeds the interest actually paid according to the books of the U.S. branch. Chapter 15 describes the complex rules for determining the amount of interest of a foreign corporation that is attributable to a U.S. branch under the 1.882-5 regulations.[259]

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[255] See IRC § 861 (a)(2)(B) (specifying the source of dividends).

[256] See Reg. § 1.884-4 (1996).

[257] IRC §§ 861(a)(1) and 862(a)(2) (assigning the source of interest income to the country of residence of the obligor).

[258] For an example of the application of the excess-interest rule, see *Taiyo Hawaii Company, Ltd. v. Com'r*, 108 T.C. 590 (1997) (applying IRC § 884(f) to hold taxpayer liable).

[259] In general, the interest allocable to a U.S. branch of a foreign corporation would exceed the interest paid by the branch if the ratio of gross income of the branch to the total gross income of the foreign corporation was greater than the ratio of the liabilities carried on the books of the branch to the total liabilities of the foreign corporation.

§ 9.02. Interest Deductions for Earnings-Stripping Payments

In tax parlance, the payment of deductible interest to a related person in lieu of a nondeductible dividend is referred to as "earnings stripping." Congress believed that some restrictions on earnings stripping were needed to prevent U.S. source jurisdiction from being eroded improperly through the tax-free payment of interest by foreign-controlled domestic corporations to their foreign parents. It also was concerned that the unlimited interest deduction of prior law had stimulated takeovers of U.S. businesses by foreign persons and, less significantly, by domestic tax-exempt entities.

To limit opportunities for earnings stripping without violating — or at least clearly violating — U.S. tax treaties, Congress enacted Code section 163(j) as part of the 1989 tax act. That section provides that corporations making (or accruing) certain interest payments to a tax-exempt related person cannot take a deduction for those payments in computing their U.S. tax liability. The limitation applies, for example, to certain interest paid by a U.S. subsidiary to its foreign parent whenever the interest is exempt, or is subject to a reduced rate, under a tax treaty. The reach of the earnings-stripping provisions was extended by the 1993 tax act to cover certain interest payments made to an unrelated person on loans that are guaranteed by a related person.[260]

As a safe-harbor rule, corporations are not subject to the earnings-stripping provisions unless the ratio of their debt to equity during the taxable year exceeds 1.5 to 1.[261] A corporation's debt/equity ratio is its total indebtedness over its net assets, computed by adding its money and the adjusted basis of its other assets and subtracting therefrom its total indebtedness. For example, if a corporation has money of $1,000 and no other assets and has indebtedness of $800, its debt/equity ratio would be 4 to 1 ($800/($1,000 minus $800)).

The amount of the interest deduction disallowed to a corporation by section 163(j) is the lesser of (1) the corporation's "disqualified interest" and (2) the corporation's "excess interest expense."[262] In general, disqualified interest is interest paid to a tax-exempt related person. Disqualified interest also includes certain interest that is paid to an unrelated person on a loan that is guaranteed by a tax-exempt related person and that is not taxable on a gross basis under the withholding tax provisions.[263] As a transitional measure, the 1989 tax act provided that disqualified interest would not include interest paid on fixed-term loans contracted before July 10, 1989.[264] That grandfathering rule was eliminated by the 1993 tax act.

A deduction for interest paid to a tax-free related party that is disallowed as excess interest in a particular year may be carried forward indefinitely. It can be deducted in a subsequent year by meeting the tests of Code section 163(j) for the deduction of disqualified interest in that year.[265]

The definition of related person, taken from Code sections 267(b) and 707(b)(1), is quite broad.[266] Corporations are related, for example, if one corporation owns, directly or constructively, more than 50

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[260] IRC § 163(j)(3)(B).

[261] IRC § 163(j)(2)(A)(ii) and Prop. Reg. § 1.163(j)-1(b) and -3 (1991). The debt to equity ratio is to be determined at the end of the taxable year. Prop. Reg. § 1.163(j)-1(b) (1991).

[262] IRC § 163(j)(1)(A).

[263] IRC § 163(j)(3)(B).

[264] IRC § 163(j)(3)(B).

[265] IRC § 163(j)(1)(B).

[266] IRC § 163(j)(4)(A).

percent of the voting stock of the other, or if they have a common parent that satisfies the over-50-percent test.[267] An individual is related to a corporation if the individual directly or indirectly owns, by value, more than 50 percent of the stock of that corporation.[268] Special rules apply to prevent avoidance of related person status through the use of partnerships. Certain close family members are also treated as related persons.[269]

When a corporation pays interest to a related person resident in a treaty country and the interest is subject to a reduced rate of tax by the United States, then only a portion of the interest is treated as disqualified interest. That portion is computed by multiplying the amount of the total payment by a fraction. The numerator of the fraction is the statutory rate of 30 percent minus the treaty rate applicable to the payment, and the denominator is the statutory withholding rate of 30 percent.[270] For example, if an interest payment of $90 is made by a U.S. subsidiary to its Japanese parent corporation and the payment is taxed at the treaty rate of 10 percent, then $60 of the payment ($90 × 20/30) will be disqualified interest.

Interest paid with respect to a guaranteed loan is characterized as disqualified interest only if the guarantee is a "disqualified guarantee."[271] The general rule is that guarantees by related persons are disqualified whenever the related person is either a foreign person or a tax-exempt organization. A guarantee is defined broadly to include "any arrangement under which a person (directly or indirectly through an entity or otherwise) assures, on a conditional or unconditional basis, the payment of another person's obligation under any indebtedness."[272] This language suggests that an arrangement need not be legally binding to constitute a guarantee.

Two exceptions apply to the general rule defining a disqualified guarantee. First, under rules to be provided by regulation, a guarantee will not be a disqualified guarantee whenever the guarantor would have been required to include the interest payments in its U.S. source net income if it had actually received those payments.[273] For example, a guarantee by a foreign bank engaged in business within the United States probably would not be characterized as a disqualified guarantee. Second, subject to exceptions provided by regulation, a guarantee generally would not be a disqualified guarantee if the borrower owns 80 percent or more of the voting stock of the corporation making the guarantee.[274] For example, a guarantee of a debt owed by a U.S. corporation would not be disqualified if the guarantee was given by the U.S. corporation's wholly-owned controlled foreign corporation (CFC). Under the subpart F provisions of the Code, however, the CFC generally would be treated as having made a taxable constructive dividend to its U.S. parent.[275]

Subject to a special averaging provision, a corporation's excess interest expense is the corporation's "net interest expense" minus 50 percent of its "adjusted taxable income."[276] The averaging provision allows

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[267] IRC §§ 267(b)(3) and (f), incorporating the definition of controlled group used for consolidated returns, but with an over-50-percent test instead of an at-least-80-percent test.

[268] IRC § 267(b)(2).

[269] IRC § 267(b)(1) and (c)(4).

[270] IRC § 163(j)(5)(B).

[271] IRC § 163(j)(3)(B)(i).

[272] IRC § 163(j)(6)(D)(iii).

[273] IRC § 163(j)(6)(D)(ii)(I).

[274] IRC § 163(j)(6)(D)(ii)(II).

[275] IRC § 956.

[276] IRC § 163(j)(2)(B)(i).

taxpayers to reduce their excess interest expense by any "excess limitation carryforward."[277] An excess limitation carryforward is the sum of the unused "excess limitations" from the prior three taxable years.[278] An excess limitation for a particular year is computed by subtracting the corporation's net interest expense for that year from 50 percent of its adjusted taxable income for that year.[279] For example, if a corporation has adjusted taxable income for the year of $100 and net interest expense for that year of $40, then it would have an excess limitation for that year of $10 (50% of $100 minus $40).

Net interest expense generally is the excess (if any) of the total interest paid or accrued by the taxpayer during the taxable year, including its disqualified interest, over its taxable interest income.[280] For example, if a corporation made interest payments of $50 to an unrelated person and $50 to a related person and received interest income of $60, then its net interest expense would be $40 ($50 + $50 minus $60).

The adjusted taxable income of a corporation is its taxable income, computed without reference to any deductions allowable (without reference to section 163(j) itself) for (1) net interest expense, (2) depreciation, amortization, or depletion, and (3) net operating loss carryovers.[281] The following example illustrates the operation of the limitations on the interest deduction under the earnings-stripping provisions.

Example 9.2: Operation of the Earnings-Stripping Provisions

KCo, a U.S. corporation, is the wholly-owned subsidiary of ICo, its Indian parent corporation. Under the U.S./India tax treaty, payments of interest by KCo to ICo are subject to the reduced withholding rate of 15 percent.

For year 1, KCo has gross income of $650, of which $50 comes from interest on bank deposits and $600 comes from its business operations within the United States. In computing its taxable income, KCo has allowable deductions (determined without reference to the earnings stripping provisions) of $100 for depreciation, $300 for interest paid to ICo, $20 for interest paid to an unrelated commercial bank, and $50 for operating expenses. All the figures are the same for year 2, except that its gross income from business operations in the United States is only $500.

The only assets of KCo for year 1 are cash of $500, a machine with an adjusted basis of $1,000, and land with an adjusted basis of $3,000, for total assets of $4,500. Its debt consists of an 8-percent note payable to ICo with a face amount of $3,800 and an 8-percent note with a face amount of $200 payable to the unrelated commercial bank. In year 2, its debt is the same, and its assets are cash of $719, the machine with an adjusted basis of $900, and the land with an adjusted basis of $3,000.

KCo's ratio of debt to equity for year 1 is 8 to 1, computed by comparing its debt of $4,000 ($3,800 + $200) to its net equity of $500 ($4,500 in assets minus $4,000 of debt). That ratio also exceeds 1.5 to 1 in year 2.

For year 1, none of KCo's interest expense is disallowed, and it has an excess limitation of $5, computed as follows:

(1) Interest paid to related persons $300

277 IRC § 163(j)(2)(B)(i)(II).

278 IRC § 163(j)(2)(B)(ii).

279 IRC § 163(j)(2)(B)(iii).

280 IRC § 163(j)(6)(B).

281 IRC § 163(j)(6)(A).

(2)	*Disqualified interest (line (1) × 15/30)*	*150*
(3)	*Interest paid to unrelated persons*	*20*
(4)	*Interest income*	*50*
(5)	*Net interest expense (line (1) + line (3) minus line (4))*	*270*
(6)	*Allowable depreciation*	*100*
(7)	*Other allowable deductions*	*50*
(8)	*Total allowable deductions (line (1) + line (3) + line (6) + line (7))*	*470*
(9)	*Gross income for year 1*	*650*
(10)	*Taxable income for year 1 (line (9) minus line (8))*	*180*
(11)	*Adjusted taxable income for year 1 (line (10) + line (5) + line (6))*	*550*
(12)	*Excess limitation (50% of line (11) minus line (5))*	*5*

For year 2, the amounts shown on lines (1) through (8) remained unchanged. KCo is denied an interest deduction of $65 for that year, computed as follows:

(13)	*Gross income for year 2*	*$500*
(14)	*Taxable income for year 2 (line (13) minus line (8))*	*30*
(15)	*Adjusted taxable income for year 2 (line (14) + line (5) + line (6))*	*400*
(16)	*Excess interest expense (line (5) minus 50% of line (15) minus line (12))*	*65*
(17)	*Interest disallowed (lesser of line (2) and line (16))*	*65*

The calculations shown above are not dependent on the amounts claimed by KCo for depreciation. Thus if KCo had been eligible for accelerated depreciation in year 1, thereby increasing its depreciation deduction to $400, the computation of adjusted taxable income in line (11) would not change, nor would the computation of net interest expenses in line (5). Thus the calculation shown in line (12) would be unchanged.

KCo would have had a portion of its interest deduction disallowed under Code section 163(j) in year 1 if it had attempted to strip off more of its profits through interest payments to ICo. Assume that ICo and KCo had agreed that KCo would pay interest on its loan to ICo at a rate of 12 percent. KCo's interest payment in year 1 would then be $456 (12% of $3,800), and its taxable income, computed without regard for Code section 163(j), would be only $24. KCo's adjusted taxable income of $550, shown on line (11), would be unchanged, and it would now have excess interest expense of $151 ($456 minus 50% of $550) rather than an excess limitation. Its disqualified interest would have increased to $228 ($456 × 15/30), with the result that all of the excess interest expense would be disallowed as a deduction under IRC § 163(j).

If the additional interest of $156 ($456 minus $300) had been paid to an unrelated party, the computation of excess interest expense in line (11) would be unchanged. That is, KCo would be considered to be excessively leveraged to the same degree whether it borrowed from ICo or from an unrelated person. The amount of disqualified interest, however, would be $150, as shown on line (2). Thus only $150 of the excess interest expense of $151 would be disallowed. In effect, KCo would be treated as if it had paid out $150 to ICo as a dividend rather than as an interest payment for purposes of computing its taxable income.

Congress anticipated that taxpayers might make efforts to avoid the limitations on the interest deduction imposed by Code section 163(j) through back-to-back loans and similar devices. The tax authorities already had regulatory authority under Code section 7701(f) to deal with back-to-back and other pass-thru transactions, but its authority was expanded by section 163(j)(7).[282] The tax authorities are also expected to provide by regulation that interest payments will not be treated as disqualified interest if the payments, in substance, are paid to unrelated persons.[283]

The extension of the earnings-stripping rules by the 1993 tax act to interest paid with respect to certain loans guaranteed by a related party has greatly increased the reach of those provisions. Congress had anticipated that the Treasury Department would be able to address by regulation the tax avoidance problems presented by related-person guaranteed loans. By 1993, however, it had become apparent that large numbers of taxpayers were avoiding the bite of the earnings-stripping provisions through the use of bank loans and other third-party loans that were guaranteed by a related person.

Foreign corporations engaged in a trade or business in the United States are to compute their effectively connected income under the earnings-stripping provisions by taking into account only income and deductions attributable to their U.S. business, under rules to be provided by regulation.[284] The coordination of the operation of the earnings-stripping provisions with the branch profits tax on foreign corporations, including the special tax on excessive interest payment, is also to be dealt with by regulation.[285]

To prevent members of an affiliated group from minimizing their exposure to the earnings-stripping provisions, by, for example, isolating loans to foreign persons in corporations having a low debt to equity ratio, the Code provides that all members of an affiliated group are generally to be treated as one taxpayer.[286] This rule is also intended to provide relief to members of an affiliated group when, for example, one member of the group has a debt to equity ratio that is uncharacteristically high for the group as a whole.[287]

Section 163(j) was designed to apply only to rather substantial cases of earnings stripping. A 1.5 to I debt/equity ratio, although not particularly high in some industries, was thought by Congress to be high enough to exclude more than half of U.S. corporations from the earnings stripping limitations.[288] The carryforward of excess limitations and the exclusion of certain deductions, such as depreciation, from the definition of adjusted taxable income are intended to prevent corporations from falling within the reach of section 1630) merely because of year-to-year fluctuations in the amount of their taxable income.[289] As

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[282] House Ways and Means Committee, *Explanation of Revenue Provisions of Revenue Reconciliation Bill of 1989,* H.R. 3150, 101 Cong., 1st Sess. (1989) at 104.

[283] Id. at 102.

[284] House Ways and Means Committee, *Explanation of Revenue Provisions of Revenue Reconciliation Bill of 1989*, H.R. 3150, 101 Cong., 1st Sess. (1989) at 106-107.

[285] Id. and IRC § 163(j)(7)(C).

[286] IRC § 163(j)(6)(C).

[287] House Ways and Means Committee, *Explanation of Revenue Provisions of Revenue Reconciliation Bill of 1989*, H.R. 3150, 101 Cong., 1st Sess. (1989) at 106.

[288] Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, Statement of Managers, *Conference Committee Report to H.R. 3299*, 101 Cong., 1st Sess., at 67 (1989) ("[T]he conferees expect that the interest deductions of many corporations will not be affected by the provision because many corporations with what can fairly be called typical capital structures have debt-equity ratios below the safe harbor ratio in the bill. The conferees understand that the median debt-equity ratio for U.S. corporations is generally measured as less than 1.5 to 1.").

[289] Id.

illustrated in *Example 9.2*, above, the amount that a corporation claims for depreciation in a particular year has no effect on the calculation of its excess interest expense or its excess limitation for that year.

§ 9.03. Statutory Exemptions

The Code provides exemptions from tax for certain categories of income received by foreign nationals. Those exemptions are described in sections 2/D3.1, 2/D3.2, and 2/D3.3, below. The traditional exemptions for income from operating a ship or aircraft and for foreign governments were curtailed by the 1986 act.

§ 9.03.1. Foreign Students, Exchange Visitors, Etc.

Code section 872(b)(3) exempts from U.S. tax the compensation received by nonresident alien individuals temporarily present in the United States on an F visa (relating to the admission of students), a J visa (relating to the admission of teachers, trainees, specialists, etc.), or a Q visa (relating to admission of temporary visitors participating in an international cultural exchange program) if the compensation is paid by a foreign employer. A foreign employer is a foreign person or a foreign branch of a U.S. corporation.[290] Many U.S. tax treaties provide a similar exemption.[291] Most treaties also provide an exemption for amounts received as scholarships by foreign students, including amounts paid for living expenses.[292]

§ 9.03.2. Reciprocal Exemption for Shipping and Aircraft

Gross income derived by a nonresident alien individual from the operation of ships or aircraft is exempt from U.S. tax if the country where that individual is resident provides a similar exemption to individuals who are a resident of the United States.[293] Income exempt under this provision includes income derived from the rental, on a full or bareboat basis, of a ship or aircraft.[294]

Foreign corporations operating ships or aircraft are given a similar exemption under some circumstances.[295] In general, the country of residence of the corporation must provide a reciprocal exemption to U.S. residents.[296] The foreign country is not required, however, to give an exemption to a U.S. corporation if that corporation is a dual-resident corporation that is taxable by the foreign country on a residence basis.[297] A foreign corporation generally does not qualify for the exemption unless at least 50 percent of its ultimate individual owners are residents of a country giving a reciprocal exemption to U.S. corporations.[298] This 50-percent look-through rule does not apply to certain publicly traded corporations

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[290] See Reg. § 1.872-2(b)(2) (1974).

[291] See, e.g., U.S./Germany tax treaty, Art. 13. For a summary of treaty benefits to students, trainees, teachers, and other temporary visitors, see IRS Publication 515, table 3 (revised annually).

[292] See, e.g., U.S. Model Treaty (2006), Art. 20. IRC § 117 generally excludes amounts received as tuition scholarships from gross income, but amounts paid for maintenance are not exempt under that section.

[293] IRC § 872(b)(1) and (2). The exemption may be provided by statute or through a bilateral tax treaty with the United States.

[294] IRC § 872(b)(5).

[295] IRC § 883(a)(1) and (2).

[296] Id. For a list of countries providing a tax exemption, through income tax conventions, diplomatic notes, or the country's domestic law, for income derived from the international operation of ships and aircraft, see Rev. Rul. 2008-17; 2008-12 I.R.B. 626, modified by Announcement 2008-57; 2008-26 I.R.B. 1192.

[297] IRC § 883(a)(5).

[298] IRC § 883(c)(1).

and their subsidiaries.[299] The look-through rule also does not apply to controlled foreign corporations (CFCs) taxable by the United States under the subpart F rules.[300]

§ 9.03.3. Foreign Governments, International Organizations, and Employees of Same

In general, foreign governments and international organizations are exempt from tax on U.S. source income derived from domestic securities, deposits in U.S. banks, or from certain other financial instruments.[301] International organizations are exempt from tax on income derived from any source. They are also exempt from the branch profit tax.[302]

Foreign governments are not exempt under the Code on income received, directly or indirectly, from commercial activity, even if that income would be exempt under the general rule stated above.[303] This limitation on the general rule was adopted as part of the 1986 tax act. "Commercial activity" is defined broadly to include any activity, other than certain listed exceptions, that is ordinarily conducted to produce current or future income or gain.[304] For example, a commercial airline operated by a government or by a corporation controlled by the government would not qualify for the exemption.[305]

Income derived by a government from certain activities qualified for the exemption even if those activities may have some commercial aspects to them. For example, governments are exempt from tax on income and gain derived from investing, staging of various cultural events, certain non-profit activities typically carried on as a governmental or charitable function, and purchasing goods for the use of their own use.[306] Certain governmental income may also be exempt under a tax treaty.[307]

The exemption generally applicable to a foreign government does not apply to income received, directly or indirectly, by a commercial entity that is controlled by a government.[308] Nor does it apply to income received from a controlled commercial entity.[309] For example, assume that FG, an agency of a foreign government, owns all of the stock of SCo, a U.S. corporation engaged in commercial activity. Under Code section 892, SCo is not exempt from U.S. tax, and the dividends that FG received from SCo are not exempt from U.S. tax.[310]

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[299] The exception for publicly traded corporations, and for certain subsidiaries of such corporations, is contained in IRC § 883(c)(3).

[300] IRC § 883(c)(2).

[301] IRC § 892(a)(1) and (b).

[302] IRC § 884(e)(5).

[303] IRC § 892(a)(2).

[304] Reg. § 892-4T(b) (1988).

[305] See *Qantas Airways Ltd. v.* U.S., 62 F.3d 385 (Fed. Cir. 1995), rev'g 30 Fed. Cl. 851 (1994), cert. denied 516 U.S. 1112 (1996), reconsideration granted, 132 F.3d 49, aff'd without opinion, 98-2 U.S.T.C. ¶50859 (Fed. Cir. 1998). Qantas is an Australian corporation organized to conduct an airline business. At the time of the case, all of its stock was owned by the Australian government. The Federal Circuit Court upheld Reg. § 1.982-1(b) (1982), on the ground that a corporation organized for commercial purposes was not a "government" within the meaning of IRC § 982. The case was remanded for a determination of whether Qantas' rental and sales activities in the United States constituted commercial activities.

[306] Reg. § 1.892-4T(c) (1988).

[307] Congress intended that a foreign government should qualify as a resident of itself for purposes of obtaining benefits under a tax treaty unless similar treatment is denied to the United States by that country. See *General Explanation of the Tax Reform Act of 1986* (1987) at 1059.

[308] Reg. § 1.892-5T (2002).

[309] Id.

[310] Reg. § 1.892-5T(a) (2002).

Compensation received by an employee of a foreign government or an international organization generally is exempt from tax if the compensation is received for the performance of official services.[311] Much to their annoyance, U.S. citizens are not exempt under this rule.[312] The exemption does not extend to services performed for a foreign government unless those services are of a character similar to services performed for the U.S. government.[313] Thus the services performed by an employee of a government-owned airline would not be exempt under this provision. A reciprocity rule provides that the exemption does not apply to the employees of a foreign government unless that government extends a similar exemption to employees of the U.S. government.[314]

§ 9.03.4. Other Special Rules

Section 9.04.1 describes briefly the gross receipts tax imposed on certain transportation income in lieu of the normal income tax. Section 9.04.2 describes a penalty tax, so far never imposed, that the president has authority to impose on the citizens and domestic corporations of countries that discriminate against U.S. citizens or U.S. corporations.

§ 9.03.4.1. Gross Receipts Tax on Transportation Income

Code section 887(a) imposes a tax of 4 percent on certain U.S. source gross transportation income of nonresident alien individuals and foreign corporations.[315] In general, U.S. source gross transportation income is equal to one half of the gross income of the taxpayer derived from operation of a vessel or aircraft in international commerce.[316] This 4-percent tax is in lieu of taxes otherwise imposed by Code section 871(a) or 881.

The 4-percent tax is imposed on gross transportation income that is derived from U.S. sources and is not effectively connected with the conduct of a U.S. trade or business.[317] Gross transportation income that is derived from regularly scheduled transportation generally will not be effectively connected income unless the taxpayer has an office or other fixed place of business within the United States that was involved in the earning of the income.[318] In addition, gross transportation income that has been derived from the leasing of a vessel or aircraft will not be classified as effectively connected income unless the foreign taxpayer has a U.S. office or other fixed place of business and substantially all of the transportation income derived from the

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[311] IRC § 893(a); Reg. § 1.893-1(a)(1) (1957). Employees of an international organization may be exempt under a specific agreement between the U.S. and that organization. U.N. officials and IMF employees, for example, are so exempt. Many U.S. tax treaties give a tax exemption to government employees performing official services. See, e.g., U.S. Model Treaty (2006), Art. 19. The treaty rule extends to government pensions.

[312] IRC § 893(a)(1). A U.S. citizen who is also a citizen of the Philippines can qualify for the exemption. Id. See *Ying v. Com'r,* 25 F.3d 84 (2d Cir. 1994), aff'g in part and rev'g in part 99 T.C. 273 (1992) (holding that Edward Ying and Fieilu Ying, both employees of the U.N., were not exempt from tax under IRC § 893 because they had filed a waiver of the exemption when applying for permanent residence status in the U.S.).

[313] IRC § 893(a)(2).

[314] IRC § 893(a)(3).

[315] The rules for complying with IRC § 887 are set forth in Rev. Proc. 91-12, 1991-1 C.B. 473. For a full discussion of that revenue procedure, see M.K. Outterson & C. Cheung, "Revenue Procedure 91-12: IRS Launches Information-Gathering Offensive Against International Transportation Operations," 3 *Tax Notes Int'l* 587 (May 1991).

[316] IRC § 863(c)(3).

[317] IRC § 887(a) and (b)(2).

[318] IRC 887(b)(3).

leasing of a vessel or aircraft is attributable to that fixed place of business.[319] U.S. source transportation income taxable in a U.S. possession under a so-called mirror system is exempt from the 4-percent tax.[320]

The Code rules imposing the 4-percent gross tax do not override U.S. treaty obligations or the reciprocal exemption for shipping and aircraft. A significant percentage of U.S. transportation income is exempt from U.S. tax by treaty or otherwise.

§ 9.03.4.2. Penalty Taxes on Nationals of Discriminatory Countries

Code section 891 provides for the doubling of taxes otherwise imposed on the citizens and corporations of a foreign country if the President of the United States finds that such country is imposing discriminatory taxes on U.S. citizens or domestic corporations.[321] The doubled tax cannot exceed 80 percent of the taxable income of the foreign person. The President must issue a proclamation stating that a county has engaged in discriminatory practices against U. S. nationals before the doubled tax may be imposed.

Code section 896 gives the President the authority to require the nationals of a foreign country to pay higher U.S. taxes on certain categories of income. The higher taxes may be imposed if U.S. nationals are subject to discriminatory taxes in that country with respect to such categories of income. The higher taxes may also be imposed if U.S. nationals are subject to taxes that are more burdensome than the taxes imposed by the United States in comparable circumstances. Certain procedural steps must be taken, including negotiations with the offending country, before the extra tax may be imposed.

The President has not yet acted to impose extra taxes on foreign persons under Code section 891 or 896. Both of these Code sections were enacted in the hope of improving the bargaining position of the United States in treaty negotiations with foreign governments.

§ 9.04. Planning Problem

The Cheese Shoppe

N is a nonresident alien individual with a tax home in the United States. She is a permanent resident and national of Canada. She operates a cheese shop in Ann Arbor, MI, which she calls *The Cheese Shoppe*. N has two employees, E1 and E-2, working full time in the shop. Both E-1 and E-2 are American citizens and residents. N pays them each $300 per week. She lives at here home in London, Ontario and visits the shop by car about twice a week to supervise operations.

N receives the items of gross income listed below during the taxable year.

Items of Income:

(1) $160,000 of gross income from the sale of cheese at *The Cheese Shoppe* in Ann Arbor.

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[319] Id.

[320] IRC § 887(b)(3). A mirror system is a possession's tax system that uses the Code as its taxing instrument, modified so as to replace "the United States" with the name of the possession (and vice versa).

[321] Reg. § 1.891 (1962).

(2) $40,000 of gross income from sale of wine, bread, crackers, mustard, and other incidentals at *The Cheese Shoppe*.

(3) Interest of $1,000 from his Ann Arbor savings account at Comerica Bank.

(4) Dividends of $125 paid on her General Motors stock.

(5) $1,000 of currency gain resulting from the purchase on credit of cheese at a price fixed in Canadian dollars and the payment of the debt in U.S. dollars.

(6) $100,000 of income derived from the sale of her personal residence located in London, Ontario.

(7) $1,000 of income derived from the sale of IBM stock on the New York stock exchange through her Ann Arbor brokerage house.

Items of Expense:

(1) $30,000 for purchases of cheese in Quebec, Canada.

(2) $10,000 for purchase of cheese in Wisconsin.

(3) $20,000 for purchase of cheese in France.

(4) $20,000 for purchase if of wine, bread, crackers, mustard, and other incidentals in Michigan.

(5) $5,000 commission to her broker for selling her personal residence in Canada.

(6) $100 commission fee paid to her U.S. brokerage house for making te sale of the IBM stock.

Questions

(1) Which (if any) of the items of gross income constitutes, in whole or in part, U.S. source gross income?

(2) Will any of those items be taxable by the United States under the Code? Ignore tax treaty issues.

(3) Are any of the results in the above question changed under the U.S./Canada tax treaty?

(4) How would you suggest N plan her affairs to minimize U.S. taxes? Should that be her goal, assuming a U.S. tax rate of 35 percent and a Canadian tax rate of 40 percent?

(5) Is N required to pay withholding taxes on the amounts paid to her two employees, E-1 and E-2?

(6) Why is N not liable for the branch profits tax?

(7) Assume that N incorporates her cheese business as NCo, a Canadian corporation. NCo operates *The Cheese Shoppe* in Ann Arbor through a branch. Assume also that *The Cheese Shoppe* has gross income of $200,000 and allowable deductions of $60,000, for net taxable income of $140,000. Is NCo liable for a branch profits tax? What additional information do you need to determine whether a branch profits tax is applicable? If it is applicable, what additional information do you need to compute the amount of the branch profits tax? Note: Do not try to calculate the tax.

(8) Assume that NCo, as described in the above question, establishes a subsidiary, ACo, to operate *The Cheese Shoppe* in Ann Arbor. In establishing the subsidiary, NCo transferred the assets of *The Cheese Shoppe* to ACo in exchange for a note of $1 million, on which annual interest of $100,000 (the market rate) is due. Is any of the interest paid by ACo to NCo disallowed under the earnings stripping rules?

Chapter 10
Filing, Withholding, and Reporting Requirements

(Warning: Not Updated)

Foreign taxpayers engaged in business within the United States are generally required to file a tax return. Some foreign taxpayers not engaged in business within the United States also are required to file. The filing requirements applicable to foreign taxpayers are set forth in section 10.01. Section 10.02 sets forth the rules governing withholding with respect to payments made to foreign persons. The special reporting requirements imposed on certain domestic and foreign corporations having a substantial foreign shareholder are discussed in section 10.03. The powers of the tax authorities to obtain records of the taxpayer are summarized in section 10.04. Section 10.05 describes reporting requirements applicable to foreign and domestic corporations that have been acquired or have made a substantial change in their capital structure. Section 10.06 describes the requirement that taxpayers claiming treaty benefits must disclose that position, typically on their tax return.

§ 10.01. Filing Rules

Foreign taxpayers engaged in a trade or business within the United States during a taxable year are required to file a tax return with the Internal Revenue Service for that year.[322] The filing requirement is not waived even if the taxpayer has no effectively connected income for the year or is exempt from tax by statute or tax treaty.[323] Nonresident alien individuals are also required to make self assessed payments of estimated tax.[324]

For foreign taxpayers not engaged in business within the United States, a tax return does not have to be filed under some circumstances. An exemption from filing is available only if all taxes due have been fully satisfied by withholding at source.[325] Tax is not treated as satisfied by withholding if the taxpayer is claiming the benefit of a tax treaty.[326] A foreign taxpayer typically would not have to file a tax return if he is not engaged in business within the United States and is receiving only periodical, etc., income on which the 30-percent tax on periodical, etc., income has been withheld by the payor.

To claim a deduction from gross income or a credit against U.S. taxes otherwise due, foreign taxpayers must file a tax return.[327] If a tax return is not filed, the tax department is authorized to assess the tax against gross income.[328]

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[322] IRC § 6012(a)(1) and (2); Reg. § 1.6012-1(b)(1) (1960) (relating to nonresident alien individuals) and Reg. § 1.6012-2(g) (1960) (relating to foreign corporations). Nonresident alien individuals file using Form 1040NR. Foreign corporations use Form 1120F.

[323] Reg. §§ 1.6012-1(b)(1)(i) (1960) and 1.6012-2(g)(1)(i) (1960).

[324] IRC § 6654(a) and (f)

[325] Reg. §§ 1.6012-1(b)(2)(i) (1960) (applicable to nonresident alien individuals) and 1.6012-2(g)(2)(i) (1960) (applicable to foreign corporations).

[326] Reg. §§ 1.6012-1(b)(1)(ii) and 1.6012-2(g)(1)(ii).

[327] IRC §§ 874(a) (applicable to individuals) and 882(c)(2) (applicable to corporations). The credit for taxes withheld will not be lost for a failure to file. IRC §§ 874(a) and 882(c)(2).

[328] Reg. §§ 1.874-1(d)(3) (1991) and 1.882-4(a)(4) (1990).

§ 10.02. Withholding Requirements

Foreign persons receiving U.S. source income are subject to withholding of U.S. tax by the payor of that income under many circumstances,[329] as described below. Withholding agents are required to file certain forms and statements with the tax authorities in conjunction with the withholding of tax.[330]

§ 10.02.1. Periodical, etc. Income

Withholding generally is required on the periodical income, other than effectively connected income, of nonresident alien individuals, generally at the rate of 30 percent.[331] Withholding at the 30 percent rate also is required on other periodical, etc., income, including capital gains of nonresident aliens present in the United States for 183 days or more. Periodical, etc. income taxable to corporations under Code section 881 is also subject to withholding at the 30-percent rate.[332]

An important exception to the withholding requirement is provided for income that is exempt from U.S. tax by treaty or is subject to a reduced U.S. withholding rate. For many years, the withholding rules applicable to foreign persons claiming treaty benefits were widely viewed to be ineffective. U.S. companies paying dividends generally were not required to withhold tax at the statutory rate if the dividend check was being sent to a U.S. address or to an address in a country having a tax treaty with the United States. No mechanism was in place for distinguishing real foreign addresses from mail drops. For other types of income, the withholding agent was permitted to rely on the unverified claim of the foreign person as to whether that person was entitled to treaty benefits. Abuse was thought to be widespread.[333] A commonly alleged abuse was for foreign financial intermediaries resident in a treaty country to invest in the U.S. corporate debt and stock on behalf of anonymous foreign (and occasionally American) individuals and improperly claiming treaty benefits on the payments received on those investments.

In 1982, Congress passed legislation requiring the U.S. Treasury Department to develop an effective system for administering the treaty withholding exemptions.[334] No immediate action was taken, however, apparently due to political pressures and a fear that effective enforcement of the law would curtail foreign investment flows into the United States. The rational basis for that fear was that many foreign investors were not reporting their U.S. periodical income to the tax authorities in their country of residence and that an

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[329] For more detailed discussion of U.S. withholding rules, see Thomas St.G. Bissell, 916-1st T.M., *International Aspects of U. S. Withholding on Wages and Service Fees* (Tax Management Portfolio 2000); Janet M. Bedell, Alan L. Fischl, and Brenda R. Viehenaess, "Withholding Regs. Aim for More Compliance, Less Burden on Agents," 7 *Journal of International Taxation* 299 (1996); Harvey Dale, "Withholding Tax on Payments to Foreign Persons," *36 Tax Law Review* 49 (1980).

[330] The forms that must be filed include Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons), Form 1042S (Foreign Person's U.S. Source Income Subject to Withholding), Form 8804 (Annual Return for Partnership Withholding Tax), Form 8288 (U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests) and Form 8288-A (Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests).

[331] IRC § 1441(a) and (b). See Reg. § 1.1441-1(b)(1) (1999) (effective for payments after December 31, 2000) and Reg. § 1.1441-1 (1980) (effective for payments made before January 1, 2001). A narrow exception provides for a 14% withholding rate on certain scholarships of nonresident alien individuals. See IRC § 1441(b).

[332] IRC § 1442

[333] See John Turro, "U. S. Debate Over Dividend Withholding System to Intensify," 2 *Tax Notes Int'l* 213 (March 1990).

[334] H.R. 4961, 97th Cong., 2nd Sess., *Tax Equity and Fiscal Responsibility Act of 1982*, P.L. 97-248, Sec. 342, provided as follows: "Not later than 2 years after the date of the enactment of this Act, the Secretary of the Treasury or his delegate shall prescribe regulations establishing certification procedures, refund procedures, or other procedures which ensure that any benefit of any treaty relating to withholding of tax under sections 1441 and 1442 of the Internal Revenue Code of 1954 is available only to persons entitled to such benefits." Treasury was not in compliance with this legislation for 13 years — until final regulations under IRC §§ 1441 and 1442 were issued in 1997.

effective U.S. withholding system would jeopardize their opportunities for investing tax-free in the United States. In 1997, the U.S. tax authorities issued detailed regulations governing withholding on payments to foreign persons.[335] Those regulations are effective beginning January 1, 2001.[336]

Under the new regulations, a withholding agent generally must withhold 30- percent of any payment made to a foreign person unless it has reliable documentation that the beneficial owner of the payment is a U.S. person or a foreign person entitled to a reduced rate of withholding.[337] This withholding obligation does not apply, however, if the obligation is shifted under the regulations to the foreign person receiving the payment.[338] The obligation is shifted to the foreign payee if the payee is (1) a qualified intermediary,[339] a U.S. branch of a foreign corporation,[340] a withholding foreign partnership,[341] or an authorized foreign agent (see section 1.1441-7(c)(1)).

The beneficial owner of an item of income subject to withholding is "the person who is the owner of the income for tax purposes and who beneficially owns that income."[342] The "owner" is generally the person who must include it in income under the principles of Code section 61. In determining who is the beneficial owner of income, the conduit rules found in U.S. case law and in the regulations under Code section 7701(l) are applicable.[343] In particular, a person receiving income in a capacity as a nominee, agent, custodian for another person is not the beneficial owner of the income.[344]

The most innovative feature of the new regulations is the treatment of qualified intermediaries. In general, a qualified intermediary is a foreign bank or other financial intermediary that invests in the United States on behalf of foreign persons who do not want to disclose their identity to the tax authorities.[345] It is permitted to furnish an intermediary withholding certificate to a withholding agent that certifies, on behalf of the unnamed beneficial owners, that those beneficial owners are entitled to reduced rates of withholding. The qualified intermediary is required to obtain withholding certificates or other appropriate documentation from the beneficial owners. It is not required, however, to present that documentation to the U.S. tax authorities or the domestic payor unless the beneficial owner is a U.S. person.[346]

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[335] The perceived need to attract hot money in the 1980s was acute, due to the huge federal budget deficits of the Reagan-Bush administrations. The greatly improved budget situation during the Clinton administration has reduced that perceived need.

[336] Reg. § 1.1441-1(f)(1) (1999). See T.D. 8856, 64 Fed. Reg. 73408 (12/30/99) (extending effective date for payments after December 31, 2000). See also T.D. 8804, 63 Fed. Reg. 72183 (12/31/98) (extending effective date to payments after December 31, 1999) and T.D. 8734, 62 Fed. Reg. 53387 (10/14/97) (promulgating regulations and establishing initial effective date of December 31, 1998).

[337] Reg. § 1.1441-1(b)(1) (1999). The withholding agent generally determines the withholding status of the payee from a withholding certificate filed by the payee. Reg. § 1.1441-1(b)(2)(i) (1999). Form W-8 or a Form 8233 is used to show the foreign status of the payee or beneficial owner, and Form W-9 is used to indicate the U.S. status of the payee. Id. Form 8233 includes the payee's taxpayer identification number (TIN). A payee may be able to obtain treaty benefits without providing a TIN at the time of the payment if the payee has received an "unexpected payment" and steps are taken immediately to obtain a TIN. Reg. § 1.1441-6T(h)(2) (2002).

[338] Reg. § 1.1441-1(b)(1) (1999).

[339] Reg. § 1.1441-1(e)(5) (1999).

[340] Reg. § 1.1441-1(b)(2)(iv) (1999).

[341] Reg. § 1.1441-5(c)(2)(i) (1999).

[342] Reg. § 1.1441-1(c)(6) (1999).

[343] For discussion of the conduit rules under IRC § 7701(l), see chapter 8/B6.

[344] Id.

[345] For rules that a financial intermediary must follow to become a "qualified" intermediary, see Rev. Proc. 2000-12, 2000-4 I.R.B. 1.

[346] See Reg. § 1.1441-1(e)(5) (1999).

The apparent intent of the rules governing financial intermediaries is twofold. First, the rules are reasonably designed to prevent foreign beneficial owners not entitled to treaty benefits from using financial intermediaries to avoid U.S. withholding taxes on U.S. source investment income and to prevent U.S. beneficial owners from posing as a foreign person to avoid U.S. source and residence taxation. Second, the rules are also apparently designed to allow foreign beneficial owners to invest in the United States without interfering with their ability to evade taxation in their country of residence.

The semi-official acceptance of tax evasion by residents of treaty countries that is implicit in the financial intermediary rules is inconsistent with the one of the stated goals of U.S. tax treaties – to prevent fiscal evasion. That acceptance also calls into question the appropriateness of limiting by tax treaty the power of the source country to tax investment income. If the country of residence in fact does not tax that income, then a rule ostensibly intended to improve economic efficiency and reduce administrative inconvenience becomes a rule that promotes tax avoidance or evasion.

§ 10.02.2. Effectively Connected Income

Withholding of tax is generally not required with respect to the effectively connected income of foreign taxpayers.[347] Three types of effectively connected income, however, are subject to withholding: (1) compensation for personal services, (2) partnership income, and (3) amounts received from sales of U.S. real property interests. Those exceptions to the general rule are discussed below.

§ 10.02.2.1. Compensation for Services

Compensation paid to foreign taxpayers for personal services can be taxable as effectively connected income or as periodical income. In most cases, it will be taxable as effectively connected income.[348] An exemption from the general withholding requirement is available unless the personal services income is classified as periodical income rather than as effectively connected income.[349]

A nonresident individual earning effectively connected income that is classified as wages is typically subject to the withholding rules of Code section 3402 (relating to withholding on wages) rather than under the general rules section 1441.[350] That is, nonresident alien individuals generally are subject to the same withholding rules with respect to wages as are applicable to U.S. citizens and residents. Section 3401 provides a list of exemptions from withholding on wages that are applicable, with some exceptions, to both U.S. citizens and residents and to nonresident alien individuals.[351]

In addition to the regular exemptions available to U.S. persons, nonresident aliens may enjoy some special exceptions from withholding on personal services income. For example, regular commuters from Canada or Mexico are exempt from withholding on their wages and on other types of compensation for personal services.[352] In addition, nonresident aliens are exempt from withholding if their wages or other compensation for personal services are not taxable under some special Code rule, such as the exemption for

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[347] IRC §§ 1441(c)(1) and 1442(b).

[348] See section 2/B1.3, above.

[349] Reg. § 1.1441-4(b)(1) (1999).

[350] See IRC § 1441(c)(1) and Reg. § 1.1441-4(b)(1) (1999).

[351] Reg. § 1.1441-4(b)(1)(ii) (1999). Payments to a nonresident alien individual from employment income are subject to withholding under IRC § 1441 if they are payments from any trust described in section 401(a), any annuity plan described in section 403(a), or any annuity, custodial account, or retirement income account described in section 403(b).

[352] Reg. § 1.1441-4(b)(1)(iii) (1999).

employees of an international organization,[353] or under an applicable tax treaty.[354] To obtain the exemption from withholding by reason of a tax treaty, a nonresident alien individual must submit a withholding certificate to the withholding agent with information showing that the individual is entitled to the requested relief.[355]

In some cases, the 30-percent withholding rate applied to gross income will result in overwithholding, especially in the case of independent contractors having significant deductible expenses. The Treasury regulations offer two relief mechanisms that can mitigate problems of overwithholding. Under the first mechanism, the taxpayer enters into an agreement with the Assistant Commissioner (International) to reduce or even eliminate the amounts subject to withholding.[356] The second mechanism is similar to the first, except that withholding is reduced or eliminated only with respect to the last payment received by the taxpayer and the agreement with the Service is reached with the District Director.[357] This latter mechanism is not available to taxpayers receiving wage income.[358] A taxpayer receiving relief under this mechanism is required to file a tax return with a copy of the agreement with the Service attached.[359]

§ 10.02.2.2. Partnership Income

Partnership income attributable to a foreign partner is subject to withholding, even if the income is effectively connected with a U.S. business.[360] Domestic and foreign partnerships earning effectively connected income during the taxable year that is attributable to foreign partners generally must withhold taxes at the highest rate of tax applicable to such partners.[361] The objective of this withholding requirement is to collect taxes from foreign persons making passive investments in the United States through a partnership engaged in business within the United States. The amount withheld from a distribution to a foreign partner may be credited against the normal tax due under the Code.[362] Prior to the enactment of this requirement, Congress believed that many partners in partnerships engaged in business within the United States were not complying with U.S. tax laws.[363] Congress has delegated substantial regulatory authority to the tax authorities to design special rules for publicly-traded partnerships.[364]

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[353] See section 2/D3.3, above.

[354] Reg. § 1.1441-4(b)(1)(iv) (1999).

[355] Reg. § 1.1441-4(b)(2) (1999). The withholding certificate is Form 8233. The withholding agent has the obligation to review the certificate and reject it if the agent knows, or has reason to know, that the certificate may be inaccurate or if the the agent cannot readily determine the eligibility of the individual for the exemption.

[356] Reg. § 1. 1441-4(b)(3) (1999).

[357] Reg. § 1. 1441-4(b)(4)(i) (1999).

[358] Id.

[359] Id.

[360] IRC § 1446.

[361] IRC § 1446. Income attributable to foreign individual partners is withheld at the highest rate specified in IRC § 1, and income attributable to foreign corporate partners is withheld at the highest rate specified in IRC § 11. See IRC § 1446(b)(2) and Table 1.1 of Chapter 1/D1. A withholding requirement was added by the 1986 tax act, modified by TAMRA (1988) and modified again by the 1989 tax act. Withholding requirements are set forth in Rev. Proc. 92-66, 1992-2 C.B. 428, and Rev. Proc. 89-31, 1989-1 C.B. 895.

[362] IRC § 1446(d).

[363] See *General Explanation of the Tax Reform Act of 1986* at 1055.

[364] IRC § 1446(f) (added by the 1989 tax act). As of January 1, 2000, no proposed or final regulations had been issued under IRC § 1446.

§ 10.02.2.3. Sale of Interest in U.S. Real Property

A foreign person making a sale of an interest in U.S. real property, as defined in Code section 897(c), is subject to withholding on the amount realized on the sale.[365] Under Code section 1445, the buyer (transferee) of the property is required to withhold 10 percent of the contract price paid to the foreign seller (transferor) unless certain exceptions apply.[366] Elaborate rules have been developed for implementing this withholding requirement.

Withholding by the buyer (transferee) of a U.S. real property interest generally is not required in the following circumstances:

(1) The seller (transferor) furnishes an affidavit, not known to be false, that sets forth the seller's U.S. taxpayer identification number and states, under penalty of perjury, that the seller is not a foreign person;[367]

(2) In the case of a sale of any interest in a domestic corporation, the seller furnishes an affidavit that the corporation is not treated as a U.S. real property holding company under Code section 897;[368]

(3) The seller provides the buyer with a statement from the Internal Revenue Service that withholding is not required, either because no tax is due or because adequate arrangements have been made for its payment;[369]

(4) The buyer is acquiring, the property for a personal residence and the contract price does not exceed $300,000;[370]

(5) The buyer is acquiring stock that is regularly traded on an established securities market;[371] or

(6) The foreign buyer has made a valid election to be treated as a domestic corporation, as permitted by Code section 897(i).[372]

If withholding by the seller is required under the above rules, the amount withheld should not exceed the maximum amount of the seller's U.S. tax liability on the sale. The seller may request that the Internal Revenue Service determine that maximum amount.[373]

Under Code section 1445(e)(1), a domestic partnership is required to withhold tax upon the partnership's disposition of a U.S. real property interest if any foreign persons are partners of the entity. A similar rule applies to the fiduciary of a domestic trust or estate that makes distributions to foreign beneficiaries. Section 1445(e)(2) provides that a foreign corporation must withhold tax upon its distribution

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[365] Prior to the adoption of the withholding requirement in the 1984 tax act, sellers of interests in U.S. real property were subject to extensive reporting requirements under IRC § 6039C. That section remains in the law but has substantially reduced significance with the addition of the withholding requirement.

[366] See Reg. § 1445-1 (1995).

[367] IRC § 1445(b)(2) and (7) and Reg. § 1.1445-2(b) (1988). Agents of a transferor or transferee must notify the transferee if they learn that a false certification statement has been provided. See Reg. § 1. 1445-4(1987).

[368] IRC § 1445(b)(3) and (7) and Reg. § 1.1441-2(c)(3) (1988).

[369] IRC § 1445(b)(4). See Reg. §§ 1.1445-3 (1987) and 1.1445-6 (1987). See also Rev. Proc. 2000-35, 2000-2 C.B. 211.

[370] IRC § 1445(b)(5) and Reg. § 1.1445-2(d)(1) (1988).

[371] IRC § 1445(b)(6) and Reg. § 1.1445-2(c)(2) (1988). But see Reg. § 1.1445-8 (1995) (special rules for withholding on payments from publicly traded partnerships, publicly traded trusts, and real estate investment trusts (REITs).

[372] See Reg. § 1,1445-7 (1987).

[373] IRC § 1445(c).

of a U.S. real property interest to its interest-holders. Finally, under section 1445(e)(3), a domestic U.S. real property holding corporation is required to withhold tax upon certain distributions to interest-holders that are foreign persons. The operation of these rules is governed by detailed regulations.[374]

§ 10.03. Reporting Requirements for Foreign-Owned Corporations

Code sections 6038A and 6038C impose some reporting requirements on any corporation that qualifies as a "reporting corporation."[375] For purposes of section 6038A, a reporting corporation is a domestic corporation that is at least 25 percent foreign owned.[376] Section 6038C defines a reporting corporation as a foreign corporation engaged in a trade or business within the United States at any time during the taxable year.[377] Very broad regulatory authority is delegated to the tax authorities to determine the scope of the reporting requirements.[378] U.S. parent corporations are subject to roughly comparable reporting requirements under section 6038 with respect to their controlled foreign corporations (CFCs).[379]

A reporting corporation must file an annual statement with the Internal Revenue Service containing information about its dealings with related parties, including identifying information about those parties.[380] It also must maintain, and in some cases create, books and records relating to its transactions with related parties.[381] Those records generally must be stored at a place specified by the tax authority by regulation.[382] In addition, each foreign related person, on request by the tax authorities, must authorize the reporting corporation to accept service of process on its behalf with respect to a summons or a request for records issued by the tax authorities.[383]

A statement disclosing dealings with related parties should include: (1) the amounts paid or received on the purchase or sale of inventory or of other tangible and intangible property; (2) rents and royalties paid and received; (3) amounts paid and received for technical services; (4) commissions paid and received; (5) amounts lent and borrowed, and interest paid or received with respect to loans; and (6) premiums paid and received for insurance.[384] For transactions in kind and transactions involving no consideration, the nature of the transactions must be explained, and an estimate of the value of the property transferred or the services performed must be provided.[385]

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374 See Reg. § 1.1445-5 (1997) (effective January 1, 2001).

375 IRC §§ 6038A(a) and 6038C(a).

376 IRC §§ 6038A(a)(1) and (2).

377 IRC § 6038C(a).

378 IRC §§ 6038A(a) and 6038C(a). Comprehensive regulations under IRC § 6038A were adopted on June 14, 1991. For detailed discussion of those regulations, see Philip H. Spector, "Final Regulations on Transfer Pricing Reporting and Recordkeeping, 3 *Tax Notes Int'l* 919-934 (August 1991).

379 Extensive reporting requirements also apply under IRC § 6038 to U.S. persons controlling a foreign partnership. See Reg. § 1.6038-3 (1999).

380 IRC 6038A(b) and 6038C(b).

381 IRC 6038A(a) and 6038C(a)(2).

382 Reg. § 1.6038A-3(e) (1995) provides that reporting corporations may enter into agreements with the Service that specify the records that must be kept and how and where they are to be kept.

383 Reg. § 1.6038A-5(b) (1991).

384 Reg. §§ 1.6038A-2(a)(2), 1.6038A-2(b)(3), and 1.6038A-2(b)(4) (1991).

385 Reg. § 1.6038A-2(b)(4) (1991).

A corporation is treated as a 25-percent foreign-owned corporation if at least 25 percent of its stock, by vote or value, is owned at any time during the taxable year by foreign persons.[386] The broad stock attribution rules of Code section 318, with modifications, are applicable in determining whether the 25-percent tests are made.[387] For purposes of sections 6038A and 6038C, is a person other than a U.S. person, as defined in 7701(a)(30), generally is a foreign person.[388]

The term "related party" is very broadly defined. It includes anyone related to the reporting corporation under (1) Code sections 267(b), relating to the disallowance of losses and deductions on transactions between related taxpayers, (2) Code section 707(b)(1), relating to transactions between related partnerships, and (3) Code section 482, relating to allocation of income and deductions among related taxpayers. It also includes any 25-percent shareholder of the reporting corporation.[389]

Stiff penalties are applicable for failure, without reasonable cause, to furnish information or maintain records in accordance with section 6038A(b) and the regulations. In addition to monetary penalties,[390] the tax authorities are given wide discretion to make an assessment of the income and deductions of the taxpayer, based on the information at their disposal, and the affected taxpayers have very limited grounds for obtaining judicial review of that assessment.[391]

Taxpayers are given special rights to begin a proceeding to quash a summons issued by the tax authorities under section 6038A. They also have rights to a judicial determination of whether they have substantially complied with a summons.[392]

As revisions of section 6038A were under discussion in 1989, Congress and the Treasury Department received complaints from U.S. treaty partners that the proposed reporting and record keeping rules were unduly burdensome and may violate U.S. treaty obligations. In response to these concerns, Congress noted in the legislative history of the revised section 6038A that the regulations should provide various exceptions, including country-specific exceptions, to the reporting and record keeping requirements.[393] It also stated that, in its view and the view of the Treasury Department, the new rules are consistent with U.S. treaty obligations.[394]

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[386] IRC § 6038A(c)(1).

[387] IRC §§ 6038A(c)(5) and 6038C(e).

[388] IRC §§ 6038A(c)(3) and 6038C(e). Under a special rule, an individual who is a citizen of the United States by reason of being a citizen of a U.S. possession is treated as a foreign person.

[389] IRC §§ 6038A(c)(2) and 6038C(e).

[390] IRC §§ 6038A(d) and 6038C(c).

[391] IRC §§ 6038A(e) and 6038C(d). See Statement of Managers, *Conference Committee Report to H.R. 3299*, 101st Cong., 1st Sess. (1989) at. 104-105.

[392] IRC §§ 6038A(e)(4) and 6038C(d)(4).

[393] Statement of Managers, *Conference Committee Report to H.R. 3299*, 101 Cong., 1st Sess. (1989) at 102-103.

[394] Id. For discussion of the treaty override issue, see Richard A. Gordon, George N. Carlson, T. Timothy Tuerff, Diane L. Renfroe, & Andre P. Fogarasi, "Do the Section 6038A Recordkeeping Rules Violates Treaty Nondiscrimination Clauses?" 3 *Tax Notes Int'l* 390 (April 1991). Any treaty claim by a U.S. treaty partner against the reporting rules has probably been lost for lack of an effective and timely protest.

§ 10.04. Production of Documents

Taxpayers subject to the reporting requirements of Code section 6038A and 6038C that refuse to provide requested information to the tax authorities are subject to fines for failure to comply.[395] In addition, taxpayers may be compelled to permit inspection of relevant books and records under Code section 7606 (granting the Internal Revenue Service the authority to issue a summons). A summons may also be served on certain third-party record keepers, such as banks and accounting firms, under Code section 7609.

Code section 982 provides that taxpayers refusing to comply with a formal document request made by the tax authorities for the production of relevant documents held in a foreign country may be prohibited from later using those documents in a court of law to resist a tax assessment. A taxpayer may avoid exclusion of a document by showing that its refusal to comply with a request for production was due to "reasonable cause."[396] The Code specifically provides that a taxpayer has not shown "reasonable cause" by demonstrating that disclosure of a requested document would violate the civil or criminal laws of a foreign country.[397] Congress believed that many taxpayers operate in a particular country because of its restrictive nondisclosure laws.[398] In the view of Congress, such taxpayers should not be allowed to use documents at trial that they allegedly could not produce on audit.

§ 10.05. Reporting of Acquisitions and Recapitalizations

Code section 6043(c), added to the Code by the 1989 tax act, gives power to the tax authorities to require corporations, foreign or domestic, to report on transactions that result either in their being acquired or in their capital structure being changed substantially. An acquisition takes place, for purposes of the reporting rule, whenever one or more persons acquires 50 percent or more of the stock, by vote or value, of a corporation.[399] A paradigm example of a substantial change in the capital structure of a corporation would be the substitution of a substantial portion of the corporation's equity with debt.[400]

Regulations implementing Code section 6043(c) have not yet been issued. Proposed regulations were issued in 1990[401] and withdrawn in 1992.[402] In its notice of withdrawal, the Service stated that in response to comments on the proposed regulations, "it now appears that the value of the information that would be collected under section 6043(c) regulations does not justify the burden to the public in complying with the rules."[403] As a result of the withdrawal, taxpayers are not required to report either current or past transactions under section 6043(c).[404] The Notice indicated that the Service might revive the reporting requirement at some future date if circumstances should change.

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[395] IRC §§ 6038A(d) and 6038C(c). For discussion, see *ASAT Inc. v. Com'r*, 108 T.C. 147 (1997) (upholding IRS reassessment).

[396] IRC § 982(b)(1).

[397] IRC § 982(b)(2).

[398] See *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* at 247. The use by the Service of its powers under IRC § 892 was upheld in *Flying Tigers Oil Co. v. Com'r,* 92 T.C. 1261 (1989) (prohibiting introduction of documents not supplied in response to IRS summons).

[399] IRC §§ 6043(c)(1) and 304(c)(1).

[400] Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, H.R. 3299, 101 Cong., 1st Sess. (1989), *House Report 101-247*, [Title XI–Revenue Reconciliations Provisions], 92-93.

[401] 55 FR 27648 (July 5, 1990).

[402] Notice 92-51, 1992-2 C.B. 381.

[403] Id.

[404] Id.

In adopting section 6043(c), Congress was concerned with the large number of leveraged buyouts of U.S. corporations, often by foreign interests, and by so-called debt-equity swaps. In most debt-equity swaps, a large amount of corporate debt ends up in the hands of tax-exempt entities, thereby reducing the amount of net income subject to the U.S. corporate income tax. Some of the tax-exempt entities are U.S. charities and pension funds, and some are foreign persons exempt from U.S. tax under a U.S. tax treaty. Congress believed that the Internal Revenue Service was having difficulty in auditing acquisition and reorganization transactions because the relevant information is spread among the tax returns of many different taxpayers.

The legislative history of Code section 6043(c) indicates that regulations would require affected corporations to report (1) on the identities of persons involved with covered transactions, (2) on the fees paid in conjunction with those transactions, and (3) on the changes made in their capital structure.[405] The tax authorities are given broad power to require that additional information be reported and to develop *de minimis* rules that would reduce compliance burdens.[406] For example, the legislative history suggests that an acquisition in which the total consideration involved is less than $10 million would likely to be exempt from reporting.[407] The time and manner for making reports under this section is left to the as yet unissued regulations.[408]

§ 10.06. Treaty-Position Disclosure Rules

Code section 6114 requires taxpayers to flag their treaty claims if they are reporting less tax that they are required to pay under the Code on the ground that a treaty of the United States overrules or modifies some provision of the Code. This disclosure requirement was inserted into the Code by TAMRA (1988). Its purpose is to allow the tax authorities to determine the merits of treaty claims in a timely manner and to limit opportunities for taxpayers to play the so-called tax lottery. In general, a taxpayer intending to defend a position on its tax return that a treaty reduces the tax otherwise payable must disclose that "return position" on a statement attached to the tax return. Some exceptions to the treaty-position disclosure rules are provided by regulation.[409] In addition, the regulations specifically mandate reporting in some cases.[410]

Under section 6114, a taxpayer is subject to the disclosure rules if it takes the position that its tax liability, as determined after the application of a treaty, is less than it would be if determined exclusively under the Code.[411] Assume, for example, that FCo, a foreign corproation, claims to be exempt from the branch profits tax on the ground that the application to it would be inconsistent with the nondiscrimination clause of a tax treaty. FCo must report that treaty claim to the Service on its tax return in the year it seeks to avoid being taxable under the Code on account of that claim.

Unless an exception applies, all treaty claims must be reported to the tax authorities. The regulations under section 6114 specifically require reporting of the following treaty positions: (1) that a nondiscrimination clause precludes the application of an otherwise applicable Code provision (with a minor exception); (2) that a treaty reduces or modifies the taxation of gain or loss on the disposition of an interest

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[405] IRC § 6043(c).

[406] Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, H.R. 3299, 101 Cong., 1st Sess. (1989), *House Report 101-247*, [Title XI–Revenue Reconciliations Provisions], 93.

[407] Id.

[408] Id.

[409] Reg. § 1.6114-1(c) (1999) (effective as of January 1, 2001).

[410] Reg. § 1.6114-1(b) (1999).

[411] See Reg. § 1.6114-1(a)(2)(i) (1999).

in U.S. real property; (3) that a treaty protects a foreign corporation from application of the branch profits tax or the tax on excess interest or limits the burden of those taxes; (4) that a treaty exempts from tax certain divided and interest payments made by foreign corporations out of income effectively connected to a U.§. business; (5) that a treaty allows a reduced withholding rate on a payment of periodical income, but only if the income was not reported properly on Form 1042S and certain other conditions are met; (6) that the permanent establishment clause of a treaty provides for treatment of effectively connected income contrary to the Code; (7) that a treaty alters the source of income (with exception); (8) that a treaty allows for a foreign tax credit not allowable under the Code; and (9) that the residency of an individual is determined under a treaty.[412]

Reporting is waived by regulation with respect to a variety of listed treaty positions. The list of waived items includes the following treaty positions: (1) that a treaty provides for a reduced withholding rate on various classes of periodic income, but only if the person claiming the exemption is the beneficial owner of the income and mandatory reporting is not specifically required; (2) that the treaty modifies the treatment of certain earned income and pensions; and (3) that a treaty provision relating to the elimination of double taxation determines the source of income for purposes of the separate basket limitations on the foreign tax credit.[413]

Various special rules apply to prevent taxpayers from having to report information already available to the tax authorities in some alternative form.[414] Other special rules allow some consolidation of reporting, so that a taxpayer having a series of income items raising the same treaty issue does not have to report each item separately.[415] In addition, a *de minimis* rule exempts individuals from making disclosure if the amount of a payment or income otherwise reportable does not exceed $10,000 ($100,000 when residency status is claimed under a treaty rule).[416]

Disclosure must be made on a form provided by the tax authorities and attached to the taxpayer's tax return.[417] If no return would otherwise be filed, the taxpayer must file a return for the purpose of making the required disclosure.[418] The required form requires that certain identifying information be provided, including, when available, the taxpayer's identification number (TIN). It must also provide a summary of the treaty claim, including a reference to the specific treaty provision relied on, and it must identify the Code provisions overruled or modified.

Under Code section 6712, a taxpayer who fails "in a material way" to report a treaty position as required by section 6114 is subject to a fine. In the case of a regular corporation, the amount of the fine is $10,000 for each failure to report. The fine is $1,000 for individuals and other taxable persons.[419] The fine may be waived if the tax authorities determine that the failure to report was not due to willful neglect.[420]

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[412] Reg. § 301.6114-1(b) (1999).

[413] Reg. § 301.6114-1(c)(1) (1999).

[414] See Reg. § 301.6614-1(c)(3)-(6) (1999).

[415] Reg. § 301.6114-1(d)(3) (1999).

[416] Reg. § 301.6114-1(c)(2) (1999).

[417] Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)). See Reg. § 301.6114(d)(1) (1999).

[418] IRC § 6114(a) and Reg. § 301.6114-1(a)(1)(i) (1999).

[419] Reg. § 301.6712-1(a) (1990).

[420] Reg. § 301.6712-1(b).

Given the importance of getting disclose of treaty positions in timely fashion, the amount of the fines appears to be extraordinarily low in the case of major offenders. Raising the dollar amounts of the fines, however, would create fairness problems for inattentive taxpayers who were not attempting to game the system. An alternative approach would be to give the tax authorities some discretion to deny treaty benefits to taxpayers that willfully failed to disclose their treaty claim.

COMMENTARY: Record Keeping Requirements

Under Code Sections 6038A and 6038C

The Hardship of Accounting

(Item VIII of Ten Mills)

Never ask of money spent

Where the spender thinks it went.

Nobody was ever meant

To remember or invent

What he did with every cent.

— Robert Frost