Lecture 8

11/14/2024

Topics covered in last class

Source rule in general

Interest Income

- Source Rule of Interest Income
- Thin Capitalization Rule
- Earning Stripping

Topics covered today

- Dividend Income
- Rentals Income
- Royalties Income
- Income from Services
- Income from Sales of property

The Source of Dividends

The Source of Dividends

- As set forth in Regulation § 1.861–3, the term "dividend" for source rule purposes encompasses distributions defined in § 316. Under that section, a dividend is any distribution of property made by a corporation to its shareholders out of current or accumulated earnings and profits.
- Dividends are generally sourced according to the situs of incorporation of the payor corporation, under § 861(a)(2).

The 25-Percent Rule

Under § 861(a)(2)(B), part of the dividends received from a foreign corporation is **U.S. source income** if 25% or more of its total gross income for the 3-year period ending with the close of its tax year preceding the declaration of dividends was **effectively connected with a trade or business in the United States**. If the corporation was formed less than 3 years before the declaration, use its total gross income from the time it was formed.

The 25–Percent Rule

- Determine the part that is U.S. source income by multiplying the dividend by the following fraction.

$$\frac{\text{Foreign corporation's gross income connected with a U.S. trade or business for the 3-year period}}{\text{Foreign corporation's gross income from all sources for that period}}$$

Example: The 25–Percent Rule

- Bel Group, a French corporate headquartered in Paris, declared $50 million dividend on May 30, 2018. Mr. Kim, a Korean citizen, receives $20,000 dividend on this occasion. The structure of gross income of Bel Group during the past five years is listed below.
- Should Mr. Kim pay taxes to the US? If yes, how much?

Example: The 25–Percent Rule

- Bel Group, a French corporate headquartered in Paris, declared $50 million dividend on May 30, 2018.
- Mr. Kim, a Korean citizen, receives $20,000 dividend on this occasion.

Gross Income Structure of Bel Group from 2013 to 2017 (million dollar)

	U.S.	France
2013	200	500
2014	400	600
2015	300	700
2016	100	600
2017	500	800

Example: The 25-Percent Rule

- Should Mr. Kim pay taxes to the US? If yes, how much?
  - Mr. Kim U.S. sourced dividend income of 2018:

$$20{,}000*\left(\frac{300+100+500}{700+600+800+300+100+500}\right)=$$

$$20{,}000*30\%=6000$$

- What if the $1.3 billion of income in 2017 is all French source income?

Source of Rentals

- Rental income is any payment you receive for the use or occupation of tangible property.
- **Rentals** from the lease of tangible property: sourced where the property is **located**.
- The residence of the lessor or lessee, or where payments take place is irrelevant.

Example

For instance, if a U.K. corporation leases computer hardware to a French corporation that uses the hardware in the United States, rental payments are___source income.

Example

In this case, the **lessor** is a UK Corporation, and the **lessee** is a French corporation. However, we know the source rule only depends on the place of the property, which is the US in this case. Therefore, the leasing income of the UK corporation is U.S. sourced. Therefore, The UK company will have to prepare tax filing to the US.

Source of Rentals

What if when a property is used both in and out of the United States?

Source of Rentals

An allocation of source is made according to the amount of time the property is used in different places, unless different rental rates can clearly be associated with different locations.

Royalty Income

A royalty is a legally-binding payment made to an individual, for the ongoing use of his or her originally-created, including

- Copyrighted works
- Patent
- Franchises
- Natural resources

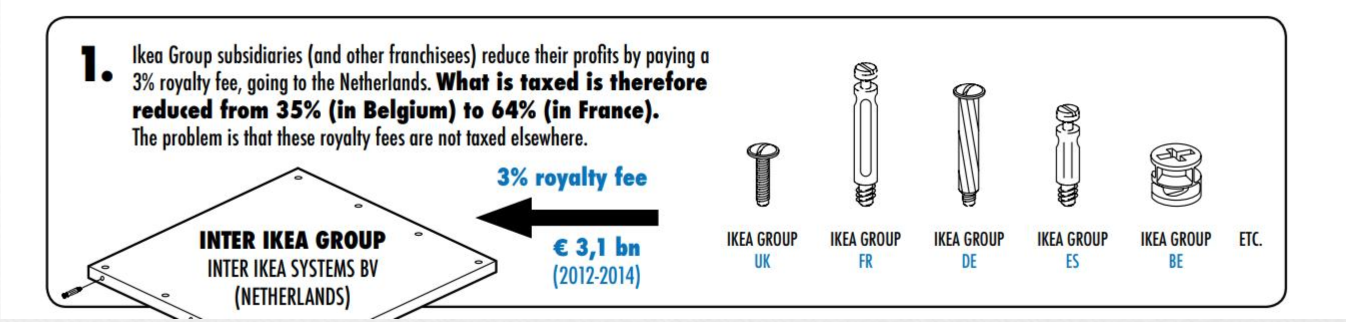
Patents

- A patent is a legal document that grants a firm the exclusive rights to use or licence a novel technology or a specified period of time.
- A firm can register legal ownership of a patent in a subsidiary that is located in a country different to the firm's headquarters, different to the location where the underlying technology was created and different to the location where the intellectual property will be applied.

Royalty Rates

The royalty rate or the amount of the royalty is typically a percentage based on factors such as sales, exclusivity of rights, technology, and the available alternatives.

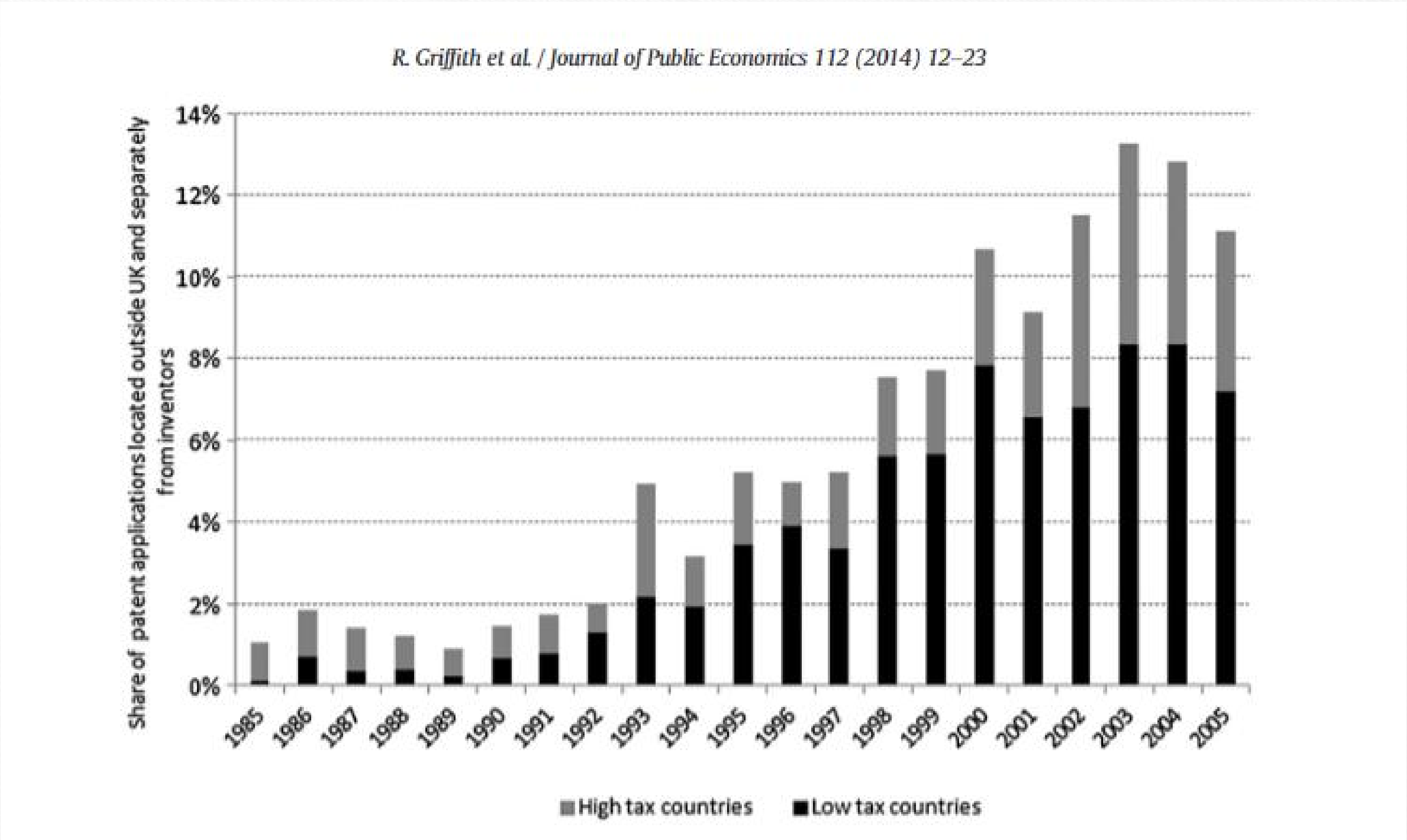
IKEA


1.
Ikea Group subsidiaries (and other franchisees) reduce their profits by paying a 3% royalty fee, going to the Netherlands. **What is taxed is therefore reduced from 35% (in Belgium) to 64% (in France).**
The problem is that these royalty fees are not taxed elsewhere.
3% royalty fee
€ 3,1 bn
(2012-2014)
INTER IKEA GROUP
INTER IKEA SYSTEMS BV
(NETHERLANDS)
IKEA GROUP UK
IKEA GROUP FR
IKEA GROUP DE
IKEA GROUP ES
IKEA GROUP BE
ETC.

Source of Royalties

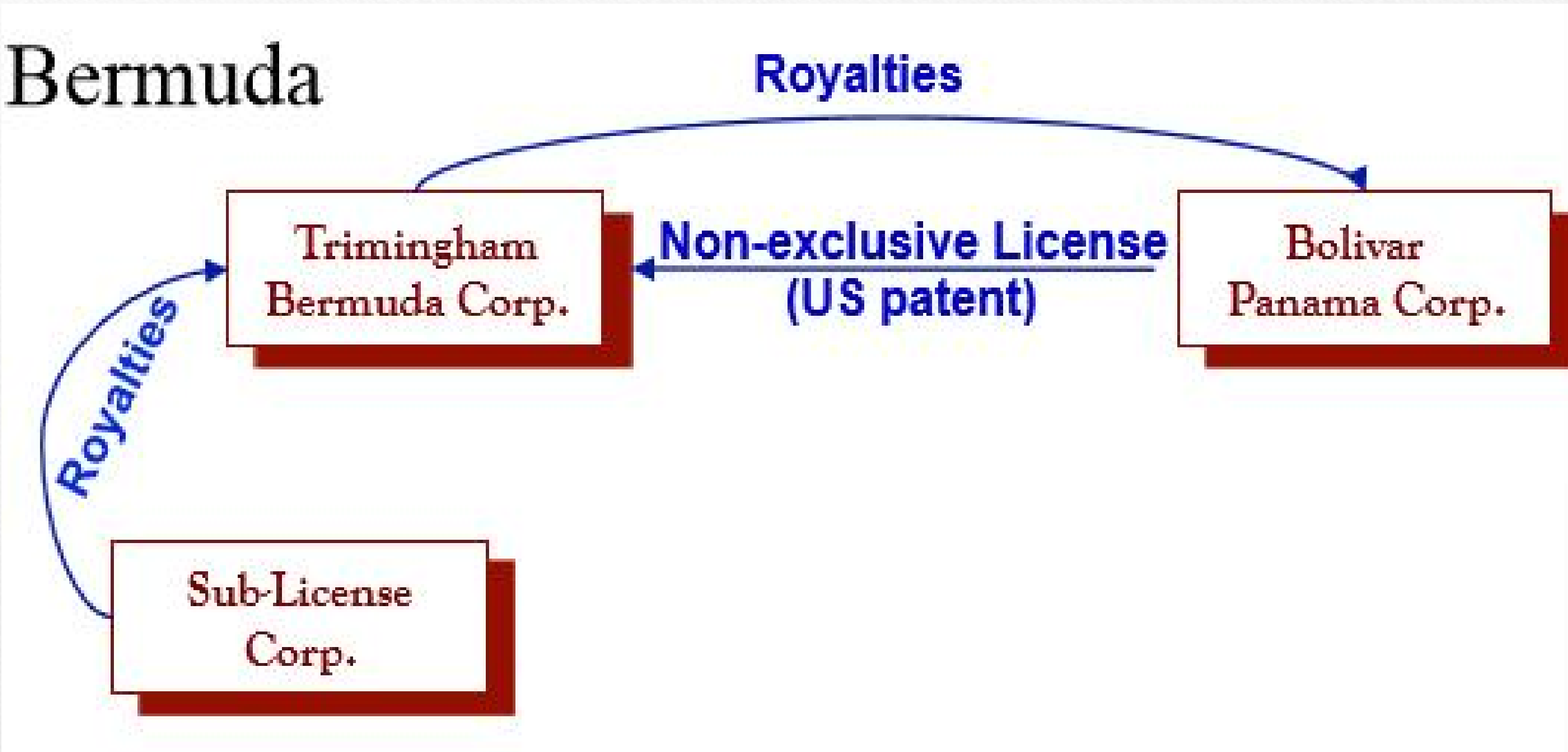
Royalties from the license of intangible property including patents, copyrights, knowhow or other intellectual property sourced according to where the intangibles

Essentially, the focus should be on where the intangible is legally protected.



Source: Griffith et al. (2014) Ownership of intellectual property and corporate taxation

The "cascading royalty" problem

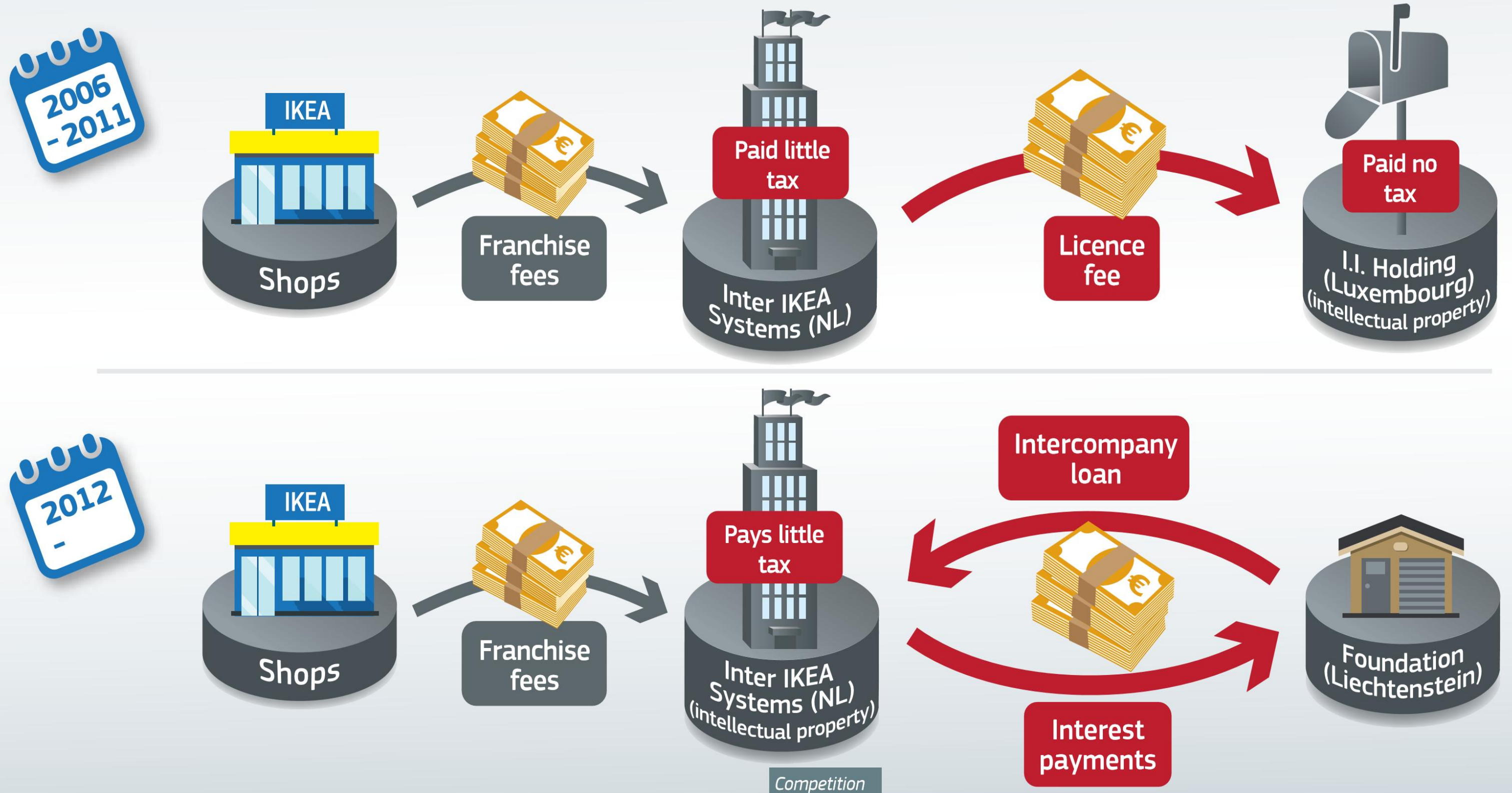


Source of Royalty Income

In practice

- Taxpayers and tax administrators have often assumed that the source of royalty income is determined by the **residence of the payer**.
- On that assumption, royalties paid by a U.S. corporation for the use of a Hong Kong copyright would constitute U.S. source income to a person, and that person would incur U.S. tax.

European Commission investigates the Netherlands' tax treatment of Inter IKEA



Competition

Source of Income from Services

Source of income from personal services: the place where the services are **performed**.

Source of Income from Services

- Under § 861(a)(3), compensation for labor or personal services performed in the United States has a United States source.
- Regulation § 1.861–4(a)(1) asserts that this rule holds true irrespective of the residence of the payor, the place in which the contract for services was made, or the place or time of payment.

Source of Income from Services

Example in Chapter 1 about double taxation

- Suppose that U.S. Co. renders services, training Indian computer programmers in the United States.

The “90–Day” Exception

Compensation for services by a foreign individual present in the United States for 90 days or less during the taxable year has foreign source if

1) the services are performed for a foreign person not engaged in business in the United States and

2) if the total compensation for the services is $3000 or less.

Example： The “90–Day” Exception

During 2023, Henry Smythe, a nonresident alien from a nontreaty country, worked for an overseas office of a U.S. partnership. Henry, who uses the calendar year as his tax year, was temporarily present in the United States for 60 days during 2023 performing personal services for the overseas office of the partnership. That office paid him a total gross salary of $2,800 for those services. **What is the source of his salary for 2023?**

Example： The “90–Day” Exception

During 2023, he was not engaged in a trade or business in the United States and his stay is less than 90 days. The salary is not considered U.S. source income and is exempt from U.S. tax.

Source of Income from Services

- **Difficulty**: Matching compensation with services performed in different places.
- Example

A business executive works all over the world for a package of salary and stock options that are not explicitly allocated to services in different locations.

It is obvious to assign source **according to time** spent in different locations ?

BUT

1) You must record or remember how much time is spent where.
2) The nature and intensity of work done may differ in different places.

The NHL Player Cases

Offseason exhibitions , games, training camps, bonuses…

Athletes paid by the year have to figure out what part of their salaries have what source. There have been over 200 cases in the U.S. courts in the 1970s on questions of source of income concerning

1) **Canadian players** who want to minimize their U.S.–source income;

2) **U.S. players** who want to maximize their foreign source earned income.

Time Basis

- The proportion of U.S. source income =

days performed services in the United States during t

Total # of days performed services during the yea

Example：Source of Income from Services

Christina Brooks, a resident of the Netherlands, worked 240 days for a U.S. company during the tax year. She received $80,000 in compensation. Christina performed services in the United States for 60 days and performed services in the Netherlands for 180 days. Using the time basis for determining the source of compensation, $____is her U.S. source income.

Source of Income from Services

Example

Christina Brooks	compensation	Performed services
resident of the Netherlands	$80,000	60 days in the U.S.
		180 days in Netherlands

compensation, $____is her U.S. source income.

Services Performed through Associations and Entities

Firms are deemed to "perform" services through their employees or agents. The source of the resulting income—the place of performance—is therefore the place where the corporation's employees or agents perform the services.

The Treasury regulations on source once determined the source of income from services entirely on a "time" basis, both for individuals and firms.

Tipton & Kalmbach Inc. v. United States (1973)

A U.S. Engineering firm performed engineering, design, and construction services both in the United States and Pakistan. The taxpayer received a single overall fee for the project, but the work performed in the United States was performed by higher paid personnel than the employees working in Pakistan. The IRS. Against its own regulations, sought to assign a source to the firm's compensation on the basis of payroll costs. The court, however, refused to deny the taxpayer the benefit of the regulations, and upheld an allocation of source based only on the number of days of work performed by the taxpayer's employees in the United States and Pakistan respectively.

Tipton & Kalmbach Inc. v. United States (1973)

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The IRS	• Sought to assign a source to the firm's compensation on the basis of payroll costs.
The court	• Upheld an allocation of source based only on the number of days of work performed by the taxpayer's employees in the U.S. and Pakistan respectively.

Source of Income from Services

- **Source of income from services**

Time Basis

Geographical Basis

- Compensation for Housing, Education, Local transportation
- Based on the location of your principal place of work

Alternative basis such as payroll cost basis

Gains from Sales of Property