INTERNATIONAL TAXATION

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Our journey begins with a misnomer, "international taxation." The body of law you are about to immerse yourself into has nothing to do with international taxation. There will be no discussion of the French VAT, the Italian IRPEF or the Swedish PAYE. What we commonly refer to as "international taxation" deals entirely with U.S. taxation - more accurately, U.S. taxation of cross-border transactions. For tax purposes, cross-border transactions are divided into two classes: outbound (Americans doing business and investing overseas), and inbound (foreigners doing business or investing in the U.S.). The tax rules that apply to inbound and outbound transactions are entirely different. We will examine both, and will then delve into the related subjects of pre-immigration tax planning (foreigners immigrating to the U.S.) and expatriation (Americans emigrating from the U.S.).

I. Outbound Taxation

Taxation of Americans operating a business or investing offshore is subject to a complex set of rules. However, the theoretical framework of these rules is not difficult to grasp.

An American who operates abroad as a sole proprietor will be taxed in the United States on whatever income is generated abroad, as U.S. citizens and residents are taxed on their worldwide income. From a theoretical viewpoint, there is no room for abuse, as all income is taxed currently. The same rules apply to Americans who operate abroad through foreign partnerships. Because partnerships pass income through on a current basis, there is similarly no opportunity for a deferral, and a U.S. resident or citizen investing in a foreign partnership will be taxed on their share of the partnership's income.

Consequently, Congress is not concerned when taxpayers go offshore and operate the business or invest in their individual capacity or as a partner in a partnership.

The tax analysis of an American investing in a foreign corporation, or operating a business through a foreign corporation, changes dramatically. The corporation itself, if it is not doing business in the U.S. and if it does not have U.S. source income, is not taxable in the U.S.

The shareholders of a corporation are not taxable on the corporate income (a foreign corporation cannot make an S election and pass through income), they are only taxable on compensation (if any) and dividend distributions. In the U.S., there are rules that deter taxpayer from accumulating earnings in a corporation. These rules subject the U.S. corporation to the accumulated earnings tax.

Foreign corporations are obviously not subject to the accumulated earnings tax as they are not subject to U.S. taxation. Consequently, the U.S. can tax only the shareholders of foreign corporations that are residents or citizens of the U.S. Not every U.S. shareholder of a foreign corporation will be currently taxable on the income of the corporation.

Generally, for a U.S. shareholder to be taxable on the undistributed income of the foreign corporation, the U.S. shareholder must be able to control whether the income is distributed or not. The following discussion explains when a U.S. investor in a foreign corporation will be currently taxed on that corporation's income.

A. Subpart F - Controlled Foreign Corporations

1. Introduction to Subpart F

a. Background

As with certain other parts of the Code, some understanding of the purpose behind the enactment of subpart F[1] is quite valuable, especially as the tax practitioner attempts to understand the complex rules and exceptions of subpart F.

Subpart F was intended to attack the problem of the "tax haven." That problem, as originally seen by Congress and the Treasury, can best be illustrated by an example. Assume Microsoft, Inc. wants to sell its Windows software in Europe. Microsoft can accomplish that task by either (i) direct sales of the software through a European division, (ii) the creation of a U.S. domestic sales subsidiary, or (iii) the creation of a foreign-incorporated sales subsidiary.

Before the enactment of subpart F, Microsoft would have chosen to organize a foreign sales subsidiary because none of the income earned by the subsidiary would be subject to taxation by the United States. Only when the foreign subsidiary distributed a dividend to Microsoft or was liquidated would Microsoft have to worry about payment of tax to the United States.

Thus, Microsoft would form a subsidiary in Switzerland or Liechtenstein, where the main office of the subsidiary would be maintained. The subsidiary would then hire salesmen to travel Europe, selling Windows. As orders were received by the salesmen, they would be passed on by the subsidiary to Microsoft. Microsoft would then fill the order by selling the products to the subsidiary for resale to customers in Europe.

The results of that program would be as follows. The sales price of Windows to the subsidiary would be just a little above Microsoft's cost of production, say $100 per unit. If it cost Microsoft $96 to manufacture the item, Microsoft would have a $4 per unit profit, subject to U.S. taxation. The European subsidiary would then resell the software to the ultimate consumer for $150, thereby realizing a before-tax profit of $50 per unit. However, the countries where the units were sold did not tax the $50 because the subsidiary had no warehouse, office, or other fixed place of business in those countries,

[1] "Subpart F" refers to subpart F of Part III of Subchapter N of the Code.

none of that $50 was subject to income tax by those countries. Further, Switzerland and Liechtenstein did not tax the income because it was earned outside of those countries.

If, however, Microsoft had sold Windows directly to the consumers in Europe, or sold through a U.S. subsidiary, the total sales profit of $54 would have been taxed by the United States. Thus, by the relatively simple device of creating a foreign sales subsidiary in a tax-haven country, the profit was rendered virtually free of tax. Finally, to complete the cycle, Microsoft would borrow money from its foreign subsidiary from time to time, thus obtaining the use of the funds without having to pay a tax on the borrowed money.

That process and countless variations thereon were addressed by Congress in subpart F. Throughout this discussion it is very important to keep in mind the objectives of the rules and the perceived abuses these rules were formulated to prevent. Subpart F was designed to prevent deferral of income for tax purposes, and its provisions simply intend to accelerate recognition of income. They are not meant as a penalty or as an obstacle to legitimate business transactions. As a matter of fact, the reader will observe that most of the planning prohibitions discussed below make an exception for businesses taken and conducted offshore for valid business reasons.

b. Statutory Outline

i. Persons Affected

Subpart F is concerned only with foreign corporations that can be classified as closely held. Specifically, the Code Sections that comprise subpart F only relate to a foreign corporation more than 50 percent of the value *or* voting power of which is owned by "U.S. shareholders."[2]

Thus, if a foreign corporation is owned equally by 11 U.S. persons, it is not a CFC. If the foreign corporation is owned 50 percent by one U.S. person and the remaining 50 percent is owned equally by six other U.S. persons, it is not a CFC. If a foreign corporation is owned 50 percent or more by a foreign person, it cannot be a CFC.

In testing for the more than 50 percent ownership, one has to remember to look not just for value, but vote as well. The voting test is not just a straightforward look at the percentage vote held by U.S. shareholders. For example, if a foreign LLC (treated as a foreign corporation under the default provisions of Code Section 7701) is owned 50-50 by a U.S. person and a foreign national, but the U.S. person is the manager of the LLC, the LLC will be treated as a CFC.

However, it is important to note that subpart F does not purport to tax or directly affect the foreign corporation. Rather, the tax is assessed against the "U.S. shareholder" of the foreign corporation. Even then, not all U.S. taxpayers who own shares in the closely held foreign corporation are subject to tax on the corporation's income. Only those

[2] Constructive ownership rules of Code Section 958(b) are used in applying the 10/50 tests.

shareholders who own, directly or indirectly, 10 percent or more of the corporation's voting power are considered U.S. shareholders and are therefore subject to tax on the foreign corporation's income. A less than 10 percent shareholder of a foreign corporation is not necessarily off the tax hook, however, for if the foreign corporation is a passive foreign investment company (see discussion, *infra*), then the shareholder is subject to specific rules discussed below.

In summary, subpart F:

- applies only to shareholders of foreign corporations, not the corporations directly;
- is only concerned with closely held foreign corporations; and
- applies to only those U.S. persons who own (or are deemed to own) 10 percent or more of the foreign corporation's voting power.

Subpart F does not apply to shareholders of a publicly held foreign corporation (unless 50+ percent of the voting power is concentrated in a few hands), nor does subpart F apply to the U.S. shareholders of a foreign corporation that does not meet the definition of a CFC. Thus, if a U.S. citizen owns 50 percent of the only class of stock of a foreign corporation and a nonresident alien owns the other 50 percent, the corporation is not a CFC and subpart F does not apply to the U.S. citizen.[3]

ii. Method of Taxation

Code Section 951, the basic Code Section upon which the rest of subpart F is built, does not assess a tax. That Code Section merely provides that the U.S. shareholder of a CFC must include in gross income (as ordinary income) certain kinds of the CFC's income on their tax return, whether or not the CFC makes a distribution to the U.S. shareholder. Because that constructive distribution is treated by the shareholder as they treat any other form of taxable income, the remaining Code Sections of subpart F set out the rules as to the kinds of income which form the basis of a constructive distribution and what happens to the corporation when a constructive dividend is deemed distributed.

Note: While the term "constructive dividend" is commonly used in this context (*i.e*, a practitioner may say something akin to: "the U.S. shareholder will recognize a constructive dividend on its share of the CFC's income"), there is no dividend in the technical sense of the word. The share of the CFC's income that a U.S. shareholder reports on their tax return is treated as ordinary income, it is never a dividend in the CFC context. As a matter of fact, even if the CFC generates a capital gain, the U.S. shareholder's share of such capital gain will be treated as ordinary income on the U.S. shareholder's income tax return.

iii. Composition of the Constructive Dividend

[3] S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), reproduced at 1962-3 C.B. 707, 784, *et. seq*.

A U.S. shareholder is to take into income their share of the CFC's "subpart F income," and their share of the CFC's "increase in earnings invested in U.S. property." Additionally, the U.S. shareholder is required to take into income as a constructive dividend a portion of the gain recognized on the sale of stock of certain foreign corporations.

iv. Subpart F Income

Subpart F income, discussed in more detail below, is the most important of the types of income generating a constructive dividend to the CFC's U.S. shareholders. Pursuant to Code Section 952, subpart F income is composed of the income derived from (i) the insurance of U.S. risks, and (ii) "foreign base company income." Code Section 952 excludes all of the CFC's income effectively connected with its conduct of a U.S. business from subpart F income. The Code Section also provides that in no event is the amount of subpart F income for any particular year to exceed the CFC's earnings and profits (calculated with certain adjustments) for such year. Subpart F income is also reduced by the Export Trade Income.[4]

v. Earnings Invested in U.S. Property and Excess Passive Assets

Code Section 956 provides that, generally, a CFC that invests any of its earnings in U.S. property will generate a constructive dividend to the CFC's U.S. shareholders.

A substantial number of foreign corporations that will be classified as CFCs never generate any subpart F income and the practitioner may assume (incorrectly) that they need not be concerned with subpart F in those cases. In light of Code Section 956 that assumption is a dangerous one, because the provisions relating to Code Section 956 apply to all CFC's, whether or not they have ever generated subpart F income. Thus, even though the CFC has carefully avoided both subpart F income and the use of a tax-haven country, as soon as the CFC begins investing in U.S. property, a constructive dividend may result.

2. Subpart F Income

a. Introduction

The U.S. shareholder must take into income their pro rata share of the CFC's subpart F income as a constructive distribution; limited, however, by the actual amount of earnings and profits which the CFC has generated during the taxable year. Subpart F income consists of (i) the insurance of U.S. risks, and (ii) "foreign base company income." In turn, the foreign base company income consists of: (i) foreign personal holding company

[4] Code Sections 970, *et. seq*.

income (Code Section 954(c)); (ii) foreign base company sales income (Code Section 954(d)); (iii) foreign base company services income (Code Section 954(e)); (iv) foreign base company shipping income (Code Section 954(f)); and (v) foreign base company oil related income (Code Section 954(h)).

b. Insurance Income

Generally, a CFC's insurance income is any income earned by a foreign insurance corporation that meets two conditions: (i) the income is from premiums attributable to issuing (or reinsuring) a policy of insurance insuring against risks arising from or related to lives or activities in a country other than the country of the insurance company's place of incorporation, and (ii) the company would be taxed (subject to certain modifications) as a domestic insurance company if the company was a domestic corporation.[5] Thus, the rule applies, of course, only to foreign insurance companies that are also CFCs.

c. Foreign Base Company Income

i. General Rule

Foreign base company income forms the basis of the large majority of constructive dividends received by U.S. shareholders. Foreign base company income is composed of five classes of income which the CFC may earn:

(1) foreign personal holding company income (passive items of income);
(2) foreign base company sales income (composed of income from sales of property to a related party or purchases from a related party);
(3) foreign base company services income (income derived from services by the CFC for or on behalf of a related party which are performed outside of the country of the CFC's incorporation); and
(4) foreign base company oil related income (consisting primarily of income earned by a large oil company from the processing, transportation, and distribution of oil and gas and their primary products).[6]

ii. Order in Which Subpart F Computations Are Made

•**Steps to Follow**

The CFC is required to proceed through a series of steps to compute its net foreign base company income. The reason the CFC needs to make the computation is that the CFC's net foreign base company income is a component part of subpart F income which, in turn, is the basis for a constructive dividend to the CFC's U.S. shareholder.

[5] Code Section 953(a).
[6] Code Section 954(a).

The steps that the CFC is to go through to determine its foreign base company income are as follows:

> (1) The CFC determines each item of gross income.
>
> (2) Expenses are allocated and apportioned to each item of income. If the result in any category of income is a loss, the taxpayer may not use that loss to reduce income in another category. "Category" is the same as a basket of income in the foreign tax credit rules (discussed below).
>
> (3) Passive foreign personal holding company income is reduced by related person interest expense allocable to that passive income.

•Items of Income

Items of income are determined as follows:

First, the income is allocated to the category of foreign base company income to which it belongs (other than the foreign personal holding company income, which is treated separately). See the detailed discussion of the categories below). Second, after the taxpayer has identified all of the categories, the income in each category is further allocated on a per-basket basis. The baskets are:

> (1) high withholding tax interest;
> (2) financial services income;
> (3) shipping income;
> (4) dividends received from a Code Section 902 corporation;
> (5) DISC dividends;
> (6) FTC dividends;
> (7) taxable income of an FSC attributable to foreign trade income;
> (8) foreign oil related income; and
> (9) general limitation income.

Once each item of income has been identified, then expenses allocable to each item of income are calculated. That step is followed by reducing items of income by general expenses not already allocated. The result is that each item of income is a net item and, taken together, they equal net foreign base company income. Finally, the foreign base company income is reduced by any item of net high tax income (discussed below).

iii. Foreign Personal Holding Company Income

• General

Foreign personal holding company ("FPHC") income consists of: (i) dividends, interest, rents, royalties and annuities; (ii) gain from certain property transactions;[7] (iii) gain from commodity transactions; (iv) foreign currency gain; (v) "income equivalent to interest;"[8] and (vi) personal services income.[9]

"Income equivalent to interest" includes the following categories of transactions:

> (1) An investment in which the return predominantly reflects the time value of money;
> (2) Financial arrangements which involve payments, the predominant portion of which are, in substance, payments for the use or forbearance of money, but are not generally treated as interest;
> (3) Certain notional principal contracts; and
> (4) Various other transactions, such as the performance of services under certain conditions, a loan commitment and other transactions that the Service later may identify.[10]

•Active Trade or Business Modification

<u>Rents and Royalties</u>

The first of two exceptions to the definition of FPHC income for CFC purposes relates to rents and royalties derived from the active conduct of a business so long as the income is not received from a related person. That exception requires the taxpayer to recognize the distinction between the active conduct of a business and a business which is not actively conducted. The Treasury Regulations describe the type of activity in which the CFC must engage if it wishes to meet the "active conduct" standard. Those provisions clarify that the scope of the exclusion includes personal as well as real property. As to real property, the standard is that the activity required is the regular performance of active and substantial management by the employees of the CFC.

Royalties are under the active business exception if they are derived from (i) the licensing of property developed by the CFC in the regular course of its property developing

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[7] Pursuant to the AJCA 2004, when a CFC owns 25 percent or more of a foreign partnership, on sale of the CFC's interest in the partnership the CFC will be deemed to be selling its proportionate interest in the partnership assets. Previously, the sale of a partnership interest was always treated as FPHC income. Now, if the partnership has active business assets, then the CFC may not be generating FPHC income on the sale of the partnership interest.
[8] Treas. Reg. Section 1.954-2(a).
[9] This new category of FPHC income was added by AJCA 2004. Specifically, the new Code Section 954(c)(1)(I) provides that FPHC income includes amounts received by a CFC under a contract under which the corporation is to provide personal services. The contract must satisfy one of the following two conditions: (i) some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or (ii) the individual who is to perform the services is designated (by name or by description) in the contract. FPHC income also includes amounts received by the CFC from the sale or other disposition of such a services contract.
[10] Treas. Reg. Section 1.954-2(h)(2)(i).

business, or (ii) property licensed as the result of the performance of substantial marketing activities in a foreign country.

Dealers in Financial Instruments

A CFC which acts as a dealer in certain types of property does not recognize income from those transactions as foreign personal holding company income. The excepted property is any type of property which generates dividends, interest, royalties, rents or annuities (that is, primarily various forms of financial instruments such as stocks and bonds) as well as inventory held by dealers in forward contracts, option contracts, notional principal contracts, and instruments referenced to commodities.

•Income from a Related Person

Certain dividends, interest, rents and royalties paid to a CFC by a related person are not FPHC income.[11] The exclusion is rather limited but useful when it applies.

Dividends and Interest. Dividends and interest received by a CFC from a related party are not FPHC income if the payor meets a two-part test:

> (1) the payor and the payee CFC are both formed in the same foreign country; and (2) the payor uses a substantial part of its assets in a business located in that country.[12] (The payor will meet that test only if, for each quarter during the fiscal year, the average value of its assets used in the business is over 50 percent of the average value of all of the payor's assets.[13])

The Code contains a restriction on the same-country dividend rule; the purpose of this restriction is to limit dividend trafficking. Even if a corporation were to meet the two requirements described above, the rule does not apply (meaning that dividends will be treated as FPHC income) if the dividend is derived from earnings accumulated by the paying corporation during a period the recipient CFC--the shareholder--did not hold the dividend-paying corporation's stock.[14]

Rents and Royalties. FPHC income does not include rents and royalties received by a CFC from a related corporation for the use of property within the country where the CFC is incorporated.[15]

Related Person. The phrase "related person" has generally the same meaning throughout the subpart F discussion and is discussed in more detail immediately below.

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[11] Code Section 954(c)(3)(A).
[12] Treas. Reg. Section 1.954-2(b)(4)(i)(B).
[13] Treas. Reg. Section 1.954-2(b)(4)(iv).
[14] Code Section 954(c)(3)(C).
[15] Code Section 954(c)(3((A)(ii); Treas. Reg. Section 1.954-2(b)(5)(i).

iv. Foreign Base Company Sales Income

•**General**

Subpart F is designed primarily to reduce the use of tax havens by U.S. companies. A tax haven involves the creation of a foreign corporation in a foreign country that has a low tax rate. That corporation then conducts its operations from that foreign base (thus, "base companies") in other foreign countries. Those operations usually involve the purchase and resale of personal property or the rendition of significant services. Refer to the Microsoft example on Page 1.

Pursuant to Code Section 954(d), foreign base company sales income includes income derived in connection with (i) the purchase of personal property from a related person and its sale to another person; (ii) the sale of personal property to another person on behalf of a related person; (iii) the purchase of personal property from any person and resale to another person; and (iv) purchase of personal property from any person on behalf of a related person; provided, however, that the property was produced or manufactured outside the country where the CFC is created, and the property is sold for use outside the country of CFC's incorporation.

Thus, under those rules, a CFC <u>will not</u> be deemed to have realized foreign base company sales income if:

> (1) the purchase and resale of the personal property is <u>not</u> from or to a "related person;"
>
> (2) the personal property being purchased and resold is manufactured, grown, produced, or mined in the same country where the CFC is incorporated;
>
> (3) the personal property being purchased and resold is to be used or otherwise disposed of in the same country where the CFC is incorporated; or
>
> (4) the personal property is not simply purchased and resold but is altered or modified by the CFC to such a degree that the CFC can be deemed to have manufactured or produced the property.

If the transaction creating the CFC's income meets any one of those four provisions, the income is not foreign base company sales income and, hence, it is not income that is includible in the U.S. shareholder's gross income as subpart F income.

•**Definition of "Related Person"**

<u>Rules Applicable to Corporations and Individuals</u>

The basic component of subpart F income is that a person related to the CFC is involved in the transaction, usually as either a buyer or a seller. Thus, if the CFC purchases the personal property from a stranger and resells it to another stranger, the income generated by the CFC from that transaction is not foreign base company income, even if all the other attributes of a tax haven operation are present.[16]

A "related person" includes an individual, trust, estate, partnership, or corporation. An individual, trust, estate, or partnership is related to the CFC if one of those entities even indirectly owns more than 50 percent of the total combined voting power of the CFC. In the case of corporations, the rules are somewhat more complex. Another corporation will be deemed related to the CFC if:

> (1) the other corporation owns more than 50 percent of the CFC's voting stock;
> (2) the CFC owns more than 50 percent of the other corporation's voting stock; or
> (3) a person or group of persons owns more than 50 percent of the outstanding voting stock of both the CFC and the other corporation.

A related person can be either a foreign person or a domestic person (a citizen, resident or nonresident).

Rules Applicable to Partnerships, Estates and Trusts

As indicated, a related person can be a partnership, estate or trust as well as an individual or a corporation. The definition of "related person" includes a partnership, estate or trust that:

> (1) controls the CFC;
> (2) is controlled by the CFC; or
> (3) is controlled by the same persons who (or which) control the CFC.[17]

For partnerships, "control" arises when the person in question--usually, a CFC, in the subpart F context--owns, directly or indirectly, more than 50 percent in value of the capital or profits of the partnership. Thus, a CFC which enters into a 50-50 joint venture with an unrelated foreign entity is not related to the venture for subpart F purposes.

A CFC is related to a trust or an estate if the CFC owns, directly or indirectly, more than 50 percent of the beneficial interest in the trust or estate.

•Production of the Property in the CFC's Native Country

Gain from the sale or leasing of property that is produced, manufactured, or processed in the same country where the CFC is incorporated is not foreign base company sales income, even if the property is sold to a related person.[18] The rationale behind that exception is that a CFC that is incorporated in the country where the products the CFC

[16] Code Section 954(d)(1).
[17] Code Section 954(d)(3).
[18] Code Section 954(d)(1)(A).

sells are grown or produced is most likely not incorporated in that country for tax-haven purposes.

•Property Sold for Use or Consumption in the CFC's Native Country

The corollary of the previously described rule is the rule that subpart F income does not include income of the CFC that is generated from sales of products sold for use or consumption in the same country where the CFC is incorporated. Subpart F income also does not include income generated by the purchase of products on behalf of a related person if such products are to be used or consumed in the CFC's country of incorporation.[19] Thus, if the CFC is incorporated in Belgium and buys products from its parent corporation for resale in Belgium, the income from those transactions is not subpart F income.

The basic problem is to determine when the products will be used or consumed in the country of incorporation. Generally, the CFC may presume that the known destination of the goods is the place where the goods will be used or consumed. Thus, a shipment of chairs to a store in another city of the CFC's country of incorporation will raise a presumption that the chairs are to be used or consumed in that country and, consequently, the exception will apply. If, however, the CFC knew, or should have known, that the goods were to be shipped on to another country, the presumption would not apply.

•Products Manufactured and Processed by the CFC

The final rule regarding whether a CFC's income is subpart F income involves the application of a large group of complex rules. The rule is that if the CFC manufactures, processes, or constructs products from parts and materials which the CFC has purchased, the income which it realizes from the sale of such products is not subpart F income, irrespective of the country in which the goods are manufactured or processed or the country in which the products are to be consumed.[20]

The major problem which the CFC faces in attempting to come within the manufacturing exception is determining just how much activity is needed to constitute manufacturing or processing. The CFC will be deemed to have produced or manufactured the product if the CFC "substantially transforms" the property. Guidelines as to when substantial transformation occurs are yet to be developed. The Treasury Regulations provide some examples as to substantial transformation, *e.g.*, wood pulp to paper; steel rods to bolts and screws; and fresh fish to canned fish, all qualify.[21] Thus, if the CFC buys wood pulp from its U.S. parent, turns it into paper, and then sells the paper in other countries, the gain realized by the CFC is not foreign base company sales income.

v. Foreign Base Company Services Income

[19] Code Section 954(d)(1)(B).
[20] Treas. Reg. Section 1.954-3(a)(4).
[21] See examples in Treas. Reg. Section 1.954-3(a)(4)(ii).

The third type of foreign base company income, in addition to foreign personal holding company income and foreign base company sales income is foreign base company services income.

Foreign base company services income is income derived from the performance of services, if, but only if, those services:

> (1) are performed by the CFC for or on behalf of a related person; and
> (2) are performed outside the country of incorporation of the CFC.[22]

The definition of "related person" is the same as that set out and discussed above. The important point to recall from the corporate point of view is that the parent corporation, the subsidiary corporation, or the sister corporation of the CFC may all be related to the CFC for purposes of the foreign base company income Code Sections.

Situations in which the CFC will be deemed to have performed services for a related person include those where:

> (1) the CFC is paid by the related person for the performance of the services;
> (2) the CFC performs services which the related person is obligated to render, whether or not the CFC is paid by the related person;
> 3) the CFC performs services in connection with property sold by the related person, which performance was a material part of the sale of the property; and
> (4) the CFC performed services which utilized the substantial assistance of a related person.

In addition to the requirement that the services are to be performed for or on behalf of a related person, the services, if the income derived from the performance of the services is to be classified as foreign base company services income, must be performed outside the CFC's country of incorporation. Unlike the problem of determining the place where personal property is sold or is to be used, determination of the place where services are performed is, at times, difficult. As a general rule, the services will be deemed performed in the place where the person who is performing the services is located when the services are performed.

vi. Foreign Base Company Shipping Income

This category has been repealed by the American Jobs Creation Act of 2004.

vii. Foreign Base Company Oil Related Income

[22] Code Section 954(e).

Code Section 954(a)(5) treats oil-related income as subpart F income. The income is so treated, however, only if it is nonextraction income. Basically, the category of income which the Code Section treats as foreign base company oil-related income is foreign source income which is described in certain subsections of the foreign tax credit rules. Since the phrase only relates to nonextraction income, however, the phrase does not include income from a foreign country in connection with:

> (1) oil or gas which was extracted from an oil or gas well located in that foreign country; or
> (2) oil, gas or a primary product of oil or gas which is sold by the CFC or a related person for use in that country or is loaded in that country on a vessel or aircraft for use as fuel by that vehicle.

The effect of that rule is to focus on the source of the income, not, as in other foreign base company rules, the place of incorporation of the CFC.

viii. Deductions from Foreign Base Company Income

Foreign base company income is defined to mean the sum of the categories of income discussed above, but in each case reduced by the deductions properly allocable to each item of income. In other words, the amount of foreign base company income which the U.S. shareholder is required to recognize is the net personal holding, sales, and services income which the corporation generates.

Generally, the CFC calculates both its gross income and its net income as if it were a domestic corporation. As to items of particular income, however, the general method of accounting is not sufficient. Rather, each item of income is to be reduced by the expenses, taxes, and other deductions directly attributable to that income item or category. Interest paid by a CFC, for example, generates a deduction which is allocated first to any FPHC income, to the extent the CFC has that form of income, if the interest is paid to a shareholder or another CFC related to the shareholder. Deductions which cannot be allocated to an item or category of income are to be apportioned ratably to all categories of gross income unless there is a deduction that does not apply to any item or category of foreign base company income.

ix. Exclusions from Foreign Base Company Income

•General

In trying to keep an eye on both the forest and the trees of subpart F, the reader consistently runs into the difficulties that arise from the operation of the seemingly endless series of exceptions and exclusions that apply to subpart F income. Thus, the basic Code Section, Code Section 951(a), does not apply in certain situations and applies to only a limited extent in other situations. Subpart F income contains its own exclusions and limitations, described below, and foreign base company income contains its own exclusions.

•The De Minimis Rule

A CFC's shareholders can disregard foreign base company and insurance income if the combination of the two is less than the lesser of $ 1 million or 5 percent of gross income.[23]

The rule as stated above does not always apply, however. Income from trade or service receivables which is treated as interest or amounts received by the CFC from loans to persons for the purpose of financing the purchase of inventory or paying for services from persons related to the CFC are interest, and are treated as foreign base company income even if the *de minimis* rule otherwise applies. Additionally, the *de minimis* rules do not apply to any portfolio interest which the CFC may receive.

The Treasury Regulations contain a so-called anti-abuse rule which allows the Service to combine the incomes of two or more CFCs if one principal purpose (not "the" principal purpose) for separate CFCs was to avoid the full inclusion or *de minimis* rule.[24]

•High Foreign Tax Income

After the CFC calculates its net foreign base company income, the CFC is to reduce any of its foreign base company income by any net item of high tax income.[25]

An item of income qualifies for the high tax exception only if:

(1) the CFC makes the proper election; and
(2) the item of income is subject to an "effective" foreign income tax rate that is greater than 90 percent of the maximum rate applicable to corporate income pursuant to Code Section 11.

The Treasury Regulations set forth the method for calculating the effective rate of tax on an item of income. Specifically, the rate is determined by dividing the income taxes paid (or accrued) on an item of income by the item of income itself.

[23] Code Section 954(b)(3)(A). The practitioner should keep in mind the corollary of the 5 percent rule, the 70 percent rule, which states that if the sum of the CFC's insurance and foreign base income exceeds 70 of the gross income, then all of the CFC's income will be deemed subpart F income.
[24] Treas. Reg. Section 1.954-1(b)(4)(i).
[25] Treas. Reg. Section 1.954-1(d)(1).

3. Earnings Invested in U. S. Assets

a. General

Generally, a CFC that invests any of its earnings (not just subpart F) in U.S. property will generate a constructive dividend to the CFC's U.S. shareholders.[26] The amount of the constructive dividend will equal the average amount of U.S. property held by the CFC at the end of each calendar quarter (to the extent that the earnings have not been previously included in income).[27]

There is one aspect of Code Section 956 to keep in mind. The Code Section has nothing to do with subpart F income. The Code Section is applicable to all CFCs, whether or not they have earned any subpart F income.[28]

For years of the CFC beginning on or after Oct. 1, 1993, the amount of income which the U.S. shareholder treats as a constructive dividend is the lesser of (i) the average amount of U.S. property held at the close of each calendar quarter to the extent that property amount exceeds the earnings previously included in income,[29] or (ii) the U.S. shareholder's share of applicable earnings by the CFC.[30]

The reference to "applicable earnings" is a reference to the concept that earnings and profits earned in years ending on or after Sept. 30, 1994 (less amounts already taken into income) are the only earnings which are to be deemed distributed.[31] Earnings generated in earlier years are, as a result of that rule, disregarded for both earnings invested in U.S. property and, for the period they were in effect, the excessive passive assets rules (excess passive asset rules were in effect prior to 1997).

U.S. property is defined to include virtually all kinds of tangible and intangible personal property that is connected with the United States. [32] The phrase includes all tangible property located in the United States, stocks or securities of a U.S. corporation (if closely held), the obligation or debt, including guarantees, of a U.S. person, and the right to use patents, copyrights, inventions and other intangible property in the United States.

Loans made to U.S. persons by the CFC are also treated as investments in U.S. property. Exempted are loans of a short duration – not exceeding one calendar quarter.

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[26] Code Section 956(a). The constructive dividend is limited by the CFC's earnings and profits.
[27] Code Sections 956(a)(1) and 956(a)(2).
[28] This rule is designed to tax currently the income of a CFC that is not subpart F income but which is effectively repatriated to the United States in a transaction that is not otherwise taxable.
[29] Code Section 951(a)(1)(B).
[30] Code Section 956(a)(2).
[31] Code Section 956(b)(1).
[32] Code Section 956(b)(1); Treas. Reg. Section 1.956-2(a)(1).

b. Foreign Pledges and Guarantees

Pursuant to Code Section 956(d), a CFC that guarantees an obligation or pledges its assets to secure an obligation of a U.S. person is treated as holding that obligation. The pledge of the stock of the foreign corporation will be deemed an indirect pledge of the assets of the CFC if (i) at least 66 2/3 percent of the total combined voting power of all classes of stock entitled to vote is pledged, and (ii) the pledge of the stock is accompanied by one or more negative covenants or similar restrictions on the shareholder, effectively limiting the corporation's discretion with respect to the disposition of assets.

In effect, following a pledge or a guarantee, a CFC is treated as making an investment in U.S. property. As a result (as discussed above), the U.S. parent or the U.S. shareholders of the CFC may have to include in current income an amount equal to the amount of the obligation guaranteed! It is very important for U.S. borrowers to be aware of the Code Section 956(d) trap.

4. Calculation of the Constructive Dividend

a. General

The constructive dividend rules apply under four fact situations:

(1) The CFC generates subpart F net income for the fiscal year.

(2) The CFC has earnings invested in U.S. property during the year and those earnings have not been previously included in income of the U.S. shareholders.

(3) The CFC has earnings invested in excess passive assets and those earnings have not been previously included in income of the U.S. shareholder.

(4) The U.S. shareholder disposes of their shares in the CFC at a gain while the CFC has earnings not previously taxed to the U.S. shareholder.

Once the CFC income is calculated, the amount of the constructive dividend may be determined.

When calculating the dividend, it must first be determined who is required to take the constructive dividend into income. That issue is important because not all U.S. shareholders are treated as receiving a constructive dividend. Only the U.S. shareholders who own directly or through a foreign entity (i.e., another foreign corporation, a foreign trust, foreign partnership or foreign estate) shares of a CFC are required to take the subpart F income in as a dividend. Thus, one who owns shares constructively is not treated as receiving a dividend.

The other point is that the basic limitation is in earnings and profits. A U.S. shareholder is not to take into income any subpart F income which exceeds the CFC's earnings and profits for the year. That rule means that if the CFC generates subpart F income of $100, after expenses, and a loss of $10 in non-subpart F activities, the amount of the constructive dividend is $90, even if the CFC has a positive earnings and profits account from prior years.

b. Treatment of a Qualified Deficit

The CFC's shareholder, when it calculates the constructive dividend for the year from the CFC, is allowed to reduce the CFC's earnings by the amount of any qualified deficit (deficit in E+P) that relates to the shareholder's shares. To be a qualified deficit, the deficit must:

> (1) have been generated for years beginning after Dec. 31, 1986;
> (2) have been generated during a period the corporation was a CFC; and
> (3) be derived from the same qualified activity as the activity giving rise to the income that is being offset by the deficit.

The forms of income-producing activity that are "qualified activities" are those which create: (i) foreign base company shipping income, (ii) foreign base company oil-related income, (iii) foreign base company sales income; (iv) foreign base company services income, (v) certain kinds of insurance income, and (vi) foreign personal holding company income generated by certain financial institutions.

The deficit provision means that if a CFC is engaged, in years after 1986, in one of the kinds of activities listed and generates a deficit, the shareholder can reduce the amount included in its gross income as a subpart F constructive dividend in one year by a deficit in that same activity in an earlier year.

Planning Note: A U.S. shareholder is required to take constructive dividends into consideration when the shareholder determines its estimated tax payments.[33] The Service has issued a revenue procedure to provide guidance to taxpayers required to calculate estimated tax payments which include constructive CFC distributions.[34]

c. The 30-Day Rule

The U.S. shareholder is only required to take their *pro rata* share of the CFC's subpart F income into gross income if the foreign corporation was a CFC for 30 days or more during the corporation's fiscal year.[35] The 30-day period must be a consecutive period of 30 days, not simply an aggregate of 30 days over the year's span. Thus, the foreign

[33] Code Sections 6654(d)(2)(D), 6655(c)(4)(A).
[34] Rev. Proc. 95-23, 1995-1 C.B. 693.
[35] Code Section 951(a)(1).

corporation could conceivably wander in and out of the status of being a CFC, so that even though the foreign corporation was a CFC for an aggregate of 100 or more days during the year, if it was not a CFC for a full uninterrupted 30-day period, none of the subpart F income which the corporation earned would have to be taken into the U.S. shareholder's gross income.

d. Ownership of Stock by U.S. Shareholders

If a person is a U.S. shareholder at any time during the taxable year of the CFC, the rule is that that shareholder is not required to take any of the CFC's subpart F income into their gross income unless they own at least one share of the corporation's stock at the end of the CFC's fiscal year.

A U.S. shareholder is deemed to own stock of a CFC which the U.S. shareholder's CFC, foreign partnership, foreign trust, or foreign estate owns. Accordingly, the rules regarding timing of stock ownership apply to lower-tier corporations as well as to corporations owned directly by the U.S. shareholders.

A modification of the "last day of the year" rule mentioned above is that the U.S. shareholder picks up their pro rata share of the CFC's subpart earnings as of the date the foreign corporation loses its CFC status.

e. Effect of Distributions to Shareholders

i. Distributions to Others than the Taxpayer-Shareholder

If the CFC made distributions during the year on account of the stock of the CFC to persons other than the taxpayer-shareholder, then the amount which the taxpayer-shareholder is to take into gross income is to be reduced by a proportionate amount of the distribution.

That rule only comes up in years when a shareholder transfers their CFC stock to the taxpayer and before the stock was transferred the transferring shareholder received a dividend on the stock which they later transferred. The amount of the reduction which the taxpayer is allowed to take is the smaller of the actual distribution or the proportion of the CFC's subpart F income which the CFC earned during the period that the predecessor shareholder owned the shares.

ii. Distribution to the Taxpayer-Shareholder

The Code treats actual distributions that relate to the standard subpart F income differently from actual distributions that relate to a constructive distribution arising from either investments in U.S. property or excess passive assets.

Actual distributions from a CFC to a U.S. shareholder may or may not be taxable to the shareholder, depending on a number of factors. One, the taxpayer must determine whether the CFC had any earnings or profits at all, because, just as with any corporation, a distribution by a CFC is a dividend only to the extent of the CFC's earnings.

Two, if the answer to the first inquiry is "yes," then the taxpayer must determine whether the distribution is attributable to earnings that the shareholder has previously taken into income. If the distribution is attributable to earnings that the shareholder has previously taken into income, it is initially treated as excluded from the taxpayer-shareholder's income. The distribution is only initially excluded from income because, before they know that the distributions are actually excluded from income, the shareholder needs to go through one more calculation, described below.

Three, the calculation mentioned above concerns the basis of the CFC's shares in the hands of the shareholder. The shareholder increases the basis of their shares by the amount of any constructive distribution the shareholder takes into income under Code Section 951(a). Conversely, the basis of the shareholder's shares is reduced by the amount of any actual distribution that is excluded from his gross income because the shareholder had a previously taxed income account with the CFC arising from receipt of a constructive dividend.[36] The CFC's earnings and profits (which had not been reduced as a result of the constructive distribution) are reduced by the amount that was distributed and excluded from income.

Finally, any amount that would have been excluded as previously taxed income is taxable nevertheless if and to the extent that the distribution exceeds the shareholder's basis in his CFC shares.

The important point to note from the application of these rules is that a U.S. shareholder may have a taxable distribution even if they have a previously taxed income account balance.

f. Ordering Rules

The ordering rules which apply to CFC constructive distributions are complex. Under the rules, a U.S. shareholder who owns shares of a CFC that has normal subpart F income, an investment in U.S. assets and excess passive assets all in addition to regular, non-subpart F income, has some calculations to complete. As the shareholder makes those calculations, they should bear in mind the overall current year's earnings and profits limitation.[37]

Perhaps the best way to approach the problem is to identify the series of steps that the shareholder needs to take to reach the numerical goal. Briefly, those steps are:

[36] Code Section 961(b)(1).
[37] Code Section 952(c)(1)(A).

(1) determine the CFC's subpart F income as limited by the current year's earnings;
(2) determine the CFC's earnings by taking into account actual distributions and current subpart F income;
(3) determine the CFC's investment in U.S. property; and
(4) determine the CFC's excessive passive assets.

Each step has its own set of substeps to allow the shareholder to reach the proper determination.

<u>Step 1 - Subpart F Income</u>

The first step requires the shareholder to determine the CFC's subpart F income. That means the shareholder must look at the CFC's income to determine how much is foreign personal holding company income, foreign base company income or any one of the other types of subpart F income.

The shareholder then applies the proper deductions to each category and the applicable limitations rules (subpart F income cannot exceed the CFC's earnings for the year, for example), and determines the CFC's overall net earnings from all sources for the year.

<u>Step 2 - Adjustments to Earnings and Profits Account</u>

Substep(a). The object of this first substep is to determine what the CFC's previously taxed subpart F income account is as of the year-end. To do that, take the previously taxed accumulated earnings account and add the current year's subpart F income to that account.

Substep (b). The purpose of this substep is to identify actual distributions made during the year, since distributions reduce the CFC's previously taxed earnings and profits. Actual distributions are deemed to have occurred after inclusion of the current year's subpart F income, although they are taken into account by the U.S. shareholder before they account for any net investment in U.S. assets of the CFC or its excess passive assets.[38]

Distributions act to first reduce earnings attributable to investment of earnings in U.S. property taken into income in prior years, and to excessive passive assets which have previously been taken into income in prior years on a pro rata basis.

Distributions next reduce earnings previously included in income as subpart F income and last, distributions reduce earnings from all other categories.[39]

After those calculations, the U.S. shareholder knows how much remains in each earnings account.

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[38] Code Section 959(f)(2).
[39] Code Section 959(c)(3).

Step 3 - Determine Current Amount Included in Income as U.S. Property

Substep (a). Determine the average amount invested in U.S. assets at the end of each quarter for the current year and reduce that amount by the earnings of the CFC that represent undistributed but previously taxed earnings invested in U.S. property.

Substep (b). Next, determine the amount of the CFC's "applicable earnings," which are calculated by reducing current and accumulated earnings (net of any current year's distributions) by previously taxed earnings attributable to both U.S. property and excess passive assets.[40]

Substep (c). Determine how much is to be included in the U.S. shareholder's income which simply is the excess of (i) the lesser of the amount determined under substep (a) or substep (b) of this Step 3 over (ii) the CFC's current and accumulated earnings attributable to previously taxed subpart F income.[41]

Substep (d). Any amounts treated as previously taxed subpart F income are converted to amounts treated as previously taxed earnings invested in U.S. property to the extent of the amount that would have been included in current income in this Step 3 except that such amount represented previously taxed subpart F income.[42]

Step 4 - Determine Current Amount Included in Income as Excess Passive Assets

The substeps are substantially similar to those set out in Step 3.

5. Sales and Reorganizations of CFCs

a. Generally

A U.S. shareholder who sells or exchanges their shares of CFC stock at a gain is to treat a certain part of the gain as a dividend. The amount of the dividend is the shareholder's pro rata share of the CFC's earnings generated while: (i) the shareholder held the foreign corporation's shares; and (ii) the foreign corporation was a CFC.[43]

The provisions of Code Section 1248 have a series of limitations and special rules including:

> (1) the corporation need not be a CFC at the time of the sale or exchange so long as it was a CFC within the preceding five years;
> (2) only the amount of gain that is recognized is subject to recharacterization as a dividend;

[40] Code Section 956(b)(1).
[41] Code Section 952(c)(1).
[42] Code Section 959(c)(2).
[43] Code Section 1248(a).

(3) the earnings subject to taxation are only those not previously included in income by the U.S. shareholder; and
(4) the amount treated as a dividend carries whatever foreign tax credit is available to the U.S. corporate shareholder.

Generally, the purpose of Code Section 1248 is to tax the CFC's accumulated earnings at full U.S. ordinary income rates when those earnings are repatriated to the United States rather than at preferential long-term capital gains rates.

b. Type of Corporation That Can Generate Code Section 1248 Gain

Generally, a shareholder who sells or disposes of shares of a foreign corporation that is or was, within the preceding five years a controlled foreign corporation is subject to the provisions of Code Section 1248.[44]

Any foreign corporation can trigger the requirement that the shareholder must treat a part of their gain from the sale or exchange of the shares as ordinary income. Note that the corporation need not be a CFC at the time of the sale or exchange. The CFC rules are important under Code Section 1248, however, because the foreign corporation must have been a CFC within the five-year period ending with the sale or exchange generating the gain. If the corporation were not a CFC during that five-year period, Code Section 1248 does not apply to the shareholder's gain.[45]

c. Who Is Taxable

Generally, the only person subject to the provisions of Code Section 1248 is one who (i) disposes of shares of a corporation that is or was during the preceding five years a CFC, and (ii) was a U.S. shareholder of the CFC during that period.[46]

i. Corporations Other Than Insurance Companies

Any U.S. person is subject to the provisions of Code Section 1248, but only if such person was, during the five years ending with the sale or exchange, a U.S. shareholder and the foreign corporation was a CFC for a period of time when the stockholder was a U.S. shareholder. In other words, if, while the U.S. person held stock in the foreign corporation, the foreign corporation becomes a CFC and, while it has that status, the U.S. person becomes a U.S. shareholder, Code Section 1248 will apply.

[44] Code Section 1248(a)(2).
[45] Treas. Reg. Section 1.1248-1(a)(2).
[46] Code Section 1248(a).

"Sale or exchange" as used in Code Section 1248 includes redemption of stock and partial or complete liquidations that are normally taxed at capital gains rates.[47]

Note that the taxpayer must be the direct holder of the stock sold in order for Code Section 1248 to apply. The attribution theory applicable to subpart F income (where the income is treated as earned by the indirect U.S. shareholder of the CFC) does not apply in the Code Section 1248 context. Thus, if a U.S. beneficiary of a foreign trust would have dividend income if they sold the CFC directly, they do not have income if they are a beneficiary and the trust sells the stock until a distribution is issued by the trust.[48]

ii. Insurance Companies

When the U.S. person holds shares of a CFC insurance company, then one of the issues is whether the character of the U.S. person's income is related-person insurance income.[49] The rule applicable to that issue is that the U.S. person is treated as a U.S. shareholder irrespective of what percentage of shares they own if the foreign insurance company is a CFC.

d. When the Shareholder Is Taxable

Generally, a U.S. shareholder of a CFC may be subject to ordinary income treatment (depending on the CFC's earnings) whenever the shareholder disposes of their shares in the CFC through a transaction which generates recognition of gain.[50]

Most nonrecognition transactions are not subject to immediate ordinary income treatment.

i. Application of the General Rule

The touchstone of Code Section 1248 is that the U.S. shareholder engages in some form of transaction pursuant to which they recognize gain. A transaction which, among domestic corporations, would be a tax-free reorganization, may be taxable if conducted with a foreign entity. When gain recognition occurs, the ordinary income provisions of Code Section 1248 come into play.

For example, boot received in an otherwise tax-free incorporation will be treated as ordinary income if it would otherwise have been capital gain when CFC stock is the property transferred to the new corporation.[51]

ii. Nonrecognition Transactions

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[47] Treas. Reg. Section 1.1248-1(b).
[48] Treas. Reg. Section 1.1248-1(a)(1).
[49] Code Section 953(c)(2).
[50] Code Section 1248(a).
[51] Rev. Rul. 75-143, 1975-1 C.B. 275.

Because Code Section 1248 only applies to convert gain from capital to ordinary, it does not apply to nonrecognition transactions. Consequently, the first priority is for the U.S. shareholder to determine if the transaction involving their shares in the CFC is a recognition or a nonrecognition transaction. If it is a nonrecognition transaction, Code Section 1248 does not apply.[52]

e. Earnings and Profits

As with other Code Sections concerning CFCs, the accurate determination of earnings and profits is critical in the context of Code Section 1248 because the amount of the dividend under Code Section 1248 cannot to exceed earnings and profits of the foreign corporation. The burden of proof as to the CFC's earnings and profits is on the taxpayer. If the taxpayer fails to accurately establish earnings and profits, the entire gain on the sale of the stock will be treated as a dividend.[53]

[52] Treas. Reg. Section 1.1248-1(c).
[53] Code Section 1248(h).

B. Passive Foreign Investment Companies

1. General

A passive foreign investment company, commonly known as a PFIC is, with some exceptions, any foreign corporation which meets either of two tests:

> (1) 75 percent or more of the corporation's gross income for the taxable year is passive; or
> (2) 50 percent or more of the corporation's assets are passive assets--that is, assets which do not produce business income.[54]

There are limited exceptions that relate to controlled foreign corporations, start-ups, and passive investment companies. First, a CFC cannot also be a PFIC. Technically, the limitation provides that stock of a CFC held by a U.S. shareholder (that is, one who owns 10 percent or more of the CFC's voting stock) is <u>not</u> to be treated as stock in a PFIC.[55] However, the CFC may still be a PFIC as to shareholders who are not U.S. shareholders--that is, who do not own at least 10 percent of the voting stock of the CFC. Additionally, if a foreign corporation qualifies as both a FPHC and a PFIC, then the U.S. shareholder of the foreign corporation will be taxable under the FPHC rules only.[56]

Second, PFIC rules do not apply to start-up corporations. A start-up will not be treated as a PFIC in the first year it has gross income if the corporation is not a PFIC in the next two succeeding years.[57]

a. Once a PFIC, Always a PFIC

Code Section 1298(b)(1) contains a rule which has come to be known as the "once a PFIC, always a PFIC" rule. Under that rule, stock which was at any time treated as PFIC stock (unless the corporation was a qualified electing fund) remains PFIC stock. The shareholder may elect out of that rule by recognizing gain. The gain to be recognized must equal what the shareholder would have recognized had the shareholder sold the PFIC stock on the last day of the year in which the stock was PFIC stock; that is, on the last day of the year just before the corporation was no longer a PFIC.

For an exception to this rule, see discussion of "pedigreed QEFs" below.

b. Passive Income

i. General

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[54] Code Sections 1297(a)(1) and (2).
[55] Code Sections 951(f) and 1297(e).
[56] Code Section 551(g).
[57] Code Section 1298(b)(2).

"Passive income" is defined as any income which is of a type which would be foreign personal holding company income as defined in Code Section 954(c).[58] That includes interest (including otherwise tax-exempt interest), dividends, rents, royalties, and annuities, as well as gain from the disposition of assets which generate any one of those types of income or do not generate income at all.

Not all rents are passive income; those received from a related party under certain conditions and those derived from the active conduct of a business are not passive.

Similarly, royalties derived from an active business are not passive.

Practitioners should be aware that a foreign corporation may become a PFIC accidentally. That result may occur because gross income is not gross receipts; rather, gross income of a sales organization is gross receipts less cost of goods sold plus other income.[59] As a result, a manufacturing corporation that generates gross receipts but not gross income (because its cost of goods sold exceeded its receipts) but which has a small amount of passive income (*e.g.*, interest on a bank account) will inadvertently become a PFIC.

Similarly, a service company (such as an engineering corporation) which does not earn income during the start-up phase of a large project may find itself in the PFIC category.

ii. Exceptions to the "Passive Asset" Category

The PFIC rules contain certain exceptions to the passive asset definition.[60] First, passive income does not include income derived from the active conduct of a banking business in the United States or income earned by a foreign corporation from the active conduct of a foreign banking business if the corporation meets three tests:

> (1) the banking test under which the corporation must conduct an active banking business;
> (2) the gross income test under which the foreign corporation must derive 60 (or more) percent of its gross income from the banking business; and
> (3) the licensing requirement under which the foreign corporation must be licensed by the jurisdiction in which it conducts its principal business.

Second, passive income does not include income derived from the active conduct of an insurance business by an insurance company.

Third, passive income does not include interest, dividends, rent or royalty income derived from a related person to the extent the income is not passive income in the hands of the related person.

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[58] Code Section 1297(b)(1).
[59] Treas. Reg. Section 1.61-3(a).
[60] Code Section 1297(b)(2)(A).

c. Asset Test

In addition to the passive income test, a foreign corporation will become a PFIC if its assets meet the 50-percent passive test.[61] Specifically, a foreign corporation will be a PFIC if 50 percent of its assets produce or are held with a view to producing passive income. The usual manner employed to determine the value of the assets used to make the asset calculation is the fair market value of those assets. The assets of a controlled foreign corporation, however, are to be valued at their adjusted bases, not value.

The Service issued a notice[62] that contains a number of rules which the taxpayer is to use in applying the asset test. The main rules are:

> (1) The asset test (for non-CFCs) is generally to be made on the basis of the fair market value of the corporation's assets averaged over the year. Value is to be determined at the end of each fiscal quarter.
> (2) The PFIC may elect to value assets at their book value. Once the election is made, it can only be revoked with the Secretary's consent.
> (3) Assets are to be valued on a gross basis; that is, liabilities are to be disregarded.
> (4) Assets which generate both active business income and passive income are to be treated as part passive assets and part nonpassive assets depending on the income generated by each part.
> (5) Intangible assets are included in the calculation of assets. Leased property, R&D expenses and licensed intangibles have specific rules.

2. Various Types of PFICs

a. Qualified Electing Fund

A qualified electing fund ("QEF") is, as to the electing shareholder, a PFIC that has made the proper QEF election, the result of which is that the U.S. shareholder is taxed currently on the PFIC's earnings.[63]

b. Pedigreed QEF

Classification as a "pedigreed QEF" (a phrase coined by the drafters of the Treasury Regulations) is determined from the shareholder's standpoint--that is, a PFIC can be a pedigreed QEF as to one shareholder but not another. Within that context, a pedigreed QEF is either (i) a PFIC that has been, as to the shareholder, a QEF during the shareholder's holding period of the PFIC stock commencing with the day the foreign

[61] Code Section 1297(a)(2).
[62] Notice 88-22, 1988-1 C.B. 489.
[63] Treas. Reg. Section 1.1291-9(j)(2)(i).

corporation became a PFIC, or (ii) makes the deemed sale election (at times, referred to as the "purging election").[64]

The Treasury Regulations discuss various ways to calculate a holding period, but basically, the holding period begins on the date the shareholder purchased the stock or on the "qualification date." The qualification date is the first day of the PFIC's first taxable year in which it is a QEF.[65]

A PFIC that is a pedigreed QEF has a number of advantages over other PFICs. The most significant is that the so-called "once a PFIC, always a PFIC" rule does not apply. The result is that a pedigreed QEF is not treated as a PFIC for any year that it does not meet the qualifications for a PFIC (i.e., the asset or income tests), whereas other PFICs will be treated as such even if they fail to qualify in a later year.

The income tax impact on the pedigreed QEF shareholder is rather straightforward--the shareholder includes in gross income each year their pro rata share of the ordinary earnings and net capital gains of the PFIC. As with a CFC, the shareholder includes the PFIC's income for the year that ends with or within the shareholder's year.

Note that the requirement covers all of the PFIC's income. Unlike the CFC rules, income is not divided into passive and active categories. Once the PFIC's QEF status is established the shareholder reflects in income their pro rata share of all of the PFIC's income for the year.

The QEF status is elected by a shareholder, and the same foreign corporation may be a QEF PFIC as to one U.S. stockholder and a non-QEF PFIC as to another.

A shareholder who has elected QEF status follows the general rules familiar to U.S. shareholders of CFCs. Specifically, the QEF shareholder takes into income his pro rata share of the PFIC's ordinary earnings; constructive distributions from earnings invested in (i) U.S. property and (ii) excess passive assets; and the PFIC's net long-term capital gain as a capital gain.[66]

Another possible election for the shareholder is the mark-to-market election under Code Section 1296. The mark-to-market election allows the shareholder to report and be taxed on any year-to-year increases in the value of the securities owned by the PFIC.

c. Unpedigreed QEF

An unpedigreed QEF is a PFIC that, as to the shareholder, is currently a QEF but was not always one during the period that the shareholder held the shares and the corporation was

[64] Treas. Reg. Section 1.1291-10.
[65] Treas. Reg. Section 1.1291-9(e)(1).
[66] Code Section 1298.

a PFIC.[67] The shareholder can elect to purge the non-QEF status of the PFIC if he wishes to, the result of which is to convert the QEF to a pedigreed QEF. The shareholder may purge the non-QEF status by making the "deemed sale election" under Code Section 1291(d)(2)(A). While the PFIC, with respect to the electing shareholder, will become a pedigreed QEF, the shareholder will be treated as having sold, for its fair market value, the stock of the PFIC. The gain recognized on the deemed sale will be taxed under Code Section 1291 as an excess distribution.[68]

The shareholder of an unpedigreed QEF takes their pro rata share of the QEF's income into their income as does the pedigreed shareholder. The difference between the two types of QEF shareholders is that the "once a PFIC, always a PFIC" rule applies to the shareholder of an unpedigreed QEF.

3. Identifying a Shareholder of a PFIC

A shareholder of a PFIC is any U.S. person that owns the stock of the PFIC either directly or indirectly.

Attribution is designed to find the first U.S. person in the chain of ownership, directly or indirectly, and then stop. In other words, PFIC shares are not attributed from one U.S. person to another person, foreign or domestic.

4. Taxation of Distributions from a PFIC

As a general rule, taxation of a PFIC shareholder depends on various factors, the most important of which is the PFIC's status or nonstatus as a QEF. The shareholder of a QEF is required to take their share of the PFIC's ordinary income into their own income as a constructive dividend.[69] Otherwise, the shareholder is to pay penalty interest on any excess distribution.[70]

a. Constructive Distributions by a QEF

A shareholder who has elected QEF status follows the general rules familiar to U.S. shareholders of CFCs. Specifically, the QEF shareholder takes into income their pro rata share of the PFIC's ordinary earnings; constructive distributions from earnings invested in (i) U.S. property and (ii) excess passive assets; and the PFIC's net long-term capital gain as a capital gain.[71]

The years when the shareholder is to take those amounts into income turns on whether the shares of the PFIC, as to the shareholder, are pedigreed or unpedigreed shares. If the shares are pedigreed income, then the shareholder reflects the PFIC's income in their own

[67] Treas. Reg. Section 1.1291-9(j)(2)(iii).
[68] Treas. Reg. Section 1.1291-10(a).
[69] Code Section 1293(a)(1).
[70] Code Section 1291(a)(1).
[71] Code Section 1298.

income only for the years that the corporation qualified as a PFIC under the statutory rules.[72]

The shareholder of an unpedigreed QEF, however, continues to take into income the corporation's ordinary earnings and capital gain so long as the shareholder holds the PFIC's shares, regardless of whether the corporation meets the income and asset tests.[73]

Once an amount is constructively taken into income, the shareholder is allowed to receive later distributions free of tax. As with the CFC, the constructive distribution does not lower the PFIC's earnings and profits but an actual distribution will. An exception to that rule is that a distribution by a PFIC that is also a CFC as to the U.S. shareholder is not to be excluded under the PFIC previously excluded income rule. To complete the circle, an inclusion in the U.S. shareholder's income under the PFIC rules is treated as if the income were included in the U.S. shareholder's income as subpart F income.

A constructive distribution does, however, increase the shareholder's basis in his PFIC stock, followed by a reduction of that basis when an actual distribution is issued. That step-up in basis is particularly important to an unpedigreed QEF because the gain on disposition of the stock of that type of PFIC is treated as an excess distribution.

b. Distributions by a Nonqualified Fund

The key to understanding the rules relating to distributions by nonqualified funds (that is, non-QEFs) is understanding the meaning of "excess distribution," because a shareholder pays a penalty tax on an excess distribution. The penalty tax is called an interest charge, calculated as if the excess distribution had been paid ratably over the period the shareholder held the PFIC's stock, but the tax due on those ratable payments had not been paid.[74]

Bearing in mind that only the excess portion of a distribution is subject to the interest charge, the taxpayer needs to know how that amount is calculated. The excess part of a distribution is calculated on a share-by-share basis to deal with those taxpayers who may have acquired their shares at different times. For any given share, the excess portion is the amount of a distribution received by the taxpayer, on account of that share, that exceeds 125 percent of the average amount of distributions made during the three years of the shareholder's holding period that immediately preceded the distribution year.[75]

Bearing in mind that the excess distribution is spread evenly over the shareholder's holding period, the rules for calculating the tax on the excess distribution are as follows:

> (1) Determine the shareholder's holding period for each share of stock of the PFIC. The holding period generally begins with the date the shareholder acquires

[72] Prop. Treas. Reg. Section 1.1293-1(a).
[73] Prop. Treas. Reg. Section 1.1293-1(a).
[74] Code Section 1291(a)(1).
[75] Prop. Treas. Reg. Section 1.1291-2(c)(3)(i).

the foreign corporation's shares (directly or indirectly) irrespective of whether the foreign corporation was then a PFIC.

(2) Divide the excess distribution by the number of days in the holding period.

(3) Determine the amount of the excess distribution that relates to both pre-PFIC days and the current year days of the holding period. Those amounts are excluded from the excess distribution and taxed as ordinary income.

(4) The remaining portions of the excess distribution are subject to a deferred tax. The deferred tax is calculated on a year-by-year basis so that the portion of the excess distribution attributable to a given year is taxed at the highest rate applicable during that year. Those taxes are aggregated and then reduced by any applicable foreign tax credits.

(5) After the total tax is calculated the interest charge (the underpayment rate under Code Section 6601) is calculated and added to the tax due. The interest is calculated as if the tax for prior years had been due for that year. The interest is also calculated on a year-by-year basis and then aggregated.

5. Disposition of PFIC Stock

All gain realized from the disposition of non-QEF PFIC stock is treated as an excess distribution unless the disposition results from a nonrecognition transaction.[76]

C. Foreign Tax Credit

The foreign tax credit is the taxpayer's primary defense against double taxation of the same items of income, once by the foreign jurisdiction and once by the United States. Virtually all developed nations have similar statutes.

1. Direct Credit

a. General

Code Section 901 authorizes taxpayers who pay foreign income, war profits, or excess profits taxes to a foreign country to elect a direct credit or a deduction for foreign taxes paid. The decision as to whether to credit or deduct foreign income taxes is to be made each year. Although it is generally accepted that a tax credit is far superior to a deduction in the normal situation, it often requires an example to bring into focus the difference in result between the use of a credit and the use of a deduction.

[76] Code Section 1291(a)(2).

Example: Assume a U.S. taxpayer has total taxable income of $100,000, all of which is derived from France. Assume further that the overall tax rate in France is 50 percent and that the tax rate in the United States is likewise 50 percent. Without a tax credit, but allowing the taxpayer a deduction for foreign taxes paid, the effective rate of tax, on the above facts, is 75 percent, calculated as follows:

	Net Taxable Income	Tax	Net Income After Tax
France	$ 100,000	$ 50,000	$ 50,000
United States	50,000	25,000	25,000

Because the taxpayer is a U.S. taxpayer, the taxable income for U.S. purposes is net taxable income, less the deduction allowed for the foreign taxes paid. If, however, the taxpayer chose to credit the French tax, the result (a 50 percent effective tax rate) is as follows:

	Net Taxable Income	Tax	Credit	Net Income After Tax
France	$ 100,000	$ 50,000	0	$ 50,000
United States	100,000	50,000	50,000	50,000

In addition to the election to take the credit or deduct the tax, the cash basis taxpayer has the election to treat foreign taxes as if the taxpayer were utilizing the accrual method of accounting. That election is necessary in order to allow the credit to have significance to cash basis taxpayers who have uneven years of income and foreign taxes, and who might otherwise lose the foreign tax credit. Unlike the election to credit rather than deduct, the election to accrue, once made, is binding for subsequent years.

While there are strict limitations on the amount of credit allowed, within the scope of those limitation provisions, the taxpayers are allowed to reduce their federal income tax, dollar for dollar.

To be creditable against federal income taxes, the levy--that is, the foreign payment--must be an income tax within the general definition of that phrase under U.S. law.[77]

The levy must also be a tax, as distinguished from a fee, a fine or other payment to a foreign governmental agency. A payment in exchange for a specific economic benefit is not a tax, nor is a subsidy a tax.

Once the levy is determined to be a “tax,” the issue is whether the tax is an “income” tax. Only if the predominant character of the tax is an income tax will the tax be creditable. To qualify, the tax (except for withholding taxes on passive income) must be imposed on “net gain,” which the taxpayer is to determine by applying the basic U.S. standards of realization, gross receipts and net income.

[77] Treas. Reg. Section 1.901-2(a)(1).

The foreign tax credit applies against only federal income taxes.[78] A host of various federal taxes are not reduced by the credit, including self-employment taxes and excise taxes. The alternative minimum tax carries its own version of the foreign tax credit, although the credit is limited to 90 percent of the foreign taxes paid or accrued in the alternative minimum tax context.[79]

b. The Basket Concept

Although the foreign tax credit is a credit against tax, it has certain limitations. Additionally, foreign taxes are allocated to what have been called "baskets." Currently the Code contains two separate baskets (10 baskets prior to AJCA 2004), one for passive income and one for all other.

The result of the basket rule is that an excess foreign tax credit in one basket cannot be used to absorb U.S. income tax payable on income falling within a different basket.

For example, if a corporation earns passive income (*e.g.*, interest) from a low-tax jurisdiction but generates operating profit in a high-tax jurisdiction, the excess foreign tax credit in the high-tax jurisdiction cannot be used to shelter the passive income.

2. Deemed-Paid Credit

Pursuant to the Deemed-Paid credit, a domestic corporate shareholder (under Code Section 902, only a corporate shareholder is entitled to the deemed-paid tax credit), upon the receipt of dividends from a foreign corporation in which the domestic corporation owns a certain amount of stock, is allowed to credit the foreign taxes paid by that foreign corporation that relate to the dividend.[80]

Under Code Section 902, the domestic corporate shareholder may take a credit against domestic income tax for the foreign income, war profits, and excess profits taxes which have been paid by the foreign subsidiary corporation if certain conditions are met. Those conditions are that:

> (1) the domestic corporate shareholder own 10 percent or more of the voting stock of the foreign corporation;
> (2) the foreign subsidiary's earnings and profits resulted from operations subject to the foreign country's or countries' income tax; and

[78] Code Section 901(a).
[79] Code Section 59(a)(2).
[80] The reasoning being that it should be no more or less advantageous to operate overseas through a subsidiary than it is through a branch. Since the domestic corporation operating as a branch would have been entitled to a direct foreign tax credit for the foreign income taxes the parent paid on the branch income, equalization between the branch and the subsidiary can be achieved only if the parent is entitled to a credit for the foreign income taxes paid by the subsidiary, i.e., only if the parent is deemed to have paid the subsidiary's tax.

(3) some or all of those earnings and profits be distributed to the domestic corporate shareholder as a dividend.

The amount of the foreign tax credit is determined by application of a formula to certain facts. When applied, the formula relates the amount of the credit to the percentage of the subsidiary's stock which the parent holds, the percentage of the subsidiary's earnings and profits which are included in the dividend, and the amount of the foreign tax paid on the earnings and profits actually distributed as a dividend in the taxable year by the foreign subsidiary. The domestic parent cannot take a deemed-paid tax credit until the first-tier foreign subsidiary (a subsidiary for this purpose including 10 percent or more voting stock ownership) issues an actual or constructive dividend.

3. Limitations

a. General

The overall limitation applicable to the foreign tax credit is that the taxpayer cannot take a foreign tax credit in excess of the statutory limit no matter how much in foreign taxes may be paid.

The foreign tax credit limitation has two distinct conceptual parts. One part requires the taxpayer to allocate the foreign taxes paid into various baskets (discussed above); the other part requires the taxpayer to apply the "overall limitation" to each basket so that the credit available cannot exceed that limitation in any basket.

The basic idea of the limitation provisions is that the amount of the foreign tax credit otherwise available to a taxpayer in any year is not to exceed a certain amount. That maximum figure is calculated in each case by merely applying the formula set forth in Code Section 904. The formula is based upon the proposition that the foreign tax credit for any year should not be greater than the United States tax on the foreign source income that generated the foreign tax.

<u>Example</u>: A corporation earns $100,000 of general limitation basket taxable income in France and in that same year has $200,000 of total income taxable by the United States, including the foreign income. The taxpayer pays $55,000 of income taxes to France (55 percent tax rate) and incurs a pre-credit liability of $70,000 for federal income taxes (35 percent tax rate). Under the limitation provisions of Code Section 904(a), the foreign taxes that may be credited in any one year are not to exceed the amount that keeps the proportion of foreign taxes to total taxes equal to the foreign taxable income/total taxable income ratio. Thus, in our example, since the ratio of taxable income from France to the total taxable income is one to two, the allowable credit for foreign taxes must maintain that same ratio with federal income taxes. The maximum tax credit in this example then, is $35,000. Put differently, the amount of the foreign tax credit may not exceed the product of the foreign source income and the U.S. tax rate.

b. Recapture of Losses

In those cases where overall foreign losses exceed foreign income, U.S. tax on U.S. source income will generally be reduced. The Code requires recapture of the tax benefit that was derived from the deduction of net foreign losses against U.S. income. The method of recapture treats a portion of the foreign income in the subsequent year as income from domestic sources. The amount of foreign income treated as U.S. source income in the subsequent profitable year is limited to the lesser of:

(1) the amount of the unrecaptured loss; or
(2) 50 percent of the foreign taxable income for the profitable year; or
(3) such larger amount as the taxpayer chooses.

In any profitable year, therefore, the amount subject to recapture does not exceed 50 percent of the foreign income unless the taxpayer chooses to recharacterize a greater percentage.

Some items do not enter into the computation of a foreign loss. Those items are:

(1) the net operating loss deduction under Code Section 172(a);
(2) any capital loss carryback or carryover under Code Section 1212;
(3) foreign expropriation losses; or
(4) an uninsured loss which arises from fire, storm, shipwreck, other casualty or theft.

Recapture of an earlier loss may also occur where property which was used in a trade or business and was used predominantly outside the United States (during a three-year test period or such shorter period if the taxpayer was not in existence for three years) is disposed of before the loss has been recaptured. This accelerated recapture applies whether or not gain is otherwise recognized in the transaction. Recapture does not take place, however, if a disposition happens to be a transfer of property to a domestic corporation in a distribution or transfer which has carryover attributes under Code Section 381(a). The gain that must be recognized is the excess of the fair market value of the property disposed of over the adjusted basis in the property, limited to the amount of the foreign losses that have not as yet been recaptured. This type of recapture results in 100 percent of the gain being recaptured, as opposed to the preceding 50 percent limitation. To add even more complexity to the rules, a disposition because of a transfer of property is only taken into consideration if the property is, was, or will be, a material factor in the realization of income.

c. Capital Gains

The taxpayer is required to net U.S. and foreign long-term and short-term capital gains and only “foreign source capital gain net income” is included in the formula for foreign source income. “Foreign source capital gain net income” means the lower of:

(1) capital gain net income from sources outside the United States; or
(2) capital gain net income.

Under the rules, the foreign capital gain can be used to increase the amount of foreign tax credit only to the extent that the foreign capital gain results in foreign source capital gain net income. Another adjustment that is required is that the foreign source capital gain net income which is taken into consideration is to be reduced by a fraction in which the numerator is the maximum corporate rate of tax reduced by the capital gains rate for corporations, and the denominator is the corporate rate. Thus, if the rates are 46 (ordinary income) and 28 (capital gains for corporations), as they were prior to the Tax Reform Act of 1986, then the formula would be (46-28)/46 multiplied by the foreign source capital gain. If the rate for ordinary income for corporations is the same as it is for capital gains (as was the case for a short time after the Tax Reform Act of 1986), the formula is 1/1.

D. Foreign Trusts

1. Introduction

No discussion of foreign taxation would be complete without even at least a mention of offshore trusts, and their treatment for U.S. tax purposes.

Offshore trusts are primarily formed for asset protection purposes or pre-immigration tax planning. An offshore trust, for U.S. tax purposes, may be treated either as a foreign trust or a domestic trust.

If an offshore trust is deemed to be a foreign trust for U.S. tax purposes, any transfer of appreciated property to the trust will be subject to taxation on the transfer, and be subject to substantially increased reporting requirements.[81]

If an offshore trust is deemed to be a grantor trust for U.S. tax purposes (usually because the trust has a U.S. beneficiary), then the grantor of the trust will remain liable for U.S. income taxes attributable to the income generated by the offshore trust.[82]

Consequently, while an offshore trust may be a great asset protection tool, it cannot be used by a U.S. grantor to shelter income from U.S. taxes.

Practitioners should keep in mind that the common denomination of a trust sited offshore as a foreign trust is not relevant in determining the trust's tax consequences. The only relevance is whether the trust is foreign or domestic for U.S. tax purposes. Thus, only because a trust is sited in Belize does not mean that the trust is a foreign trust for U.S. tax purposes. To the contrary, because of the potentially disastrous tax results of having a

[81] Code Sections 684 and 6048.
[82] Code Sections 673-677.

foreign trust for tax purposes, practitioners often take steps necessary to ensure that a foreign asset protection trust is a domestic trust for tax purposes.

2. Foreign or Domestic

Code Section 7701(a)(30)(E) provides that the term "United States person" means any trust if (a) a court within the U.S. is able to exercise primary supervision of the administration of the trust (the "Court Test"), and (b) one or more U.S. persons have the authority to control all substantial decisions of the trust (the "Control Test"). A trust will be treated as a U.S. person on any day that the trust meets both the Court Test and the Control Test. A foreign trust is any trust other than one described in Code Section 7701(a)(30)(E).

a. Court Test

To meet the Court Test, any U.S. court must have authority under applicable law to render orders or judgments resolving issues concerning the administration of the trust. Primary supervision means that a court has or would have authority to determine substantially all issues regarding the administration of the entire trust.

If both a U.S. court and a foreign court can exercise primary supervision, the trust meets the Court Test.

A trust will fail the court test if it has a migration provision which kicks in when a U.S. court attempts to exercise jurisdiction.

b. Control Test

A trust will meet the control test if one or more U.S. persons have authority to control all substantial decisions of the trust. Substantial decisions include: deciding whether to distribute income or corpus, amounts of distributions, selection of beneficiary, decision to terminate trust, replace or remove trustee, and appointment of successor trustee.

In the event of an inadvertent change in any person that has the power to make substantial decisions that would cause the domestic or foreign residency of the trust to change for tax purposes, the trust is allowed 12 months from the date of the change to substitute a new person and avoid a change in residency. A change of the trust's status from domestic to foreign will be treated as a deemed sale of the assets of the domestic trust to the "new" foreign trust.

E. The IC-DISC

Tax law loves a good acronym, and sometimes for a good reason. It is much easier to say "IC-DISC" than an "interest charge – domestic international sales corporation." An IC-DISC is the least talked about and the most potent of all tax shelters, if you happen to be an exporter.

To promote the growth of U.S. exports, beginning in the 1970s, U.S. Congress introduced various tax incentives. Chronologically, these included DISCs, foreign sales corporations and the extraterritorial income exclusion. All were challenged by the U.S. trading partners under the General Agreement on Tariffs and Trade, and more recently by the World Trade Organization. The IC-DISC is sole survivor.

An IC-DISC is a U.S. corporation that exists and functions entirely on paper. It is either a subsidiary or a sister company of a U.S. exporter, to which the exporter either pays a commission or sells its products (which are then exported by the IC-DISC). Usually it is the U.S. exporter that enters into contracts with its customers, arranges for shipment, billing and collections. The U.S. exporter's business partners need not be aware of the IC-DISC's existence.

The IC-DISC rules allow an exporter to either (1) convert ordinary income into a qualifying dividend, or (2) indefinitely defer U.S. income taxation on 50% of its net income from the first $10 million in foreign sales. It is a very significant tax benefit and is available to any business that exports: movie producers, software developers, architects and engineers, and manufacturers of every stripe.

IC-DISC Qualification

To qualify as an IC-DISC a U.S. corporation must meet the following requirements:

(1) is duly incorporated and existing under the laws of any U.S. state,
(2) 95 percent or more of the corporation's gross receipts consist of qualified export receipts (as defined in Code Section 993(a)(1) and addressed in more detail below),
(3) the adjusted basis of the corporation's qualified export assets (as defined in Code Section 993(b) and addressed in more detail below) at the close of the taxable year equals or exceeds 95 percent of the sum of the adjusted basis of all assets of the corporation at the close of the taxable year,
(4) the corporation does not have more than one class of stock and the par or stated value of its outstanding stock is at least $2,500 on each day of the taxable year,
(5) makes an election within 90 days of the first tax year to be treated as a DISC by filing IRS Form 4876-A and receiving consent of all shareholders (an existing corporation must elect within 90 days prior to the start of the new tax year),
(6) maintains separate books and records,

(7) is an eligible corporation (tax exempts, S corporations and certain other corporations cannot be DISCs), and
(8) is not in the same control group as a foreign sales corporation.[83]

Qualified export receipts are defined in Code Section 993(a)(1) to include receipts and services related to such receipts from the sale, exchange, lease or rent of export property. Services related to the sale, exchange, lease or rent of export property may include warranty, maintenance, repair and transportation. Qualified export receipts do not include receipts and related services from the sale, exchange, lease or rent for ultimate use in the U.S.[84]

Export property means property (1) manufactured, produced, grown or extracted in the U.S. by someone other than the IC-DISC, (2) sold, leased, rented in the ordinary course of business outside the U.S. (will be deemed satisfied if delivered to a carrier or freight forwarded for shipment outside the U.S.), and (3) having at least 50% U.S. content.[85] With the exception of copyrights used in the motion picture or recording industries, export property does not include intellectual property of any kind.[86]

Qualified export assets must be documented in the IC-DISC application and must include assets used primarily in connection with the sale, lease, rental, storage, handling, transportation, packaging, assembly, or servicing of export property, and certain accounts receivable, bank accounts, producer's loans (loan by the DISC of its accumulated tax deferred profits to its U.S. parent manufacturing company), and obligations.[87]

If a corporation fails to qualify as a DISC because it does not meet the 95% gross receipt test or the 95% export assets test, it can still qualify by distributing to its shareholders all of its gross receipts which are not qualified, and/or all of the assets which are not qualified.[88]

IC-DISC Structure and Tax Benefits

An IC-DISC is a U.S.-based corporation that has not made an "S" election (it cannot be an LLC that elects to be taxed as a corporation). While a "C" corporation is subject to a corporate level tax, an IC-DISC is exempt from federal income tax.[89] State taxation is less certain, with approximately half of the states following the federal tax treatment and the remainder taxing IC-DISCs. As a practical matter the IC-DISC corporation is often organized in Delaware or another state that does not tax income.

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[83] Code Section 992 and Treas. Reg. Sections 1.992-1 and 2. All Code references are to the Internal Revenue Code of 1984 as set forth in Title 26 of the United States Code.
[84] Code Section 993(a)(2).
[85] Code Section 993(c)(1).
[86] Code Section 993(c)(2).
[87] Code Section 993(b).
[88] Code Section 992(c).
[89] Code Section 991.

Following organization the corporation (1) files IRS Form 4876-A within the time prescribed in the Code, (2) enters into a commission agreement with the U.S. exporter (the agreement will outline the services to be performed by the IC-DISC for the sale of export property), (3) opens a bank account with a minimum capital contribution of $2,500, (4) maintains its own books and records to track commission payments, and (5) annually file IRS Form 1120-IC DISC and any required state income tax returns.

The IC-DISC is effectively a transfer pricing regime - income is transferred from the U.S. exporter to the IC-DISC by allowing the exporter to deduct the commission paid.[90] The income is transferred either by paying the IC-DISC a commission for its services, or by selling products to IC-DISC which it then exports. Even though all transactions with IC-DISCs have no substance, the distinction between the payment of commission and the resale of products is not purely semantic. A commission DISC is protected by the safe-harbor rules of Code Section 994 (see below), while a buy/sell DISC must satisfy the transfer pricing rules of Code Section 482.

To qualify for the safe-harbor of Code Section 994, the commission cannot be greater than: (1) four percent of IC-DISC's qualified export receipts on reselling the property,[91] plus 10% of its export promotion expenses, or (2) fifty percent of the combined taxable income from export sales of the exporter and the IC-DISC, plus 10% of IC-DISC's export promotion expenses.[92] N.B. It is 4% of up to $10 million in export sales (always $400,000) or 50% of taxable income generated on the first $10 million in export sales (this varies based on profitability), which are two very different measures.

The ownership of an IC-DISC is not restricted and there is no limitation on the number of IC-DISCs that may be formed. It may be a subsidiary of the exporter, may have common shareholders or may have one of the more advanced ownership structures discussed below. The exporter itself maybe a C or an S corporation, an LLC taxed in any form, or an individual. S corporations, partnerships and disregarded entities are often used as shareholders of IC-DISCs to allow for flow through income tax treatment of dividend distributions by IC-DISCs.

As noted above, the IC-DISC is exempt from tax, and tax on its income is deferred to the extent not distributed to the shareholders. The tax may be deferred only on the first $10 million of qualified export receipts.[93] When qualified export receipts exceed $10 million, shareholders are taxed on a deemed dividend from the IC-DISC at the preferential dividend rate.[94] The shareholders pay an annual interest charge (at the one-year Treasury constant maturity yield (which is 0.11% as of the moment of this writing)) on the tax deferred.[95] The interest charge is computed on IRS Form 8404.

[90] Code Section 994 and Treas. Reg. Section 1.994-1(a).
[91] The 4% method may be calculated using the marginal costing method to determine the profit from the sale of export property. The marginal costing method takes into account only the direct labor and material costs of production, resulting in a higher profit. Treas. Reg. Section 1.994-2(a).
[92] Code Section 994(a).
[93] Code Section 995(b)(1)(E).
[94] Code Section 995(b)(1)(E).
[95] Code Section 995(f)(1).

If the IC-DISC distributes its income currently shareholders are taxed at the preferential 20% qualifying dividend tax rate.[96] Thus, even without a deferral, the use of an IC-DISC structure allows the exporter to deduct commission paid to an IC-DISC at its ordinary income tax rate (currently 39.6 for individuals and 35% for corporations), and then tax the same commission amount to the shareholders at the 20% tax rate.

If the shareholder of the IC-DISC is located in a favorable tax treaty country than the dividend may be either significantly reduced or eliminated entirely.

Advanced Planning

The benefits of IC-DISCs are not limited to reducing the exporter's income tax liability. Assume that the IC-DISC is owned by an irrevocable trust settled by the owner of the exporter for the benefit of his children. Now each commission payment to the IC-DISC not only generates an income tax deduction for the exporter, but it also transfers wealth to the younger generation and retains the wealth inside of an irrevocable trust, protected from the claims of creditors.

The IC-DISC Planning Example

Jerry and Elaine manufacture and distribute breakfast cereal. In 2014 their sales were $14 million, of which $10 million (conveniently) were attributed to sales in Europe and the remainder in the U.S. Their net income was $3.5 million, with $2.4 million attributable to Europe. Jerry and Elaine form a Delaware corporation, transfer ownership to an irrevocable trust and name their child Cosmo as the trust beneficiary. The trust makes an IC-DISC election for the Delaware corporation and has the corporation enter into a commission agreement with Jerry and Elaine.

The commission that Jerry and Elaine can pay to the IC-DISC is the greater of $400,000 (4% of foreign sales), or $1.2 million (50% of net income attributable to foreign sales). Each year they deduct $1.2 million (at 39.6% tax rate their economic benefit is $475,200) and transfer the same amount out of their estate. If IC-DISC retains the $1.2 million, a nominal interest charge is paid. If the IC-DISC dividends out the $1.2 million, Cosmo pays a 20% tax on dividends received - which is $240,000 (assume trust currently distributes all of its income). Even with a current dividend and no deferral, Jerry and Elaine achieve an income tax arbitrage of $235,200 per year. An admirable result.

[96] Treas. Reg. Section 1.995-1(a)(2).

II. Inbound Taxation

The following rules of inbound taxation deal with the U.S. federal taxation of nonresident aliens. A nonresident alien is an individual who is neither a citizen nor a resident of the U.S., and is therefore not a U.S. taxpayer under Code Section 7701.

A. Transfer Taxes that Apply to Nonresident Aliens

1. Estate Tax

Nonresident aliens are not subject to the same U.S. estate taxes as U.S. citizens or residents. Estate tax is applied to nonresident aliens under Chapter 11, Subchapter B of the Code.

The estate tax is imposed by Code Section 2101 on that part of the gross estate of the nonresident alien which at the time of death is situated in the U.S.[97] The rate of the estate tax is the same that is used for general estate tax purposes under Code Section 2001, but the unified credit is only $13,000 (equivalent to about $60,000 of property value).[98] The estate tax form used by a nonresident alien is 706NA. These harsh rules may be ameliorated by an estate tax treaty. The U.S. does not maintain as many estate tax treaties as income tax treaties, but there are estate tax treaties in place with most Western European countries, Australia and Japan.

The following are specifically included by the Code in the definition of property situated in the U.S.: (i) shares of stock of a U.S. corporation, (ii) revocable transfers or transfers within three years of death of U.S. property or transfers with a retained interest (described in Code Sections 2035 to 2038), and (iii) debt issued by a U.S. person or a governmental entity within the U.S. (like municipal bonds).[99]

The Treasury Regulations add the following property to the list of property in the U.S.: (i) real estate in the U.S. (if debt is recourse it is ignored – gross value is included, not just equity) and (ii) tangible personal property, like works of art, furniture, cars (and even currency in a safety deposit box).[100]

A beneficial interest in a trust holding U.S. property is also included.[101]

The following are specifically excluded from the definition of property situated in the U.S.: (i) life insurance proceeds paid on the life of the nonresident alien, (ii) bank accounts (unless they are connected to a U.S. business, and (iii) portfolio interest loans.[102]

[97] Code Section 2103.
[98] Code Section 2102(b)(1).
[99] Code Section 2104.
[100] Treas. Reg. Section 20.2104-1(a).
[101] Rev. Rul. 55-163, 1955-1 C.B. 674.
[102] Code Section 2105.

The gross estate is reduced by various deductions relating to property within the U.S. (all assets have to be disclosed on the estate tax return to determine what ratio U.S. assets bear to non-U.S. assets and therefore determine what portion of the deductions are usable) and by charitable donations.[103] Recourse mortgages, that do not reduce the value of real property for estate taxation of nonresident aliens, are deductions against the gross estate, but are subject to the above apportionment and therefore not fully deductible.

Assets passing to the surviving spouse are deductible under the principles of Code Section 2056 (marital deduction).[104] This ordinarily means that the deduction is allowed if the surviving spouse is a U.S. citizen or if transfer to the surviving spouse is through a QDOT. The deductions are allowed only if the estate tax return is filed.

Advance planning can eliminate or reduce the U.S. estate tax obligations of nonresident aliens. For example, U.S. real estate should be owned through a foreign corporation (it is OK to interpose an LLC that is a disregarded entity to make it easier to eventually sell the real estate). This effectively converts U.S. real property into non-U.S. intangible asset. It may, sometimes, be beneficial to pay an income tax today on the transfer of the real estate to a foreign corporation (usually treated as a sale) to avoid the estate tax in the future.

Real estate may also be encumbered by a nonrecourse mortgage to reduce its value for estate tax purposes.

Residency should also be closely examined to take advantage of any applicable estate tax treaties. Residency for estate tax purposes is determined with reference to intent, and not under the income tax residency rules. One can be a U.S. resident for income tax purposes but not for transfer tax purposes. Relevant intent is whether the decedent had intent to be domiciled in the U.S. For example, if the decedent was in the U.S. on a nonimmigrant visa, as opposed to an immigrant visa, that supports lack of intent to make U.S. a permanent domicile. Many other factors are considered as well: (i) length of stay in the U.S. and frequency of travel, (ii) size and cost of home in the U.S., (iii) location of family, (iv) participation in community activities, (v) participation in U.S. business and ownership of assets in the U.S., and (vi) voting.

The U.S. has entered into gift and estate tax treaties with various nations to avoid double taxation. There are two types of estate tax treaties.

A **situs-type** treaty allows the country in which the property is located to tax the estate. If the decedent's country of residence also taxes this same property, the residence country must give credit for the estate tax paid to the country where the property is located.

Example. Vincent died a resident and citizen of Italy, but he owned land in Florida (no one knows why). Because U.S. and Italy have a situs-type treaty, U.S. will impose an

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[103] Code Section 2105(a)(1) and (2).
[104] Code Section 2105(a)(3).

estate tax on the land. Italy must then provide Vincent with credit for the U.S. estate tax paid.

You must read the treaty to determine the situs of an asset. Typically, real estate is sited where it is located, corporate stock where the corporation is organized and intellectual property where it is registered.

A domicile-type treaty allows the country in which the decedent had fiscal domicile to tax the estate. Fiscal domicile is usually the country with which the decedent had the closest economic ties. Other countries that seek to tax the decedent's estate must give credit for estate taxes paid to the fiscal domicile.

The primary thrust of estate tax planning for NRAs is through the use of (i) foreign corporations to own U.S. assets, or (ii) the gift tax exemption for intangibles to remove assets from the U.S.

If the NRA dies owning shares of stock in a foreign corporation, the shares are not included in the NRA's estate, regardless of the situs of the corporation's assets. It is important that the corporation have a business purpose and activity, lest it be deemed a sham designed to avoid U.S. estate taxes (See, e.g., *Jackson v. Comm'r*, 233 F. 2d 289 (2d Cir. 1956)).

2. Gift Tax

While the estate tax rules applicable to nonresident aliens are set out separately in Chapter 11, Subchapter B, all gift tax rules are in Chapter 12, with certain specific provisions set out for nonresident aliens.

Gift taxes are always imposed on the donor. If the donor is a nonresident alien, they are not subject to taxation by the U.S. and can make gift of property with situs outside the U.S. of an unlimited amount to any person, including U.S. citizens and residents. U.S. citizens and residents have to report the gifts that they received from a nonresident alien when they exceed $100,000 (technically $10,000 adjusted for inflation, but IRS allows $100,000). The reporting is done on Form 3520.

Gifts of assets sited within the U.S. are subject to gift taxes with the exception of intangibles. Gifts by nonresident aliens of intangible assets are not subject to gift taxes.[105]

Tangible personal property and real property is sited within the U.S. if it is physically located in the U.S.[106]

[105] Code Section 2501(a)(2).
[106] Treas. Reg. Section 25.2511-3(b).

Nonresident alien donors are allowed the same annual gift tax exclusion as other taxpayers and are subject to the same rate schedule for gift taxes. However, the lifetime unified credit is not available to nonresident alien donors.

Gift tax planning for NRAs focuses on gifting intangible assets. The gift of an intangible, wherever situated, by an NRA is not subject to gift tax. Shares in U.S. corporations and interests in partnerships or LLCs are intangibles (See, e.g., *Jackson v. Comm'r*, 233 F. 2d 289 (2d Cir. 1956)). Consequently, real estate owned by the NRA through a U.S. corporation, partnership or an LLC may be removed from the NRA's U.S. estate by gifting entity interests to foreign relatives gift tax free.

B. Income Taxation of Investing in Real Estate

Falling real estate prices coupled with a falling U.S. dollar have made U.S. real estate an attractive investment opportunity for foreign investors. Such investors must carefully consider the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA").

FIRPTA created Code Sections 897, 1445 and 6039C. These sections impose income tax, withholding tax and information reporting requirements on nonresident aliens who sell (or dispose of in any manner) U.S. real property interests ("USRPIs"). Generally, FIRTPA subjects the disposition of a USRPI to tax as if the nonresident alien was engaged in a U.S. trade or business. This means that the traditional income tax rules that apply to U.S. taxpayers will also apply to nonresident aliens. Transferees who acquire a USRPI from a nonresident alien are obligated to withhold 10 percent of the amount realized on the disposition.

1. Definition of USRPI

A USRPI is defined as any interest in (i) real property located in the U.S., or (ii) a domestic corporation that is a "United States real property holding corporation" ("USRPHC").[107]

a. USRPI

An interest in real property includes any ownership of land, buildings, mineral deposits, crops, fixtures, personal property used to (i) exploit natural resources, (ii) construct improvements, (iii) operate a lodging facility, or (iv) to provide a furnished office to a tenant (like movable walls or furnishings), improvements, leaseholds, or options to acquire any of the above.[108] Ownership interests may be of different kinds: fee ownership, co-ownership, leasehold, time-share, a life estate, a remainder, a reversion or

[107] Code Section 897(c)(1).
[108] Code Section 897(c) and Treas. Reg. Section 1.897-1(b).

a right to participate in the appreciation of real property or in the profits from real property.[109]

These rules are fairly involved and complex. For example, what does it mean to share in the appreciation of real property? A debt instrument whose terms allow the holder of the instrument to receive more money based on the appreciation of some real property is a USRPI. A debt instrument where the rate of return is tied to a general inflation index is not a USRPI, but one that is tied to a real estate inflation index is a USRPI. The right of a debt instrument holder to foreclose on real estate does not create a USRPI (although indirectly the debt instrument holder may benefit from the appreciation of the collateral).

A partnership interest is treated as a USRPI if (i) 50 percent or more of the value of partnership gross assets consists of USRPIs, and (ii) 90 percent or more of the value of partnership gross assets consist of USRPIs plus cash and cash equivalents.[110] The disposition of such partnership interest will be subject to FIRPTA to the extent such partnership owns USRPIs and will be subject to withholding.

An interest in a REIT which is less than 50 percent owned by foreigners is not a USRPI. The foreign ownership is subject to a five-year lookback.

b. USRPHC

A domestic corporation will be treated as a USRPHC if USRPIs equal or exceed 50 percent of the sum of such corporation's USRPIs, foreign real estate and trade and business assets.[111]

The disposition of an interest in a domestic corporation will not be subject to these rules if on the date of the disposition the corporation had no USRPIs and all of the gain was fully recognized on the sale of any USRPIs sold within the past five years (no installment sales or exchanges).

A foreign corporation cannot be a USRPHC.

This means that FIRPTA may be avoided by owning real estate in the U.S. through a foreign corporation, or through a domestic corporation which has assets other than U.S. real estate.

2. Withholding

Code Section 1445 governs the withholding regime under FIRPTA. Any foreigner (individual or corporation) selling a USRPI is subject to withholding at the rate of 10 percent of the amount realized. The withholding obligation is imposed on the purchaser, who must report the withholding and pay over the tax using Form 8288 within 20 days of

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[109] Treas. Reg. Section 1.897-1(d)(2)(i).
[110] Temp. Reg. Section 1.897-7T.
[111] Code Section 897(c)(2).

the purchase. If the purchaser fails to collect the withholding tax from the foreigner, the purchaser will be liable for the tax, plus any applicable penalties and interest.

The purchaser is not required to withhold if the tax liability is zero (need a withholding certificate issued by the IRS), or is fully paid by the seller.

The withheld taxes are later credited against the total tax liability of the foreigner.

FIRPTA withholding is not required if: (i) the seller provides a certificate of nonforeign status, (ii) property acquired by the purchaser is not a USRPI, (iii) the transferred property is stock of a domestic corporation and the corporation provides a certificate that it is not a USRPHC, (iv) the USRPI acquired will be used by the purchaser as a residence and the amount realized by the foreigner on the disposition is $300,000 or less, (v) the disposition is not subject tax (a tax-free exchange), or (vi) the amount realized by the foreigner on the disposition is zero.

3. Structuring Options

a. Direct Investment

A direct investment would include ownership of real estate directly in the name of the foreigner or through a single-member LLC that is disregarded.

The direct investment structure is simple and is subject to only one level of tax on the disposition. If the real estate is held long enough, the sale may be subject to the 15 percent capital gains rate.

The disadvantages of the direct investment are two-fold: the foreign investor will have to file U.S. income tax returns and the real estate will be included in the foreigner's estate on death.

Note that foreigners who invest through a partnership will be treated in the same manner as if they invested directly.

b. U.S. Corporation

Ownership of USRPI through a domestic corporation (the domestic corporation will always have to be a "C" and not an "S," as the foreign shareholder will disqualify the "S") will obviate the foreigner's need to file U.S. income tax returns. Only engaging in a U.S. trade or business (which includes ownership of a USRPI) requires a U.S. tax return. Ownership of stock does not.

If the domestic corporation owns multiple properties (to allow for losses from one property to offset gains from another), each property should be held in a single-member LLC to segregate the properties for liability purposes.

There are three disadvantages to the ownership of a USRPI through a domestic corporation: (i) federal and state corporate income tax at the corporate level will add a second layer of tax, (ii) dividends from the domestic corporation to its foreign shareholder will be subject to 30 percent withholding, and (iii) the shares of the domestic corporation will be included in the U.S. estate of the foreign shareholder.

On the disposition of the stock in the corporation the foreign shareholder will be subject to FIRPTA, because the corporation will be treated as a USRPHC. This will require the filing of a U.S. income tax return and 10 percent withholding by the purchaser of the shares.

One way to avoid withholding taxes on dividend payments is to capitalize the corporation with, at least in part, debt. The debt may then be structured as a portfolio interest loan, which is exempt from withholding. However, if the foreigner owns 10 percent or more of the voting stock of the domestic corporation, the favorable portfolio interest rules will not apply. The foreign may be issued less than 10 percent voting stock and the rest as nonvoting stock to allow them to qualify for the portfolio interest rules. N.B. Some tax treaties eliminate withholding on interest payments, in which case the foreign shareholder may own all of the voting stock of the domestic corporation.

c. Foreign Corporation

The foreign corporation offers the following advantages: (i) liability protection, (ii) no U.S. income tax or filing requirement for the foreign shareholder, (iii) shares in the foreign corporation are sited outside the U.S. and not included in the U.S. estate, (iv) dividends are not subject to U.S. withholding, and (v) no tax or filing requirement on the disposition of the stock.

The primary disadvantage of using the foreign corporation are corporate level taxes (just like with the domestic corporation), because the foreign corporation will be deemed engaged in a U.S. trade or business. The foreign corporation will also be subject to the 30 percent branch profits tax.

d. Optimal Structure

Because the branch profits tax is often not reduced or eliminated by a treaty, the most advantageous structure for ownership of U.S. assets by NRAs is through the foreign corporation-U.S. corporation structure. Here, the NRA owns a foreign corporation, which in turn owns a U.S. LLC taxed as a corporation. This structure affords privacy and liability protection, escapes U.S. income tax filing requirements, avoids U.S. estate taxes, allows for gift tax-free lifetime transfers and avoids the branch profits tax. Distributions from the U.S. subsidiary to the foreign parent are subject to the 30% FDAP withholding, but the timing and the amount of such dividend is within the NRA's control.

C. Income Not from a U.S. Business

As a general rule, a nonresident alien pays a flat tax of 30 percent on U.S.-source income that is not effectively connected to a U.S. trade or business.[112] The rate of tax may be reduced by an applicable treaty. The income is taxed on a gross basis, with almost no offsetting deductions. The most common category of such income is income that is "fixed or determinable annual or periodical" ("FDAP").

1. FDAP Income

FDAP income includes interest, dividends, royalties and rents. This means, for example, that if a nonresident alien receives interest income from sources in the U.S., he pays a 30 percent tax on such income. Other miscellaneous categories of income have been included within FDAP either by regulations, ruling or court case, including: certain insurance premiums, annuity payments, gambling winnings, alimony. The term does not apply to gains on sale of property.

a. Interest Income

Not all types of interest income are subject to the 30 percent tax. Interest income that is tax exempt under Code Section 103 will be exempt for foreigners as well. Also, interest on bank deposits and interest on portfolio interest loans is exempt from the 30 percent tax.[113] By creating exemptions for bank deposits and portfolio loans, Congress has allowed foreign investors to lend money to U.S. residents and businesses free of tax, in effect encouraging such lending.

A portfolio interest obligation issued prior to March 2012 was a bearer obligation that met the following three tests: (i) it was designed to be sold only to a nonresident alien, (ii) interest was payable outside the U.S. and (iii) the face of the obligation bore a prescribed legend (Any United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in sections 165(j) and 1287(a) of the Internal Revenue Code.).[114] As of March 2012, the portfolio interest exemption applies only to obligations issued in registered form which has significantly curtailed its usefulness. The portfolio interest exclusion does not apply to a 10 percent owner of the entity paying the interest.

b. Dividends

Dividends are included in the FDAP income, which means that nonresident aliens pay a 30 percent tax on dividends received from U.S. sources.

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[112] Code Sections 871(a) and 881.
[113] Code Section 871(h).
[114] Code Section 163(f)(2)(B).

If the domestic corporation derives at least 80 percent of its income from an active foreign business, then the percentage of the dividend that correlates to the percentage of the corporation's foreign income to overall income is not subject to the 30 percent tax.[115]

c. Rents and Royalties

Rents are treated as FDAP income under Code Section 871(a)(1)(A) and royalties under Treasury Reg. Section 1.871-7(b).

Nonresident aliens are taxed on their gross rents, without offsetting the income with deductions (including depreciation). In many cases it may be beneficial for the nonresident alien to elect to treat their real property income as if it was effectively connected to a U.S. trade or business.[116] The effect of the election is convert gross income taxable at 30 percent rate, to potentially no income taxable at the regular tax rates. The election is available only for real property held for the production of income.

d. Salaries, Wages and Compensation

Code Section 871(a)(1)(A) includes salaries, wages and compensation in FDAP income. In most cases salaries, wages and compensation will be effectively connected to a U.S. business, requiring a regular income tax return and subject to the regular income tax rates.

2. Capital Gains

Nonresident aliens are generally not taxable on their capital gains from U.S. sources unless (i) the alien is present in the U.S. for more than 182 days, (ii) gains are effectively connected to a U.S. trade or business or (iii) gains are from the sale of certain timber, coal or domestic iron ore assets. When the above exceptions apply, the nonresident alien is taxed on U.S. source capital gains at the rate of 30 percent.[117]

If the nonresident alien is present in the U.S. for more than 182 days, then Code Section 7701(b) will define such person as a U.S. resident, and the 30 percent tax no longer applies (residents are subject to the traditional U.S. income tax rules). There are some limited cases where a person may be a resident for the purposes of Code Section 871 and not 7701.

D. Income from a U.S. Business (effectively connected)

A nonresident alien is taxed on his income effectively connected to a U.S. trade or business under the same rules as all other U.S. taxpayers. Income may be reduced by

[115] Code Section 871(i).
[116] Election is made under Code Sections 871(d) and 882(d).
[117] Code Section 871(a)(2).

appropriate deductions (connected to the U.S. trade or business) and standard tax rates apply.[118] Because traditional tax rules apply, this discussion is necessarily limited to two issues: what constitutes U.S. trade or business and what constitutes "effectively connected."

1. U.S. Trade or Business

There is no centralized definition of what constitutes U.S. trade or business. The Code, regulations, ruling and cases include the following in U.S. trade or business: providing personal services in the U.S., selling products in the U.S. directly or through an agent, soliciting orders from the U.S. and then exporting merchandise outside the U.S. More obvious activities will also constitute U.S. trade or business: manufacturing, having a retail store, corporate offices, etc.

A nonresident alien will be engaged in a U.S. trade or business if they are a partner (doesn't matter what kind of partner) in a U.S. partnership engaged in a trade or business.[119] Similarly, a beneficiary of a U.S. estate or trust will be engaged in trade or business if the estate or trust is so engaged.[120]

2. Effectively Connected

Once the determination has been made that the nonresident alien is engaging in a U.S. trade or business, the next step is to determine whether there is U.S.-source income generated by such alien that is effectively connected to the U.S. trade or business.

Generally, the test is whether income is effectively connected to a trade or business in that taxable year. There are two notable exceptions.

When income is a deferred payment item, test for trade or business in the year the transaction that gave rise to the payment was completed.[121] For example, the foreigner performs services in the U.S. in one year, but does not get paid on account of such services until the next year. To determine whether the payment received in Year 2 is effectively connected, you test to see whether it is effectively connected to the services performed in the preceding year.

When property is used in business is later sold, there is a 10-year lookback from the date of the sale.[122] For example, a foreigner uses a truck as part of a delivery service in California. He discontinues the business, moves the truck to Mexico, and then sells it seven years later. The sale of the truck seven years later will be deemed effectively connected to the earlier delivery business and therefore subject to the regular tax rates.

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[118] Code Sections 871(b) and 882.
[119] Code Section 875(1).
[120] Code Section 875(2).
[121] Code Section 864(c)(6).
[122] Code Section 864(c)(7).

There are two broad categories of income that are used to test for "effectively connected."

a. FDAP, Portfolio Interest, Capital Gains

The first category, under Code Section 864(c)(2), covers fixed or determinable annual or periodical income, portfolio interest and capital gains from assets located in the U.S. This income will be deemed effectively connected to a U.S. trade or business if it meets either the "asset-use" test or the "business-activities" test.

The asset-use test covers the above described types of income generated from assets used in a U.S. trade or business. An asset is deemed "used" in a trade or business if the asset is needed in that trade or business. For example, a business maintains a large cash reserve to cover payroll. Because the cash reserve is needed to operate the business, the cash reserved is deemed used in the business, and the interest income on that reserve will be FDAP and effectively connected. That results in the interest income on the cash reserve being taxed at regular tax rates.

The business-activities test looks to whether the activity that generated income was a material factor in the realization of income of that trade or business. The business activities test is primarily used for passive assets, because such assets are not themselves often critical to the operation of a business. For example, a foreigner carries on an active trade or business in the U.S., and then invests the profits in deeds of trust. The interest income from the deeds of trust is not related to the U.S. trade or business and is not effectively connected. Check to see whether the foreigner generated passive income from an activity that is ancillary to their main business.

b. All Other U.S.-Source Income

All other categories of income (i.e., not FDAP, portfolio interest or capital gains) are automatically "effectively connected" under the "force of attraction" rule set forth in Code Section 864(c)(3). Under this rule if a nonresident alien has a U.S. trade or business, all U.S.-source income (other than FDAP, portfolio interest or capital gain) is deemed effectively connected to a U.S. trade or business. This result is true even if the U.S.-source income has absolutely no connection to the U.S. trade or business. The taxpayer will be deemed engaging in a U.S. trade or business for the year if they were engaged in such a business at any time during that year.

Example. Pierre, a Tahitian citizen and resident, manufactures cultured black pearls in the U.S. By virtue of that business he is engaging in a U.S. trade or business. He also has a separate business in Tahiti selling locally harvested pearls. Customers may place orders on the internet for his Tahitian pearls. Such orders generate U.S.-source income that under the force of attraction rule is effectively connected to Pierre's U.S. pearl business.

E. Branch Profits Tax

If a foreign individual or a foreign corporation owns a U.S. corporation, then there are two levels of tax. First, the U.S. corporation will be subject to the regular income tax on its profits, and second, there will be a tax on dividends paid to the foreign shareholders, subject to 30 percent withholding.

The so-called branch profits tax seeks to replicate the double tax when the U.S. business is operated by a foreign corporation through a U.S. branch that is not incorporated (i.e., the branch is not subject to a separate income tax). The foreign corporation will be subject to tax under Code Section 882 on its effectively connected income, and will also be subject to tax under Code Section 884 (branch profits tax) on any of its profits not reinvested in the U.S. (effectively, then, paid out as a dividend).

The branch profits tax applies at the rate of 30 percent,[123] but may be reduced by an applicable treaty. The U.S. has treaties covering the branch profits tax with most of the European nations, reducing the tax to between 0-10% (usually to the same rate that a dividend would be subject to under the same treaty). Qualifying for treaty benefits is difficult, as the foreign corporation must establish that it is not "treaty shopping" – meaning it is organized in the treaty country for a purpose other than tax avoidance (shareholders are resident in the treaty country, it does not distribute most of its income out of the treaty country, or it is engaging in an active trade or business in the treaty country).

The 30 percent tax applies to what is called a "dividend equivalent amount." The dividend equivalent amount is computed as the corporation's effectively connected earnings and profits for the year, less investments the corporation makes in its U.S. assets (money and adjusted bases of property connected with the conduct of a U.S. trade or business).

If the equity of the U.S. trade or business drops for the year (meaning the foreign corporation divested from the U.S.), the earnings and profits are increased by such drop (but subject to some limitations) to calculate the dividend equivalent amount. Actual distributions made by the foreign corporation to its shareholders do not decrease the dividend equivalent amount (but if the dividend itself is distributed in the same year when the foreign corporation pays a branch profits tax, the dividend may escape the 30% withholding tax) (Code Section 884(e)(3)(A)).

A quick example: Bermuda Inc. has $100 of effectively connected earnings and profits for the year. At the beginning of the year it had U.S. assets of $500 and liabilities of $200, resulting in $300 of equity in its U.S. business. At the end of the year, Bermuda Inc. has $600 of assets and $250 of liabilities, resulting in $350 of equity. The dividend equivalent amount is $50, calculated as $100 of earnings and profits reduced by the $50 increase in equity.

If a foreign corporation completely terminates its U.S. business, it is not subject to the branch profits tax for that year (Treas. Reg. Section 1.884-2T(a)(1)). As a planning note,

[123] Code Section 884(a).

if a foreign investor is planning on operating several U.S. businesses that will generate little or no earnings and profits (like depreciable real estate), it would make sense to form several foreign corporations, with each foreign corporation operating a separate branch. For example, if a foreign investor acquires two U.S. apartment buildings through a foreign corporation, on the sale of one building there may be a branch profits tax (as the resulting cash will not be necessary for the continued operation of the U.S. trade or business). If two separate corporations owned two buildings, then on the sale of one building the foreign corporation that is the seller would terminate its U.S. business and will not be subject to the branch profits tax.

F. Pre-Immigration Tax Planning

When a foreign individual intends to become a U.S. taxpayer, either by spending sufficient time in the U.S. or obtaining a permanent residence visa, he should plan in advance to deal with the inevitable worldwide income taxation by the U.S. and the eventual U.S. estate that will be imposed on his worldwide assets.

Income tax planning for a would-be immigrant includes: (i) accelerating recognition of foreign source income (only income recognized following date of U.S. residence may be taxed by the U.S.); (ii) disposing of appreciated assets in a taxable transaction to establish higher tax basis. This may, for example, include the sale of the assets to a spouse that will remain an NRA, or the liquidation of a foreign holding company, which is then deemed to have sold all of its assets for cash, or a deemed liquidation of the foreign company by electing to classify an existing foreign corporation as a disregarded entity for U.S. tax purposes; (iii) deferring recognition of loss or use of deductible expenses; (iv) receive a distribution of all earnings and profits from any foreign corporation that will later be deemed a CFC (see below)); (v) invest in U.S. tax compliant annuities or life insurance policies (these investments are not subject to U.S. income tax); or (vi) establish a pre-immigration foreign trust.

A pre-immigration foreign trust is used both for income and estate tax planning for an immigrant. If properly structured, the assets of the trust will not be deemed the assets of the trust's settlor. This excludes the income of the trust from U.S. taxation and excludes the assets of the trust from the settlor's estate (Note that Code Section 679(a)(4) provides that a trust established by an NRA will be treated as a grantor trust if the NRA funds the trust within five years of becoming a U.S. resident. Consequently, the NRA should either have a third-party fund the trust, or plan more than five years in advance).

The would-be immigrant should also gift foreign assets or U.S. intangibles to foreign or U.S. family members, before such gifts become subject to U.S. transfer taxes.

III. Expatriation

A. Current Rules

Expatriation refers to not simply leaving the U.S. and living abroad, but also to surrendering U.S. citizenship or permanent residency. If someone does surrender U.S. citizenship, moves abroad and picks up a new citizenship, the U.S. government may be unable to recover taxes due to it by the expat (no more jurisdiction over the person). Consequently, the expatriation rules of the Code look to exact a tax from the expat while the U.S. still has jurisdiction. This is commonly referred to as the "exit tax."

Expatriation may present a long-term income tax advantage. U.S. taxpayers are subject to federal income taxes on their worldwide income, whereas nonresident aliens (individuals who are neither citizens nor residents) are subject to tax only their U.S.-source income.

The current expatriation rules are governed by the so-called Reed Amendment passed in 1996[124] and by the Heart Act.[125] The Reed Amendment allows the U.S. Attorney General to deny reentry of a former citizen to the U.S. if the AG determines that expatriation was for the purpose of tax avoidance. To date, the Reed Amendment has not been invoked in any case.

The Heart Act introduces a mark-to-market regime for expatriates, by taxing the expatriate on all of the accrued appreciation in his property on the date of the expatriation. Expatriation is reported by filing Form 8854. This is a one-time filing requirement and it replaces the 10-year filing requirement that existed prior to the Heart Act.

The new Code Sections 877A and 2801 introduced by the Heart Act apply to a "covered expatriate." A covered expatriate is defined in Section 877A(g) (with reference to Section 877(a)(2) as a person who relinquishes their U.S. citizenship or their permanent resident status (held for 8 out prior 15 years), and who has (i) an average annual net income tax liability for the preceding five years of $124,000 (indexed for inflation), (ii) has a net worth of $2 million or more, or (iii) failed to certify compliance with U.S. tax obligations for the prior five years.

Individuals who were born citizens of the U.S. and another country, and still retain their citizenship and residency in the other country will not be subject to the exit tax if they were not resident in the U.S. for more than 10 of the preceding 15 years. This covers dual citizens who spend the majority of their time living in the other country they have a citizenship in.

[124] Section 1182(a)(10(E) of the Immigration and Nationality Act.
[125] The Heroes Earnings Assistance and Relief Tax Act of 2008.

The mark-to-market rules of the Heart Act subject covered expatriates to a tax on the unrecognized gain in their property to the extent that such gain exceeds $600,000 (adjusted for inflation). Effectively, the covered expatriate is treated as if they sold all of his assets, worldwide, for their fair market value on the day before expatriation.

The payment of tax may be deferred if the covered expatriate posts a bond to secure the payment of tax. The election to defer may be made on a property-by-property basis. The deferred tax liability accrues interest at the underpayment rate.

The Service has published Notice 2009-85 to provide substantive guidance on these rules. For example, the Notice provides that when determining what assets to include in the tax base of the exit tax, use the estate tax rules–the assets that would have been included in the expatriate's estate if he died on the day before the expatriation, will be subject to the mark-to-market rules, using the valuation principles used in the estate tax arena.

If the covered expat owns tax deferred accounts (like a 401(k) plan), they must file Form W-8CE with the plan. Filing of the form notifies the plan that all payments from the plan to the covered expat are subject to income tax withholding at the rate of 30 percent. IRAs and certain other specific plans are subject to an immediate exit tax.

If the expat is a beneficiary of a nongrantor trust, they will either be subject to the 30 percent withholding on the distributions, or must include the value of their beneficial interest in computing the exit tax (the Service must agree to the value in a PLR). Note that the withholding applies only to a nongrantor trust, because if the trust is grantor, its assets are included in calculating the exit tax and withholding is not necessary.

A new set of rules has been introduced to tax gifts made by covered expatriates to U.S. citizens and residents (other than a spouse or charity).[126] This gift tax liability is imposed on the recipient of the gift. Whereas the old rules applied for only 10 years following expatriation, the new rules apply without a limitation. The new gift tax rules apply whether the gift was made directly or through a trust.

B. Planning to Expatriate

Expatriation planning is all about planning in advance. For example, the exit tax applies to the extent all assets owned by the expat have a built in gain in excess of $600,000. If the expat owns a residence, he does not get to increase that threshold by the Section 121 exclusion amount. A personal residence should be sold prior to expatriation, taking advantage of the Section 121 gain exclusion and the $600,000 gain threshold.

Only assets with a built-in gain present a problem in the mark-to-market regime. Slowly converting property into liquid form may solve that problem. Using valuation rules

[126] Code Section 2801.

applicable in the estate tax arena speaks to the value of using FLP structures to obtain a valuation discount for the purposes of the exit tax.

It is also generally desirable to position the expatriate to own fewer assets in the U.S. and more assets outside the U.S.

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Mr. Stein is an author of several books, over two dozen scholarly articles and technical manuals. He is the co-author of *International Joint Ventures – A Concise Guide for Attorneys & Business Owners,* published in 2014; a *Lawyer's Guide to Asset Protection Planning in California*, published in September of 2011, the only legal treatise on asset protection specific to California. The companion book for non-lawyers, *Asset Protection for California Residents*, was published in October 2011. *His Asset Protection Planning* and *Advanced Tax Planning Techniques* manuals have been used by the California CPA Education Foundation for the past 10 years.

Mr. Stein is a frequent lecturer to various attorney, CPA and other professional groups, teaching over 50 seminars per year. His presentation topics include A Foreigner's Guide to Investing in U.S. Real Estate, Tax Planning for Cross-Border Joint Ventures, Creative Planning with Controlled Foreign Corporations, Advanced Asset Protection Planning, Choice of Entity Planning, Estate Tax Planning and various courses on trust law. Jacob is an instructor with the California CPA Education Foundation, National Business Institute, Thomson Reuters, the Rossdale Group and Lorman Education Services where he teaches courses on advanced tax planning, structuring international business transactions, asset protection and trust law. He is an adjunct professor of taxation at the CSU, Northridge Graduate Tax Program.

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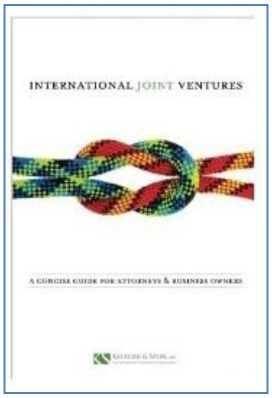

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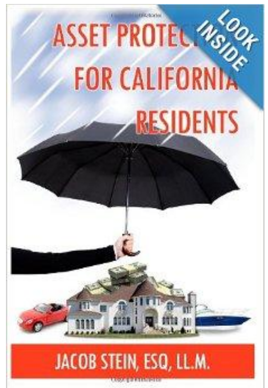

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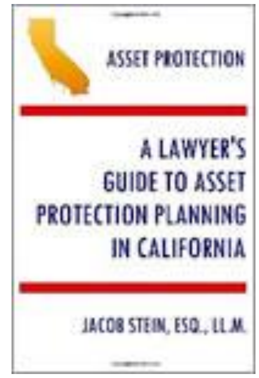

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