

International Taxation: A Transactional Approach

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Preface

Welcome to *International Taxation: A Transactional Approach*. This book introduces you to the contours of the field of U.S international taxation. Before delving into the material, I'd like to briefly highlight some of the characteristics that distinguish this book from other international tax casebooks. A quick perusal of the table of contents of each would reveal that the topic coverage is virtually identical: residence, source of income, taxation of foreign persons investing or doing business in the United States, the taxation of U.S. persons investing or doing business abroad, related party transactions, and perhaps, foreign currency issues and international mergers and acquisitions. So, why should you use this one?

First, since it's free, you can use it together with any other casebook or materials assigned by your professor. Second, I've tried to alter the presentation to make learning and retaining the material a bit easier. Given the complexity of the topic for neophytes, I have found that even highly motivated students can often miss the forest for the trees. For example, a student may be able to recite the holding of a case or conclusion of a revenue ruling on the application of the portfolio debt rules but not be able to tell you how the United States generally taxes foreigners on returns on debt capital.

Each topic begins with an overview that sketches out, sometimes in considerable detail, the contours of the subject matter. The overview will usually walk you through the relevant code sections, perhaps highlight some regulatory guidance, and applicable tax treaty provisions. A complaint I have had with many casebooks was understanding the larger relevance of a holding of a particular case. The more in-depth material is addressed in the materials that follow the overview, such as cases, administrative guidance, legislative history, comments, and problems.

This book incorporates income tax treaties as an integral part of the U.S. international tax regime. As the United States has entered into tax treaties with almost all of its important trading and investment partners, many of the U.S. rules for taxing foreigners are found in tax treaties rather than in the bowels of the Internal Revenue Code.

Without fail, the positive portions of student evaluations have generally lauded the benefit of applying the materials to problems and often have suggested covering even more problems. As most students in the class are third-

years with some legal work experience, the appeal of problems probably reflects the correct view that transactional attorneys are hired to help clients solve their pressing current business problems and avoid future ones.

Finally, there are two other novelties that readers may find useful. I incorporate some introductory accounting treatment of transactions. Especially for publicly traded entities, a tax advisor must be aware of the accounting treatment of a proposed transaction. Creative tax saving ideas without a concomitant accounting benefit often fall by the wayside. In addition, *International Taxation: A Transactional Approach* also introduces students to the foreign law treatment of certain items. Although the book's primary focus is the U.S. taxation of international income, a good tax planner must take into account all relevant effects, including foreign law. Many structures and transactions involving U.S. based multinationals cannot be understood without an awareness of foreign law concerns.

Over the last twenty years, many U.S.-based multinationals, especially those with significant intangible property, such as technology and pharmaceutical companies, structured their foreign operations so that they pay little or no foreign or U.S. tax on their current profits, giving rise to so-called *stateless income*. Many of these U.S. multinationals accumulated abroad vast sums of untaxed capital: Apple alone reported having \$200 billion of overseas cash in 2016. Since bringing back those untaxed earnings to the United States could have resulted in a U.S. tax of 35% to 40%, it was advantageous from a tax, finance, and accounting perspective to leave those earning abroad, even if the capital could be more profitably employed in the United States. The U.S. multinationals though complained the relatively high U.S. corporate tax rate of 35% placed them at a competitive disadvantage to multinationals based in foreign countries with lower tax rates. During the early 2010's, Congress, tax commentators, and the popular press focused much attention on these structures and the massive loss of U.S. tax revenue.

In response to the continuing rise of stateless income and accumulation of untaxed profits overseas, Congress enacted in 2017 the most sweeping changes in more than 30 years to the U.S. international tax regime in the Tax Cut and Jobs Act. In the TCJA, Congress enacted a territorial system (participation exemption) under which certain dividends from foreign corporations are exempt from U.S. tax; subjected to current taxation, albeit at a reduced rate, a U.S. shareholder's portion of a foreign subsidiary's global intangible low-taxed income (GILTI); taxed U.S. shareholders on the accumulated foreign earnings of their foreign subsidiaries; imposed a 10% tax on certain deductible base erosion payments (BEAT) to related foreign persons; and provided an export subsidiary in the form of a reduced U.S. corporate tax rate on the foreign-derived intangible income of U.S. corporations (FDII). Importantly, the TCJA reduced the U.S. corporate tax rate from 35% to 21%, one of the lowest rates among our major trading partners.

Surprisingly the TCJA left intact many of previous pillars of the U.S. inter-

national tax regime applicable to U.S. multinationals, including the subpart F and passive foreign investment companies (PFIC) provisions. In the four years since the enactment of the TCJA international provisions, Treasury has issued massive and complicated regulations to sort out the interaction of the old and new provisions.

Parallel with the U.S. response to the rise of *stateless income*, the OECD, in its *Base Erosion and Profit Shifting (BEPS) action plan*, has begun to address on a multilateral basis how many of the long-standing international tax norms that have guided international capital flows over the last 80 years should be modernized. Many existing international tax laws have been based on physical presence. Given the digitalization of many aspects of the economy and production activities, the OECD has begun important initiatives to revise these norms.

Two major OECD initiatives are Pillar 1 and Pillar 2. Under Pillar 1, a portion of the profits of certain large multinationals would be reallocated to countries where they sell products or provide services, even in the absence of physical presence. Under the Pillar 2 Global Anti-Base Erosion (GLoBE) Rules, certain large multinationals would be subject to a 15% minimum tax in each jurisdiction in which they operate. These initiatives continue at full speed, and it seems likely that they will be adopted in some form by most countries in the near future. In 2022, the United States enacted a 15% minimum tax on the book (accounting) income of large, publicly traded domestic corporations. It remains to be seen whether this minimum tax is compliant with Pillar 2.

It's virtually certain the current U.S. international tax regime will continue to be revised in the coming years, although the changes may be more incremental than those in the TCJA. Furthermore, the issuance of Treasury regulations show no sign of diminishing. For students, this is a wonderful opportunity: you will be acquiring your knowledge of the new U.S. international rules at the same time as your future bosses and will therefore know as much as they do.

As this is a work in progress, I'd appreciate any suggestions on how to improve the book and accompanying materials. They can be sent to the author at: jcolon@fordham.edu.

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Chapter 1

Introduction to U.S. International Taxation

This chapter gives a brief overview of the U.S. international tax system. It describes the concepts of residence and source basis taxation, the basic U.S. tax rules applicable to foreign persons with U.S. activities and U.S. persons with foreign activities, and the role and function of income tax treaties.

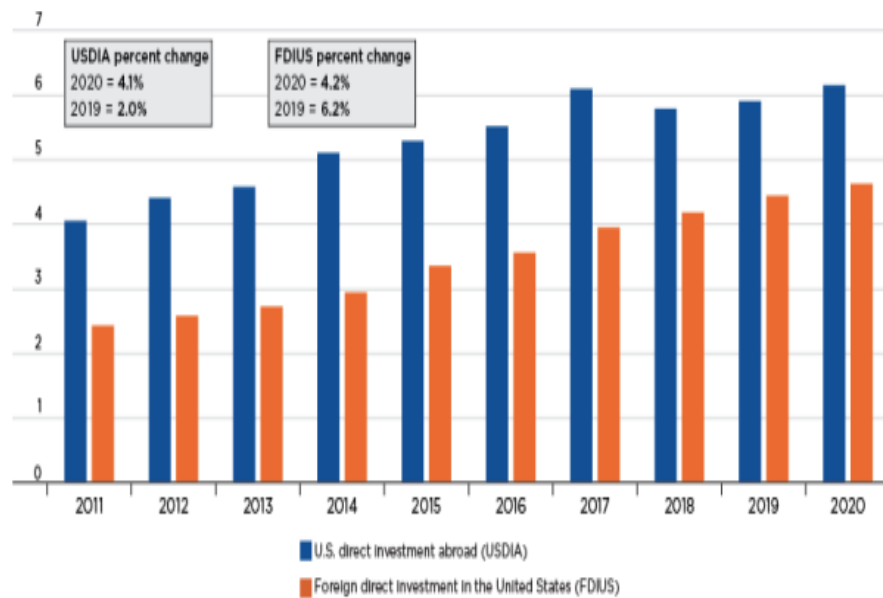
International tax refers, in this book, to the set of U.S. tax rules that apply to foreign persons investing or transacting business in the United States and U.S. persons investing or engaging in business outside of the United States. Some examples of where these rules apply include: the payment of interest or dividends by a U.S. corporation to a foreigner; the temporary assignment of a foreign executive to the United States; the U.S. branch operations of a foreign bank; a U.S. attorney working in London; the establishment of an Asian manufacturing and distribution network by a U.S. corporation; the sales of cars by Toyota Japan to its U.S. subsidiary; and the transfer by a U.S. corporation of intellectual property to an offshore affiliate to be used in producing property to be sold. The rules governing these transactions are found in the Internal Revenue Code and accompanying Treasury regulations; administrative guidance, such as revenue rulings; judicial decisions; and bi-lateral tax treaties between the United States and its major trading partners.

If no U.S. person invested abroad or no foreigner invested in United States, there would be no need for this special tax regime. Very fortunately, that is not the universe we inhabit for it would be a poor and miserable one. A quick flip through the history books or a few minutes reading about the economic fortunes of residents of countries closed to international trade and investment, *e.g.*, North Korea, should quickly disabuse anyone of the notion that an economy closed to foreigners and their capital is one in which you would like to live, work, or raise a family. Also, for those in whom xenophobic tendencies rage strong, don't hold your breath that cross-border investment or trade will

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cease anytime in the near future: the continuing U.S. trade deficits—exports minus imports—ensures that foreigners will have excess dollars that need to be invested in U.S. assets. The following chart displays the amount of and significant growth in both inbound and outbound direct investment over the last 10 years.

Figure 1.1: Inbound and Outbound Direct Investment



118 Bureau of Economic Analysis

The U.S. international tax rules are found primarily in subchapter N (§§861 through 999) of the Internal Revenue Code, but scattered outside of subchapter N are some important international tax provisions, such as section §59A (BEAT), §250 (FDII), §367 (reorganizations involving foreign corporations), §482 (related party transactions), §1248 (sales of the stock of foreign corporations), and §§1291-1298 (passive foreign investment companies). Importantly, the principles and rules you have learned in your other tax classes regarding the timing of an item of income or deduction, the tax classification (interest, dividend, or sale of goods or services), and the tax character (ordinary income or capital gain), do not cease to apply because one of the parties is foreign or the transaction occurs abroad. In fact, because many types of income earned by foreign persons, such as capital gains, are generally exempt from U.S. tax, these determinations are often more important for foreign persons than domestic taxpayers.

1.1 Overview Source and Residence Basis Taxation

Most countries exert their taxing authority on two bases or types of jurisdictions: source and residence. A country exercises *source basis* tax jurisdiction over income arising within its borders that is earned by a foreign person, which can be an individual, corporate entity, or sovereign. A dividend paid by a U.S. corporation, for example, is classified as U.S. source income, and if received by a foreign person, is generally subject to U.S. tax, even though the foreign person was never physically present in the United States. The rationale behind source basis taxation is that the source country has provided the primary benefits, such as infrastructure, markets, and property rights, to generate the income and therefore has the primary right to tax the income.

Source basis taxation applies to income arising in a country.

Two distinct U.S. tax regimes apply to U.S. source income earned by foreign persons. Foreign persons who earn only U.S. source passive or investment income such as dividends, rents, and royalties, are taxed at a flat 30% rate (no deductions permitted) on the gross income. In contrast, foreign persons who have a U.S. trade or business are taxed on the *net* U.S. source income (gross income reduced by allocable deductions) that is *effectively connected* with the U.S. trade or business at the same graduated rates applicable to U.S. persons. Gains from the sale of U.S. real property interests are taxed as effectively connected income.

Foreign persons are taxed on a *gross* basis on U.S. source investment income and on a *net* basis on U.S. source business income.

A country exerts *residence basis* taxation over persons on the basis of their legal status. Persons (including legal entities such as corporations) subject to residence basis taxation are taxed on their worldwide income. Under the ability-to-pay principle, residence basis taxation is justified on the grounds that both U.S. and foreign source income equally affect a person's ability to pay. In addition, exempting foreign source income could cause capital to flow abroad even if it could be invested at a higher pre-tax rate of return in the United States.

Residence basis taxation applies to persons, including legal persons.

The United States taxes its citizens (with some exceptions), resident aliens, and corporations incorporated in one of the fifty states on a residence basis. The United States, it should be noted, is unique among economically advanced nations in taxing its nonresident citizens on a residence basis.

A U.S. person could easily avoid U.S. residence basis taxation merely by forming a foreign corporation and holding investment and business assets in the corporation. Left unchecked, such a system could lead to a substantial reduction in U.S. tax revenue and an uneconomic skewing of investment and business capital. To thwart such tax planning, the U.S. has enacted three anti-deferral regimes: the subpart F/controlled foreign corporation (CFC), the passive foreign investment company (PFIC), and the global intangible low-taxed income (GILTI) regime. These regimes tax currently U.S. shareholders on some or all of their foreign corporations' current earnings, regardless whether the earnings are actually distributed to the shareholders (or are subject to an interest charge when the earnings are distributed). The income of a controlled

The U.S. foreign anti-deferral regime zoo: Subpart F, GILTI, and PFIC.

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foreign corporation that is not subject to the CFC, PFIC, or GILTI regime is generally not taxed by the United States when it earned or when it is remitted.

The treatment of business profits earned by foreign subsidiaries of U.S.-based multinational corporations presents many policy and administrative challenges. Some argue that such profits should be taxed currently at regular corporate rates (or a reduced rate) so that U.S. multinationals will not have a tax incentive to locate operations and jobs offshore. Others argue that since many other developed countries do not tax the foreign business operations of their multinationals, if the United States taxed the offshore operations of its multinationals, they would be at a competitive tax disadvantage vis-a-vis their foreign counterparts.

The current U.S. regime is a complicated amalgamation of both of these positions. Subpart F income is taxed currently at regular corporate rates, PFIC earnings are taxed currently at regular rates, and GILTI inclusions are taxed currently at 10.5%, but the business earnings and gains that escape subpart F, PFIC, and GILTI are exempt from U.S. tax. Consequently, the regulatory regime governing these provisions is extremely complex because it must coordinate the interaction of these three regimes and the associated income, expenses, and credits.

To avoid the sting of the U.S. anti-deferral regimes, some U.S. multinationals have *inverted* their corporate structure by making the former U.S. parent a subsidiary of a new foreign parent, but without changing the identity of the shareholders. Also, some recent public mergers between U.S. and foreign companies have resulted in inverted structures as well, much to the chagrin of some members of Congress and U.S. tax administrators. Although there are U.S. tax provisions that attempt to discourage inversions by treating certain foreign corporations as U.S. corporations, Congress continues to strengthen these rules.

International double taxation arises when two or more countries assert tax jurisdiction over the same income or same persons. For example, if a U.S. resident receives a dividend from a U.K. corporation and the U.K. taxes the dividend, the dividend will be taxed twice, once by the United States on a residence basis and once by the United Kingdom on a source basis. Double taxation is anathema to both taxpayers and governments: multiple layers of taxation can quickly become confiscatory, and if left unchecked, would significantly reduce cross-border trade and investment.

To ameliorate double taxation, the residence country generally cedes primary taxing jurisdiction to the source country. The justification is that the source country is primarily responsible for the generation of the income, and source basis taxation should therefore take precedence. The United States unilaterally mitigates double taxation by allowing a credit for foreign taxes paid on foreign source income, and at the end of 2021, Treasury issued the most sweeping changes to the U.S. foreign tax credit regime in 40 years. Other countries mitigate double taxation through a credit system, exemption of for-

Double taxation is generally mitigated by the residence country ceding primary tax jurisdiction to the source country. Source trumps residence.

foreign source income, or a particular tax treaty provision. Even if every country had the same double tax relief mechanism, however, double taxation would invariably arise because of different national definitions of residence, source, and the characterization of income.

1.2 Overview of Income Tax Treaties

To resolve these fundamental fiscal conflicts, countries enter into bi-lateral income tax treaties. Treaties, which generally take precedence over domestic law, mitigate double taxation by providing rules of precedence when fiscal conflicts arise. For example, a person who is a resident of more than one country—a U.S. green card holder residing in another country—could be subject to residence basis taxation by both the United States and his country of residence. Tax treaties prevent this by establishing a single fiscal residence. Treaties also often contain specific source rules and double tax relief provisions, the latter being especially important for persons residing in a country without a domestic foreign tax credit.

Treaties also aim to foster increased trade and investment by lowering source country taxation. U.S. source dividends paid to a foreign treaty resident, for instance, are generally taxed at a maximum 15% (or sometimes 5% or 0%) instead of 30% under U.S. domestic law. Also, income of a U.S. trade or business earned by a treaty resident is not taxed by U.S. unless the trade or business rises to the level of a *permanent establishment*, which requires more substantive activities and presence than a trade or business. By lowering source basis taxation, treaties in essence shift tax revenue from source countries to residence countries.

Treaties lower source basis taxation and thereby increase the revenue of residence countries.

Most tax treaties are based on the Organization of Economic Cooperation and Development (OECD) Model Tax Convention on Income and Capital and the detailed Commentaries, which are used in implementing and interpreting treaty provisions. The OECD Model Treaty was first developed in 1958 and was based on the work of economists from the 1920's.¹

The United States has entered into over 60 income tax treaties, including treaties with almost all of its major trading and investment partners, and is continually expanding its treaty network. The United States also has issued various model treaties, the most recent being the 2016 U.S. Model Treaty, which supersedes the 2006 Model. The model treaties are updated to reflect changes in U.S. tax policy.

¹ The OECD was formed in 1960 when 20 countries (the 18 members of the Organization for European Economic Cooperation, the United States, and Canada) signed the OECD Convention, which endeavors to promote growth and improved standards of living for members, sound economic expansion of member countries, and expansion of world trade. Since its founding the OECD has grown to include 38 members (as of 2023) from around the world, with Costa Rica and Columbia becoming the most recent countries to join.

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This book uses the U.S.-U.K. income tax treaty as its reference treaty. This treaty was signed in 2001 and came into force on March 31, 2003. The U.S.-U.K. treaty is a treaty with a major trading partner and contains many provisions that specifically reflect recent U.S. international tax policy concerns. The U.S.-U.K. treaty and the U.S. Treasury Technical Explanation of the Treaty are found [on the class web page]. I opted to use an actual tax treaty rather than either the OECD or U.S. Model Treaty mostly to avoid awkward phrasings such as “X is a resident of a country with which the U.S. has tax treaty identical to the U.S. or OECD Model Treaty,” or “X is a resident of Treatyland.” In addition, you can see how a particular treaty resolves specific conflicts that arise when two separate fiscal regimes meet.

This rise of stateless income, the growth in digital business activities, and the concern that unilateral responses by OECD members could result in double taxation and increased tax uncertainty for cross-border investments led the OECD to address base erosion and profit shifting (BEPS) in the context of cross-border transactions. In response to their findings, the OECD approved in 2013 the *BEPS Action Plan*, which identified 15 action items that required new international standards.² Key action items are electronic commerce, hybrid mismatch arrangements, transfer pricing aspects of intellectual property, CFC rules, interest deductibility, and data collection. Final reports on all items were finished in 2015 and endorsed by the G20 leaders.³

Given the importance of these fiscal matters, the OECD established the OECD/G20 Inclusive Framework on BEPS (IF) in 2016 to ensure the participation of all interested countries and jurisdictions, including developing countries. The IF now has over 141 countries and jurisdictions.

One of the most important topics addressed by the IF is the tax challenges of the digital economy, which is BEPS Action 1. The IF has issued various public reports⁴ and the two-pillar approach of the OECD. Under Pillar One, certain large, profitable multinationals could have their profits reallocated and taxed by a country where they have sufficient economic nexus, such as marketing rights and user participation, but not necessarily physical presence, which is generally required under traditional international tax norms.⁵ Pillar One also addresses dispute resolution mechanisms to avoid double taxation.

Pillar Two responds to concerns of tax competition and establishes a framework for a minimum corporate tax of at least 15% on large multinationals regardless where they are headquartered or where they operate.⁶

On 20 December 2021, the OECD published detailed Pillar Two model

²OECD, *Action Plan on Base Erosion and Profit Shifting*, July 19, 2013.

³OECD, *BEPS Actions*

⁴OECD, *BEPS Digital Economy Reports*

⁵OECD, *Tax Challenges Arising from Digitalisation—Report on Pillar One Blueprint*

⁶OECD, *Tax Challenges Arising from Digitalisation—Report on Pillar Two Blueprint*.

For a brief overview of Pillar Two, see OECD, *Pillar Two in a Nutshell*

rules.⁷ In 2022, the OECD released further guidance on Pillar Two, including Model GLoBE Rules, Commentary, and Illustrative Examples.

Individual countries, including the United States, have already begun to implement some of the action items. In 2022, the United States enacted a 15% minimum tax (CMAT) on the financial statement income of large U.S. corporations. It is unclear whether the CMAT is consistent with Pillar Two. We'll visit these topics throughout the semester.

1.3 Overview of Text

After examining the rules that classify persons as foreign or U.S. and legal entities as either partnerships or corporations, we will focus our study of U.S. international tax rules on two main areas: (1) the taxation of foreigners investing and doing business in the United States (source basis tax jurisdiction); and (2) the taxation of U.S. persons investing and doing business abroad (residence basis jurisdiction), including the U.S. anti-deferral regimes, *i.e.*, the subpart F, PFIC, and GILTI regimes. We also examine the U.S. foreign tax credit regime, the domestic mechanism the United States employs to coordinate overlapping tax jurisdiction, which underwent significant changes in 2022. Tax treaty provisions are integrated throughout with the relevant domestic provisions. We also examine §482, which requires related parties to deal with each other on an arm's-length basis. This important provisions applies to both U.S. and foreign taxpayers. We'll also seek to tie in some of the OECD developments as well.

Inbound refers to the taxation of foreigners' U.S. investments and activities, and *Outbound* to the taxation of the foreign operations of U.S. persons

Like other parts of the Internal Revenue Code, the international tax provisions reflect many compromises among competing objectives such as fairness vis-a-vis U.S. taxpayers, revenue raising, administration, and encouraging foreign investment. Because these objectives are sometimes contradictory, the U.S. international tax rules are not entirely consistent or simple. But that makes the course stimulating and challenging and the field an interesting and potentially lucrative one to work in.

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⁷OECD, *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two)*

Chapter 2

Residence, Nationality, and U.S. Tax Jurisdiction

2.1 Citizens and Residence Basis Taxation

Code: 1
Regulations: 1.1-1(b) and (c)
Treaty: 1(1), 1(4), and 1(5); 4; and 23(1) and (2) (skim only)

This chapter discusses the tax residence of individuals and legal entities. It focuses first on U.S. citizens and explores the long-standing U.S. position of taxing its citizens (and resident aliens) on their worldwide income, regardless of actual physical residence or economic contacts with the United States. It then addresses §7701(b), which determines when a foreign national is treated as a U.S. resident. Next, the rules regarding the tax residence of legal entities, such as partnerships and corporations, are covered, including the check-the-box regulations (Reg. §§301.7701-1, 2, and 3), which, after the TCJA amendments, are one of most important developments in the U.S. international tax regime in the last twenty years. Finally, the residence of trusts and estates is briefly addressed.

2.1.1 Taxation of Citizens and Residents under U.S. Law

The notion of residence is one of the cornerstones of the U.S. international tax regime. U.S. citizens, including dual citizens, and resident aliens are generally taxed on a residence basis, regardless of their actual physical residence, domicile, or economic contacts with the United States. Thus, all income, regardless of its geographic origin, is subject to U.S. income tax. *Cook v. Tait*, below, recognizes that the constitutional power to levy income taxes on U.S. citizens (and by extension resident aliens) is not tethered at the U.S. border. Nonresident aliens, in contrast, are taxed on a source basis, and income of a nonresident

The United States is the only country that taxes its non-domiciled citizens and resident aliens on a residence basis.

that does not have any nexus to the United States (foreign source income) is not taxed by the United States. Because of the fundamental distinction between residence and source basis taxation, one of the first determinations you must make as a tax advisor is your client's tax residence.

A notable exception to residence basis taxation is found in §911, which permits a citizen or resident alien who resides and earns income abroad to elect to exclude from U.S. tax a portion of his foreign earned income (up to \$120,000 for 2023) and other non-cash benefits.

Aware that the lure of source basis taxation may be an irresistible inducement to well-heeled citizens and resident aliens to renounce their U.S. citizenship or residence, Congress has enacted special income, gift, and estate provisions intended to discourage persons from renouncing their U.S. citizenship or long-term residency solely for tax purposes. Under §877A, certain citizens and long-term resident aliens who renounce their citizenship or abandon their U.S. residency are subject to tax on the unrecognized gain in their property. In addition, they are also subject to a modified U.S. estate and gift tax regime. Sections 911 and 877A are discussed below in Chapter 8.

The Constitution imposes virtually no limits on Congress's power to tax income. Article I, Section 8, Clause 1 of the Constitution grants Congress the "the power To Lay and collect Taxes, Duties, Imposts, and Excises..." Although "direct taxes" must be apportioned among the states in proportion to their population (Article I, Section 9, Clause 4), the Sixteenth Amendment abolished the apportionment requirement for "taxes on incomes, from whatever source derived..."

The word "source" in the Sixteenth Amendment refers to the economic origin or source of the income, *e.g.*, wages or property, and not to geographic source. Early Treasury regulations extended the income tax to encompass the income of U.S. citizens and resident aliens arising from any geographic source. The validity of this regulation, and the U.S. constitutional power to tax the worldwide income of its citizens and resident aliens, even those with a foreign domicile, was affirmed in *Cook v. Tait*

Cook v. Tait
265 U.S. 47 (1924)

JUSTICE MCKENNA delivered the opinion of the Court.

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

Note the maximum federal tax rate.

States the rate upon the first \$4,000 of such excess amount shall be 4 per centum.”¹

Plaintiff is a native citizen of the United States and was such when he took up his residence and became domiciled in the City of Mexico...

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

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

Is this what Cook argued?

.....

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

The contention was rejected that a citizen’s property without the limits of the United States derives no benefit from the United States. The contention, it was said, came from the confusion of thought in “mistaking the scope and extent of the sovereign power of the United States as a nation and its relations to its citizens and their relations to it.” And that power in its scope and extent, it was decided, is based on the presumption that government by

¹... [R]egulation, No. 62 ... provides in Article 3: “Citizens of the United States except those entitled to the benefits of section 262 [...] wherever resident, are liable to the tax. It makes no difference that they may own no assets within the United States and may receive no income from sources within the United States. Every resident alien individual is liable to the tax, even though his income is wholly from sources outside the United States. Every nonresident alien individual is liable to the tax on his income from sources within the United States.”

The benefits and burden rationale.

its very nature benefits the citizen and his property wherever found, and that opposition to it holds on to citizenship while it “belittles and destroys its advantages and blessings by denying the possession by government of an essential power required to make citizenship completely beneficial.” In other words, the principle was declared that the government, by its very nature, benefits the citizen and his property wherever found and, therefore, has the power to make the benefit complete. Or to express it another way, the basis of the power to tax was not and cannot be made dependent upon the situs of the property in all cases, it being in or out of the United States, and was not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation as citizen to the United States and the relation of the latter to him as citizen. The consequence of the relations is that the native citizen who is taxed may have domicile, and the property from which his income is derived may have situs, in a foreign country and the tax be legal—the government having power to impose the tax.

Judgment affirmed.



Comments

1. The *Cook* court invokes the benefits and burden rationale to support its holding. Under the benefits principle, a person is taxed (the burden) in order to pay for the services (the benefits) provided by the government. The court did not consider the question of whether the benefits provided by the U.S. government to nonresident citizens are the same as those provided to resident citizens. A moment’s reflection should be sufficient to answer that question in the negative. Logically extended, the benefits rationale would at least require different tax rates for foreign income and U.S. income. Perhaps the benefits rationale can be salvaged if one views the minimum benefit provided to all citizens and resident aliens is the right return to and live in the United States. Finally, the benefits principle of taxation is incompatible with the notion that an aim of government is to redistribute goods and services to those who do not have the means to purchase them in the market.

Under the more modern ability-to-pay principle, the tax burden should be borne in relation to a person’s ability to pay as measured by his income. Since \$100 of foreign income and \$100 of U.S. income both equally increases a person’s ability to pay, both should be included in the tax base. In addition, including foreign income in the tax base ensures that capital is allocated efficiently. If foreign income were exempt from tax, U.S. persons would have a tax incentive to shift capital abroad.

Before 2018, the U.S. tax system departed significantly from the ability-to-pay principle by deferring tax on the business income of the foreign subsidiaries of U.S. multinationals until the income was remitted to the U.S. parent. The enactment of the GILTI regime (§§951A and 250) in the TCJA significantly expanded the base of earnings of foreign subsidiaries subject to current tax. The same legislation saw, however, the enactment of a participation exemption (§245A), which permanently excludes from U.S. tax the foreign earnings of foreign subsidiaries not otherwise caught in the web of the subpart F, GILTI, or PFIC regimes. The U.S. anti-deferral regimes are explored more fully below in Chapters 7, 10, and 11.

The benefits and burden principle may still have relevance if it is viewed as jurisdiction principle. A wealthy foreigner clearly has more ability to pay than a U.S. pauper, but if the foreigner has no economic nexus to the United States, he pays no U.S. tax. Could the United States tax wealthy foreigners with no nexus to the United States? Such a regime would certainly raise due process concerns. And if the United States implemented such a regime, it is certain that other countries would follow, potentially leading to a tax or trade war. But more fundamentally, we do not tax such persons because they have not received any economic benefit from the United States.

2. Some scholars have questioned U.S. citizenship taxation on the basis that since it imposes tax and compliance barriers it may undermine the important value of free movement. It may discourage the emigration of talented foreigners and thereby place the United States at a competitive disadvantage. *See* Ruth Mason, *Citizenship Taxation*, 89 S. Cal. L. Rev. 169 (2016).

2.1.2 Tax Treaties and U.S. Citizens and Residents

A tax treaty bestows tax benefits—generally in the form of reduced source basis taxation—only to a treaty *resident*. Article 1(1). To qualify for treaty benefits, a person (including legal persons) must be a *resident* as determined in Article 4; a legal person, such as a corporation, must also be a *qualified person* under Article 23. Article 23(1) and (2).

An individual is a treaty resident if he is subject to tax by one of the contracting states “by reason of his domicile, residence, citizenship . . . or any other criterion of a similar nature.” Article 4(1). Although a U.S. citizen or resident alien will generally qualify as a U.S. treaty resident, Article 4(2), however, requires a U.S. citizen or resident alien with a “green card” to satisfy two additional requirements to be a treaty resident. First, he must have a “substantial presence, permanent home, or habitual abode in the United States”; and second, he must not be treated as a treaty resident under any other U.K. treaty

Residence is defined in Article 4. Legal entities must also be qualified persons under Article 23.

with a third country. Article 4(2). Consequently, a U.S. citizen or green card holder with minimal physical presence or economic connections to the United States is not a resident under the Treaty. The Technical Explanation to Article 4(2) states that the second requirement prevents a citizen or resident alien from choosing the (potentially superior) benefits of the Treaty over those of the treaty between the United Kingdom and his foreign country of residence.

The United States generally negotiates to extend treaty benefits to U.S. citizens and green card holders wherever resident. This is beneficial to the United States as reducing source basis taxation generally increases the tax revenues of the residence country.

To illustrate, assume a U.S. citizen whose marginal tax rate is 35%, receives \$100 of interest from a U.K. corporation that would be taxed at 30% by the United Kingdom but is taxed at 0% under Article 11(1) of the Treaty. If the Treaty did not apply, the United States would also tax the \$100 but would grant a credit for the 30% U.K. tax paid leaving the U.S. fisc with a residual \$5 (\$35 U.S. tax liability less a credit of \$30) of U.K. tax. As a result of the Treaty, the U.K. tax rate is 0%, and United States now collects the entire \$35 for an increase in U.S. tax revenues of \$30. See Example 1.

**EXAMPLE 1: TREATIES SHIFT REVENUES FROM SOURCE TO
RESIDENCE COUNTRIES**

P, a U.S. citizen whose marginal tax rate is 35%, receives \$100 of interest from a U.K. corporation. The U.K. tax rate in the absence of the Treaty is 30%. Assuming that P can credit the U.K. tax against his (pre-credit) U.S. tax liability of \$35, P pays an additional \$5 to the United States, which receives only \$5. If the Treaty applies, however, the U.K. tax rate is 0%, and P pays \$35 to the United States. P pays of total of \$35 in either case, but the Treaty shifts \$30 of revenue from the United Kingdom (source country) to the United States (residence country).

	No Treaty	Treaty
Taxable Income	100	100
US Tax (Pre-credit)	35	35
Less credit for U.K. Tax	(30)	(0)
Residual U.S. Tax	5	35

Our treaty partners, such as the United Kingdom, however, are generally not so keen to extend treaty benefits to resident aliens or U.S. citizens residing in third countries. Because most of our treaty partners generally do not tax the worldwide income of their nonresident citizens, any source basis tax concession

given by the United States to, for instance, a U.K. citizen residing in Mexico and not subject to U.K. tax on his worldwide income, would not affect U.K. tax revenues. Assume that a U.K. citizen residing in Mexico receives a royalty for the use of a patent in the United States that is subject to a 30% U.S. withholding tax. If the U.K. citizen were able to use the Treaty to reduce the U.S. tax rate to 0%, the United States would forego \$30 of revenue, but because the United Kingdom does not tax the non-U.K. income of its non-domiciled citizens, U.K. tax revenues would remain unchanged. Thus, if the United Kingdom were to agree to give up source basis taxes on U.S. citizens and residents residing in third countries, its tax revenues from U.S. persons would decrease, but its tax revenues from its nonresident citizens would remain unchanged even with a reciprocal U.S. concession.

2.2 Dual Citizens

U.S. citizenship can be acquired in many ways: being born in the United States, becoming a naturalized citizen through marriage or residence in the United States, or being born outside of the United States to parents who are U.S. citizens. A citizen retains his citizenship regardless where he subsequently resides, unless it is renounced. Many citizens who were born abroad, have resided abroad their entire lives, and possess citizenship of another country may not be aware of their U.S. citizenship and the U.S. fiscal responsibilities that accompany it.

A dual citizen of the United States and another country is also subject to residence basis taxation by the United States, unless he renounces his citizenship. In Rev. Rul. 75-82, 1975-1 C.B. 5, the IRS ruled that a naturalized U.S. citizen who was born in Canada and eventually reestablished Canadian residence did not lose his U.S. citizenship solely by returning to Canada. In addition, he continued to remain subject to U.S. tax.

Since the mere act of returning to and residing in Canada is not one of the acts described in 8 U.S.C. section 1481 by which United States nationality is lost, and since the individual in the instant case had never performed any of the acts by which United States nationality is lost, he remained a United States citizen when he returned to Canada after attaining majority. Accordingly, he is not relieved of the duty incumbent on United States citizens of filing Federal income tax returns.

Dual citizens are subject to overlapping residence tax claims by both countries. The domestic law of each country rarely will provide complete relief against overlapping dual residence taxation, and in the absence of a tax treaty, double taxation will inevitably arise.

Tax treaties mitigate the problem of dual residence taxation by employing a

To eliminate residence basis taxation by two countries, treaties provide for a single tax residence.

series of tie breaker rules that generally result in the determination of a *single* country of tax residence. Under Article 4(4), a dual resident is considered to be a resident of the country in which he has a permanent home, where his personal and economic relations are closer, where he maintains a habitual abode, or where he is a national. These tests are applied in order, so for example, if a dual resident has a permanent home in only one country, he will be a resident of that country regardless of his economic nexus with either country or his nationality.

To protect residence basis taxation of its citizens residing abroad, the United States generally reserves the right pursuant to the so-called “savings clause”—Article 1(4)—to tax its citizens and resident aliens regardless of any treaty benefits to which they otherwise may be entitled. Thus, even if a U.S. citizen is treated as a U.K. resident under Article 4(4), the savings clause would prevent him from using the Treaty to lower U.S. tax. As there are almost no rules without exceptions, Article 1(5)(a) and (b) exempt certain narrow categories of income and individuals from the savings clause.¹ But, you may ask yourself, wouldn’t a U.S. citizen who’s also a U.K. resident potentially be subject to double taxation? The answer is yes, but Article 24(6) of the Treaty aims to coordinate overlapping fiscal claims to ameliorate possible double taxation.

Under the savings clause, a U.S. citizen cannot generally use the Treaty to reduce U.S. tax.

Citizenship Regained

If a U.S. citizen has lost or renounced his citizenship and has it restored retroactively, how should he be taxed during the period he was not treated as a U.S. citizen and did not reside in the United States or avail himself of any benefits of citizenship? Resolving this issue raises questions about the underlying basis on which U.S. residence basis tax is levied.

In *Felix Benitez Rexach v. U.S.*, 390 F.2d 631 (1st. Cir. 1968), *cert. denied*, 393 U.S. 833 (1968), Rexach, a U.S. citizen who resided in the Dominican Republic and worked on large scale construction projects, renounced his citizenship in 1958. When then-Dictator Trujillo was assassinated in 1961, Rexach had a change of heart. He successfully argued that his renunciation was coerced and had his U.S. citizenship restored *ab initio*. After restoring his citizenship, the United States then sued Rexach for income taxes during these years. Rexach argued that “since the United States ‘owed’ him, or apparently owed him, no citizen’s protection, he, in turn, owed no tax.” The court rejected Rexach, stating:

While there is language in *Cook v. Tait*, *supra*, indicative that these are reciprocal obligations, the Court also observed that “government by its very nature benefits the citizen * * *.” . . . We cannot agree that the reciprocal obligations are mutual, at least in the

¹For instance, a U.S. citizen who is a U.K. resident is not subject to U.S. tax on U.S. social security benefits. Articles 1(5)(a) and 17(3).

sense that taxpayer contends. It is sufficient that the government's stem from its de jure relationship without regard to the subjective quid pro quo in any particular case. We will not hold that assessment of benefits is a prerequisite to assessment of taxes...²

A related case, *U.S. v. Lucienne d'Hotelle de Benitez Rexach*, 558 F.2d 37 (1st. Cir. 1977), involved Lucienne, Felix's wife. Lucienne was born in France and became a naturalized citizen in 1942. She returned to France in 1946 and remained a French resident until May 20, 1952. During that time, §404(b) of the Nationality Act of 1940 provided that naturalized citizens who returned to their country of birth and resided there for three years lost their American citizenship. Her U.S. passport was renewed in 1947 and 1949, but her citizenship was stripped on May 20, 1952 pursuant to §404(b). The successor statute to §404(b) was held to be unconstitutional in *Schneider v. Rusk*, 377 U.S. 163 (1964), and its holding was applied retroactively. Because the Dominican Republic was a community property state, Lucienne legally owned one-half of Felix's income, and the U.S. government sued to collect tax on her share. Lucienne had accepted her loss of citizenship and never applied to have it reinstated.

The First Circuit upheld the government's position that she was liable to U.S. taxes for the years 1949 (the date her citizenship was lost under §404(b)) through 1952 (the date a certificate of loss of nationality was issued to her) stating that "...the balance of the equities mandates that back income taxes be collectible for periods during which the involuntarily expatriated persons affirmatively exercised a specific right of citizenship." In Lucienne's case, the specific right of citizenship was her possession and use of an American passport. For the post-1952 years, however, the court said *in dicta* that the government should not be allowed to tax her:

Although estoppel is rarely a proper defense against the government, there are instances where it would be unconscionable to allow the government to reverse an earlier position. . . . This is one of those instances. Lucienne cannot be dunned for taxes to support the United States government during the years in which she was denied its protection. . . . Here, Lucienne severed her ties to this country at the direction of the State Department. The right hand will not be permitted to demand payment for something which the left hand has taken away.³

Why was Felix taxed during his period of non-citizenship but Lucienne was not? Should the basis on which citizenship was lost and restored matter if it is

²*Felix Benitez Rexach v. U.S.*, 390 F.2d 631, 632 (1st. Cir. 1968), *cert. denied*, 393 U.S. 833 (1968)

³*U.S. v. Lucienne d'Hotelle de Benitez Rexach*, 558 F.2d 37, 43 (1st. Cir. 1977).

restored retroactively? If such persons should not be taxed because they did not receive any benefits of citizenship from the United States during the period of non-citizenship, then could it be argued that the foreign source income of U.S. persons residing abroad should also not be taxed or taxed at a lower rate? Does a nonresident citizen receive the same benefits and protections as a resident citizen, especially with respect to property that is located abroad? Can §911 be construed as a partial attempt to implement a modified benefits principle for nonresident citizens?

In addition to income taxes, the United States also subjects its residents and citizens to U.S. gift, estate, and generation skipping taxes on the worldwide transfers of property and worldwide estates. The international implications of these taxes are discussed below in Chapter (). Nonresidents, as specially defined for gift and estate tax purposes, are also subject to U.S. gift and estate taxes but generally only with respect to transfers of U.S. situs property. Thus, a former citizen who regains his U.S. citizenship must not only determine whether he will be subject to income tax on a residence basis while an expatriate, but also whether he will be subject to U.S. gift or estate tax on a residence basis while an expatriate.

Comments

1. As a result of a series of Supreme Court decisions in the 1960's and 1970's that struck down certain provisions of prior U.S. immigration and nationality laws, many former U.S. citizens were entitled to have their citizenship restored retroactively. To provide guidance for the tax consequences of the period of non-citizenship, the IRS issued Rev. Rul. 92-109, 1992-2 C.B. 3, which considers four situations: (1) A citizen performed an expatriating act in 1981 and had his citizenship restored retroactively in 1990; (2) A citizen performed an expatriating act in 1979, but has not applied to have his citizenship restored; (3) A citizen performed an expatriating act in 1980, but did not report this act to the Department of State and never lost his citizenship; and (4) A citizen resides outside of the United States and has never performed an expatriating act or filed tax returns.

For persons in Situation 1, the IRS ruled that they would not be liable for U.S. taxes during the period prior to the restoration of their citizenship. For persons in Situation 2 whose citizenship is eventually restored, the IRS ruled that they would not be liable for U.S. taxes from the time of expatriation until their first tax year beginning after December 31, 1992. For person in Situation 3 who believed erroneously they had lost their citizenship, the IRS ruled that they may be eligible for administrative relief to be treated similarly to persons in Situations 1 and 2, provided "they acted in a manner consistent with a good faith belief that they had lost United States citizenship by, among other things, not affirmatively

exercising any rights of United States citizenship in the period when they did not file federal tax returns as United States citizens.” Finally, for persons in Situation 4, no special relief is granted under the ruling.

Which of the *Rexach* cases does the IRS follow in Situation 1? In Situation 2? What is the carrot the IRS holds out for fence sitters, *i.e.*, those persons who are considering applying to have their citizenship restored?

2. When reading a particular provision treaty, you should remember that the saving clause is generally separately stated and will apply to a U.S. citizen or resident unless the income falls under a particular exception. Treaty provisions cannot always be read in isolation.

In *LeTourneau v. CIR*, T.C. Memo. 2012-45 (2012), the taxpayer, LeTourneau, was a U.S. citizen and French resident under the U.S.-France Treaty who worked for United Airlines. She argued that her income was exempt under Art. 15(3) of U.S.-France Treaty [Art. 14(3) of the Treaty], which prohibits source basis taxation of income derived in respect of an employment exercised as a member of a regular complement of a ship or aircraft operated in international traffic. The Tax Court gave short shrift to LeTourneau’s argument:

Although this provision on its face seems to favor petitioner’s position, it cannot be read in isolation. Unlike many foreign countries, the United States taxes its citizens on their worldwide income. To reserve its right to tax its citizens on the basis of the provisions of the Internal Revenue Code without regard to the provisions of a treaty or convention, the United States typically includes a so-called saving clause in its tax treaties and conventions. The Convention contains such a saving clause in article 29, paragraph 2, which provides in relevant part: “Notwithstanding any provision of the Convention except the provisions of paragraph 3, the United States may tax its residents, as determined under Article 4 (Resident), and its citizens as if the Convention had not come into effect.”

Although paragraph 3 of article 29 of the Convention provides that certain articles of the Convention take precedence over the saving clause, article 15, upon which petitioner relies, is not among those provisions. Accordingly, notwithstanding the provisions of article 15, paragraph 3 of the Convention, petitioner is subject to U.S. taxation on her wages earned while residing in France.

The court further reminded LeTourneau that the Technical Explanation specifically states that the saving clause permits the United States to tax

its citizens under the Code, and that the exemption for crew members operating in international traffic is subject to the saving clause. Busted.

3. Many U.S. citizens, dual citizens, and resident aliens residing abroad may not be aware of (or intentionally neglect) their U.S. tax filing and reporting obligations. They do so at considerable risk to their financial well being (and at considerable benefit to the financial well being of their tax advisors). For example, to exclude foreign earned income under §911, a U.S. person must make a specific election on his tax return.

Under §6038D, a U.S. person that hold interests in foreign financial assets, such as foreign bank accounts or stock or securities in foreign corporations, must disclose annually certain information about these holdings or risk significant, confiscatory financial penalties.

In addition, there are myriad reporting requirements covering such events as the receipt of large gifts from foreign persons (§6039F), the transfer of property to a foreign corporation or partnership (§6038B), and the transfer of property to a foreign trust (§6048). Finally, under §7345, a U.S. citizen can be denied a passport or have his passport revoked if he has *seriously delinquent tax debt*, which is defined to be an unpaid tax liability of greater than \$50,000. *See, e.g., Maehr v. U.S. Dept. of State* (10th Cir. 2021) (upholding lower court decision that revocation of passport under §7345 was not unconstitutional).

One very important non-tax reporting obligation is found in the *Currency and Foreign Transactions Reporting Act of 1970*, 31 USC §§5311-5332, which is known as the *Bank Secrecy Act*. A U.S. person is required to disclose annually on FinCEN [Financial Crimes Enforcement Network] Form 114 any interest in a foreign financial account with a value in excess of \$10,000 (the so-called FBAR filing). Congress found that many Americans intentionally disregarded this obligation, and the IRS has aggressively enforced the draconian penalty provisions—up to 50% of the account balances—for willful violations. *See, e.g., U.S. v. Markus*, CN 16-2133 (2018) (penalties of \$842k on foreign accounts of \$1.1mm), and *U.S. v. Molyneux*, 22 Civ. 10654 (2022) (US attempting to impose \$400,000 penalty for failure to file FBARs for two years on accounts that had maximum balances of \$29k and \$65K). For some inexplicable reason, the FBAR must be filed separately from a taxpayer's tax return.

The New Kid in Town: Beneficial Ownership Reporting Rules Under the Corporate Transparency Act (CTA) enacted in 2021, many private LLCs, corporations, and other entities formed to do business in the United States will be required to file reports disclosing their beneficial ownership and update the reports upon changes in beneficial ownership. A beneficial owner is an individual who directly or indirectly exercises substantial control over an entity or owns or controls at least 25% of the

ownership interest. These rules will take effect on Jan. 1, 2024. For those with extreme insomnia, here is the final rule issued by the Financial Crimes Enforcement Network (FinCEN), Treasury on Sept. 30, 2022: (*Beneficial Ownership Reporting Rule*). The information required to be disclosed under the CTA will not be available to the general public. In December, 2022, the Treasury issued a proposed rule regarding access by authorized recipients to the beneficial ownership information reported to FinCen.

It's pretty clear that a whole career can be based on helping clients satisfy their international reporting requirements.

Last updated on 2 Jan 2023; *residence_1_3_Jan23*

2.3 Resident and Nonresident Aliens

Code: 2(d); 6851(d); and 7701(b)
 Regulations: 1.871-1(a) and (b); 1.871-2 (skim); 301.7701(b)-2(d) and (f),
 -3(b)(3), (4), (5), (6), and (7); -3(b)(5), -8(a)(1), and -8(d)
 (skim)
 Treaty: Article 4

A foreign national who is not a U.S. citizen is either taxed on a residence or source basis depending on whether he is a resident or nonresident alien. Resident aliens are subject to residence basis taxation on their worldwide income, but nonresident aliens ("NRAs") are subject to source basis taxation. In particular, NRAs are taxed only on certain limited categories of U.S. source investment income and income that is effectively connected with a U.S. trade or business. Thus, the foreign source income of nonresident aliens is not taxed by the United States.

Until 1985, an alien was a U.S. resident if he was physically present in the United States and was "not a mere transient or sojourner." Reg. §1.871-2(b). It was not necessary to show that an alien intended to reside permanently in the United States—which is closer to the concept of domicile—but only that he did not have an actual intention to return at a definite time to another country. The regulations state that whether an alien was transient is "determined by his intentions with regard to the length and nature of his stay." Ascertaining someone's intentions is never a simple exercise because the available facts are often ambiguous. Courts and administrators focused on such factors as the alien's length of stay, U.S. and foreign dwelling arrangements, immigration status, family ties in the United States, and U.S. civic and social activity, but these determinations required significant administrative resources. In addition, the unique factual settings of the cases made it difficult to advise aliens with certainty whether they would be resident aliens.

Residence for gift and estate taxes is determined by an alien's domicile—residence and intention to remain indefinitely. Reg. §25.2501-1(b)

To forestall these disputes, Congress in 1984 enacted §7701(b), which provides bright-line tests based on immigration status or physical presence to determine the tax residence of an alien. Note, the definition of residence under the 871 regulations still applies in limited circumstances, for example, to determine whether a U.S. citizen is a bona fide resident of a foreign country under §911(d)(1)(A). In addition, some sections have special residence rules that supersede the §7701(b) definition, *e.g.*, §865(g) (definition of residence for sourcing gains from personal property sales).

Lawfully Admitted for Permanent Residence. An alien is a U.S. resident if he is legally entitled to reside in the United States, is physically present in the United States for more than 183 days, or has elected to be a resident alien. §7701(b)(1)(A). An alien is legally entitled to reside permanently in the United States if he has been granted a Permanent Resident Card, better known as a *green card*. Once secured, permanent residence status continues until rescinded or is administratively or judicially determined to have been abandoned. §7701(b)(6); Reg. §301.7701(b)-1(b). Thus, even if a green card holder spends no time in the United States, he is taxed on a residence basis. The residency starting date for a green card holder (who does not otherwise satisfy the substantial presence test) is the first day he is present in the United States while having a green card. §7701(b)(2)(A)(ii).

Substantial Presence Test. An alien satisfies the substantial presence test if he is (1) present in the United States more than 31 days during the current calendar year; *and* (2) present 183 days or more during the current and previous two years. In determining whether the 183-day test is satisfied, each day present in the current year counts as one day; each day present in the preceding year counts as $\frac{1}{3}$; and each day present in the second preceding year counts as $\frac{1}{6}$.

SUBSTANTIAL PRESENCE EXAMPLE

A, a U.K. citizen, is present in the United States for 90 days in 2019; 150 days in 2020; and 120 days in 2021. For what years does A satisfy the substantial presence test?

A is not a resident alien for 2019 because he is present for only 90 days. A is also not a resident alien in 2020 because he is present for only 180 days: $150 \text{ (2020)} + 90 \times \frac{1}{3} \text{ (2019)}$. A is a resident alien in 2021 because he is present for 185 days, determined as follows:

	(a)	(b)	(a) × (b)
Year	Days in US	Weight	Counted Days
2021	120	1	120
2020	150	$\frac{1}{3}$	50
2019	90	$\frac{1}{6}$	15
Total			185

Closer Connection Exception. An important goal of Congress in amending the definition of resident alien was to provide bright-line rules for determining an alien's U.S. tax residence. Congress retained some elements of the prior regime that require a facts and circumstances determination. An alien that otherwise satisfies the substantial presence test but is here for less than 183 days in the *current year* can be treated as a nonresident, provided the alien has a *foreign tax home* and a *closer connection* to the foreign country. §7701(b)(3)(B). The definition of tax home for purposes of the closer connection is same as under §162, and the regulations clarify that a tax home is "located at an individual's regular or principal (if more than one regular) place of business." Reg. §301.7701(b)-2(c)(1). An alien without a regular or principal place of business or who is not engaged in a trade or business has a tax home at his "regular place of abode in a real and substantial sense." *Id.*

The regulations also provide a non-exhaustive list of factors to be considered in determining whether an alien has a closer connection to a foreign country. Some of the facts and circumstances are the location of the alien's permanent home, the location of family and personal belongings, the location where the alien conducts his routine personal banking activities, the jurisdiction in which the individual votes and holds a driver's license, and the country of residence indicated on forms and documents. Reg. §301.7701(b)-2(d)(1). These factors are similar to those used by courts under the pre-1985 definition of resident alien. For a well-heeled alien who has the flexibility to establish a firm economic connection to one country but who's required to spend time in another, it should not be too difficult to follow the road map of the regulations and adjust his economic arrangements to be fairly certain that he has a closer connection to a foreign country.

CLOSER CONNECTION EXCEPTION

Same facts as previous example. For what years can A potentially claim a closer connection to the United Kingdom?

Since A is not a resident alien for either 2019 or 2020, the closer connection exception does not apply. A is a resident alien in 2021 under the substantial presence test, but since he is present for fewer than 183 days in 2021, he is potentially eligible for the closer connection example. Whether he has a closer connection to the United Kingdom will depend on the location of his tax home and U.K. connections.

Days of Presence. In applying the substantial presence test, an alien must generally count each day of presence in the United States. For certain

categories of aliens, referred to in the statute as *exempt individuals*, their days of presence in the United States do not count under the substantial presence test. Therefore, provided an exempt individual does not have a green card, he will not be a resident alien. Exempt individuals include diplomats and full-time employees of international organizations such as the Inter-American Investment Corporation, the International Committee of the Red Cross, and the International Cotton Advisory Committee. Also covered are students, teachers, and trainees.

To prevent a wealthy, bon vivant cafe habitué from cloaking himself in student status, the regulations limit teacher and student status to holders of the appropriate visa, which include F, J, M, and Q visas, and require *substantial compliance* with the terms of the visa. §7701(b)(5)(C)(ii); Reg. §301.7701(b)-3(b)(2), (3), and (4). In addition, teachers and trainees cannot exclude days of presence if they have been exempt as teacher, trainee, or student for any part of two of the preceding six years. §7701(b)(5)(E); Reg. §301.7701(b)-3(b)(7)(i). A student is limited generally to five years of exemption unless he can demonstrate that he does not intend to reside permanently in the United States. §7701(b)(5)(E)(ii); Reg. §301.7701(b)-3(b)(7)(iii).

Regular commuters from Canada and Mexico are also exempt individuals. §7701(b)(7)(B); Reg. §301.7701(b)-3(d). A regular commuter is one that commutes from Canada or Mexico on more than 75% of the *workdays* during the *working period*, terms that are fleshed out in the regulations. Reg. §301.7701(b)-3(e)(1) and (2). A person present in the United States who is in transit between two foreign countries is not treated as present, provided that he is here for less than 24 hours and does not undertake any activities connected with the United States, such as having a business meeting. §7701(b)(7)(C); Reg. §301.7701(b)-3(d).

One curious exception is for professional athletes who compete in *charitable sports events*. §7701(b)(5)(A)(iv). At first glance, it is unclear who would benefit from such an exclusion. One potential category would be athletes that come to compete in international competitions in the United States, such as the Olympics or World Cup, but such competitions are rare and generally of such short duration that it is unlikely an athlete would otherwise even come close to satisfying the substantial presence test. Digging a bit deeper, one discovers that the intended recipients of this statutory largesse were professional golfers who compete in golf tournaments organized as charitable events.⁴ Interpreted liberally, this exception would allow professional golfers to live and compete in the United States, but not pay tax on their worldwide income. Of course, any winnings from U.S. golf tournaments and other U.S. source income, such as fees for promotions would certainly be taxed by the United States, but

⁴Most PGA tournaments are set up as charities, but apparently very little of the gross receipts (about 16%) are spent on charitable activities. See Tax Breaks and the PGA. Shocking.

their foreign source income and all investment income would be exempt. The regulations, however, largely eviscerate this exception by limiting it to only days spent competing and not days spent preparing, promoting, or traveling. Reg. §301.7701(b)-3(b)(5).

Beginning and Ending of Resident Alien Status. The day that residence alien status begins determines when an alien ceases to be taxed on a source basis taxation and begins to be taxed on a residence basis. For the year during which an alien becomes a resident alien (or ceases to be a resident alien), the alien's taxable year is bifurcated, and he is taxed on a source basis while a nonresident and on a residence basis while a resident. Reg. §1.871-13(a)(1). The U.S. tax consequences to a person receiving income or paying an expense are determined based "on the status of the foreign taxpayer at the time of receipt or payment." *Id.*

An alien's residency starting date generally depends on how resident alien status is acquired. If a resident alien has a green card, the residency starting date is the first day of presence in the United States while a green card holder. §7701(b)(2)(A)(ii). If an alien satisfies the substantial presence test, the residency starting period begins on the first day of U.S. presence. §7701(b)(2)(A)(iii). For an alien who had a green card and also satisfies the substantial presence test, the residency starting date is the earlier of the two dates. Reg. §301.7701(b)-4(a). If an alien satisfies the substantial presence test, he may exclude up to 10 days of presence in the United States in determining his residency starting date if he can show a foreign tax home and closer connection to a foreign country. §7701(b)(2)(C). The exception is of interest to an alien who is planning to become a U.S. resident and in anticipation of the move comes to the United States, for example, on house hunting trips.

Although certain days are excluded for purposes of the residency starting date, they count for calculating substantial presence. Reg. §301.7701(b)-4(c)(1).

If a resident alien is a resident alien during the current year but is not for the following year, his residency termination date is the generally the last day of the calendar year. Reg. §301.7701(b)-4(b)(1). If, however, he can show a foreign tax home and closer connection to the foreign country than to the United States, the residence termination date is the last day of presence in the United States. Reg. §301.7701(b)-4(b)(2).

Comments

1. In *Topsnik v. CIR*, 143 T.C. No. 12 (2014), Topsnik, a German citizen and a resident alien (he had a green card), sold stock in 2004 on an installment basis, with the installments to be paid over the next 5 years. Because Topsnik did not file returns for 2006-2009, the IRS filed substitute returns on his behalf. Topsnik eventually filed returns for those years claiming that he was no longer a resident alien, and even if he were, he owned no tax because he was a German resident under the U.S.-German treaty, which prohibits the taxation of capital gains by the source country. The Tax Court found that Topsnik continued to be

a resident alien until 2010 when he filed a Form I-407 and surrendered his green card as required by Reg. §301.7701(b)-1(b)(3). Even though U.S. immigration law permits the informal abandonment of permanent resident status, the tax law's more specific rules take precedence, and Topsnik had not satisfied those rules. The Court also rejected Topsnik's treaty claims on the basis that Topsnik was not a resident under the German treaty because he was not subject to tax on his worldwide income and had no habitual residence or domicile in Germany,

2. In *Diran Li v. CIR*, T. C. Summ. Op. 2016-49 (2016), Li, a Canadian citizen and resident, attempted to claim education credits against his U.S. wage income. In 2012, Li was present in the U. S. from Feb. 22 to 24 and March 15 to 17 for job interviews and eventually accepted an offer from Microsoft beginning on July 1, 2012. Li filed a Form 1040 for 2012. The Tax Court found that under section 7701(b)(2)(A)(iii) Li's starting date for his U.S. residency in 2012 was the first day he was present in the United States, Feb. 22. Consequently, since Li was a nonresident alien for part of the year, he was not eligible for the education credits pursuant to §25A(g)(7).
3. An alien is not treated as present in the United States if the person could not leave because of a medical condition that arose while the person was present in the United States. §7701(b)(3)(D)(ii); Reg. §301.7701(b)-3(c)(1). This exception is not available if the medical condition arose while the person was present in the United States if the condition or problem existed before his arrival and the individual was aware of the condition or problem. Reg. §301.7701(b)-3(c)(3). A bit rough, no? In Rev. Proc. 2020-20, the IRS allowed certain aliens to exclude up to 60 days of presence in the United States if they were unable to leave the United States because of COVID emergency travel disruptions.
4. ***Pre-Immigration Tax Planning.*** For an alien with few assets and who derives most of his income as wages where he resides, there may be very little difference between source basis and residence basis taxation: if he performs services here, his service income will generally be taxed at graduated rates whether he is taxed on a source or residence basis. For an alien owning appreciated or depreciated property, however, a change in tax status from nonresident to resident will subject gains (and losses) to U.S. residence taxation when they were hitherto subject only to source basis taxation. Changing tax status thus presents tax planning challenges and opportunities for the peripatetic alien.

PRACTICE NOTE: PRE-IMMIGRATION TAX PLANNING
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Because an alien's tax status at the time of receipt of income generally determines how the income is taxed, it is generally advisable to accelerate any foreign source income before becoming a resident alien. For example, if an alien is entitled to compensation that is attributable to services performed abroad and the income will *not* be subject to U.S. tax if it is received before becoming a resident alien it, but will be taxed by the United States if it is received after becoming a resident alien, the income should be accelerated. Of course, the foreign tax consequences of accelerating income will also have to be considered. Sometimes it is possible for income not to be taxed anywhere. For example, if ending date of foreign tax residence does not coincide with the beginning date of U.S. tax residence, income received between the two dates may not be taxed by either country.

A change in tax status from nonresident alien to resident alien generally has no effect for U.S. tax purposes on unrealized gains or losses. Consequently, if property is sold while a foreign national is a resident but was purchased before he became a resident, the property's basis for computing gain or loss must be determined. In general, the property's basis is determined as if the taxpayer and property had always been subject to U.S. tax. This requires that the property's tax history be recreated under U.S. tax principles and generally using U.S. dollars. One unpleasant consequence of this rule is that an alien can have purchased property in foreign currency that has fallen in value in terms of the foreign currency, but if the foreign currency has appreciated vis-a-vis the dollar since the property was purchased, a sale of the property can result in taxable gain.

The look on a client's face when you inform of this rule—after you inform him of the scope of residence basis taxation—is similar to the one seen on a person receiving a sharp unexpected blow to the solar plexus.

HISTORICAL U.S. DOLLAR BASIS FOR PROPERTY

A, a Spanish resident and citizen, purchases a house for 1 million euros when the exchange rate is $\$1 = \text{€}1.17$. In 2018, A moves to the U.S. and becomes a resident alien. He sells the property for €950,000 on July 15, 2018, but if the euro-dollar exchange rate is now $\$1 = \text{€}0.6280$, the dollar value of his house has increased from \$854,700 to \$1,512,738. A will not be too pleased when you inform him that he has a taxable gain of \$658,038. He will rightly feel that he has suffered an economic loss of €50,000.

Furthermore, although simple to state in principle, the historical U.S. tax basis rule can be very complicated to apply in practice. It can be straightforward to recreate the basis of property in certain cases, for

example, the basis of a share of stock or piece of land. There is no clear guidance, however, on how to take into account adjustments such as depreciation and certain elections that could have been made had the person and property been subject to U.S. tax jurisdiction. In addition, the proper method to adjust for changes in the value of foreign currency is not clear for business property.⁵

2.4 Dual Residents

Because the definition of resident varies among countries, it is possible for a person to be a resident of more than one country. A dual resident is subject to U.S. tax on a residence basis unless a treaty applies to treat the resident alien as a resident of the treaty country instead of a resident of the United States. For dual residents, the specter of double taxation looms large unless one or both of the countries gives a credit for taxes levied by the other country. The U.S. foreign tax credit regime may ameliorate but not eliminate double taxation that can arise when two countries assert residence basis taxation. For example, if a dual resident performs services in the United States, but is also taxed by another country on those services, the U.S. foreign tax credit mechanism may be insufficient to relieve double taxation.

DOUBLE TAXATION

A, a U.K. national, is a resident under the domestic laws of the United States and the United Kingdom. A earns \$100,000 for services performed in the United States and is taxed at a marginal tax rate of 35% by both countries. Because the services are performed in the United States, A cannot credit U.K. taxes paid against his U.S. tax liability. If A cannot credit or deduct either U.S. taxes paid against his U.K. taxes or U.K. taxes against his U.S. tax liability, he could end up being subject to a marginal tax rate of 70%.

Tax treaties attempt to prevent double taxation on a residence basis by providing a single residence for treaty purposes. In general, a person is a resident for purposes of the Treaty if he is liable to tax by reason of his “domicile [or] residence...” Article 4(1). Thus, an alien who is resident under section 7701(b) would generally be a resident under the Treaty. Greencard holders,

⁵For a more detailed discussion of these issues, see Jeffrey M. Colón, *Changing U.S. Tax Jurisdiction: Expatriates, Immigrants and the Need for a Coherent Tax Policy*, 24 San Diego L. Rev. 1, 60-87 (1997); and Jasper L. Cummings, *Determining Basis and Other Tax Items of Foreigners*, 151 Tax Notes 479 (Apr. 25, 2016).

like citizens, are treaty residents only if they have a substantial presence, permanent home or habitual abode in the United States *and* they are not residents under any treaty between the United Kingdom and another country. Article 4(2). The Technical Explanation to Article 4 states that substantial presence under the Treaty has the same meaning it does under section 7701(b)(3). If a U.S. resident alien is also a U.K. resident, the tie-breaker tests of Article 4(4) will apply to determine a single residence for Treaty purposes. These tests are discussed above in Chapter 2.2.

If a U.S. resident alien is a dual resident, but a U.K. resident under Article 4(4), he will be a U.K. resident for all purposes of the Treaty, including the savings clause. Consequently, the person would be subject to U.S. tax only as permitted by the Treaty. Note, however, that if a dual resident is a U.K. resident under the Treaty, he is surprisingly still treated as a U.S. person for other purposes of the Code, such as reporting foreign bank accounts and foreign stock ownership requirements, which may have sometimes negative tax consequences to other U.S. persons. *See* Reg. §301.7701(b)-7(a)(3).

Comments

1. Determining a resident's center of vital interest for treaty purposes can require a detailed factual analysis. In, *Elliott v. The Queen*, Tax Ct. No. 2010-898 (IT)G (Feb. 21, 2013), the Canadian Tax Court addressed the treaty residence of three U.S. citizens who lived and worked in Canada as consultants for two years. Relying on the OECD Commentaries to the OECD Model Convention—the Technical Explanation wasn't helpful—the tax court found that consultants' rented apartments constituted a permanent home under the treaty, and thus they had permanent homes in both countries. The court then addressed to which country the consultants' personal and economic relations were closer, that is, their center of vital interests. Finding that the consultants had only lived in Canada while they were fulfilling their contractual duties and left when the work was concluded, maintained all pre-existing ties to the United States, such as bank accounts, cars, cell phones, health insurance, investments, families, driver's licenses, the tax court found that the United States was their center of vital interest.
2. Congress should consider allowing or requiring foreigners who become resident aliens to adjust the basis of their foreign property to fair market value. This would prevent the importation of unrealized losses to use against U.S. income and treat foreigners with illiquid assets, such as stock of a closely-held corporation, similarly to how foreigners holding liquid assets are treated—a foreigner holding liquid assets can purge pre-immigration gain merely by selling and repurchasing the assets. Long-term resident aliens who give up their resident alien status and are subject to U.S. tax on their unrealized gains under §877A may elect to step

up the basis of any property held upon becoming a resident alien to its fair market value. §877A(h)(2). Query why the basis of property with an unrealized loss is not required to be adjusted. *See also* §362(e)(1) (requiring the basis of property with a built-in loss imported into U.S. tax jurisdiction by a corporation as a tax-free contribution to capital or in a reorganization to be adjusted to its fair market value).

3. Section 6114(a) generally requires a taxpayer to disclose when a treaty overrides a Code provision, but certain exceptions are provided for in regulations. The disclosure is made on Form 8833. The position that a taxpayer's residency is determined under a treaty and not the Code specifically must be disclosed. *See also* Reg. §301.7701(b)-7 (detailing filing requirements for dual residents asserting treaty benefits); Reg. §301.6114-1(b)(8). Failure to disclose can result in penalties. *See* §6712(a).
4. One of silliest sections of the Code that applies to foreigners is §6851(d), which requires aliens departing from the United States to first obtain a certificate of compliance with U.S. tax law, which is known as a *sailing permit*. The regulations mercifully exempt students, diplomats, and their families, but every other alien, including a resident alien, is potentially caught in the sailing permit web. If a reader knows of any person who has complied with this rule, please let the author know.

Last revised 2 Jan 2023; *residence_2_Jan2_23*

2.5 Corporations and Partnerships

Code: 11(d); 7701(a)(1)-(10); 7701(a)(30) and (31)
 Regulations: 1.881-1(a), (b), and (c); 301.7701-1(a)(1) and (b), -2(a),
 (b)(1)-(8)(i), -3(a) (skim), (b)(1) and (2), -5
 Treaty: Articles 1(8); 3(1)(a)-(e); and 4

A business entity in the United States is generally classified as either a partnership or a corporation. §7701(a)(2) and (3). Corporations are generally taxed separately from their owners. §11(a). In contrast, a partnership is not subject to tax, but the partners must take into account their share of the partnership's income, gain, or loss, etc. §§701 and 702.

As in the case of individuals, a tax demarcation exists between U.S. and foreign legal entities: a U.S. corporation (including an association taxable as a corporation), trust, or estate, is subject to U.S. residence basis taxation, but a foreign corporation, trust, or estate is subject only to source basis taxation. A partnership (including an LLC treated as a partnership) can be either U.S. or foreign. Although a partnership is not subject to tax, a partner who is a

Whether a partnership is U.S. or foreign is relevant for other tax purposes, for example, in determining the source of interest paid by a partnership and certain U.S. reporting and withholding tax requirements.

U.S. person—citizen, resident alien, U.S. corporation, trust, or estate—will be taxed on a residence basis, and a foreign partner will be taxed on a source basis regardless of whether the partnership is U.S. or foreign.

Also remember that a partnership’s activities are often imputed to its partners, both limited and general. In particular, a foreign partner of a partnership that engaged in a U.S. trade or business will be taxed on his distributive share of the partnership’s income that is connected with the U.S. trade or business as if he were directly engaged in the U.S. business. Thus, when dealing with legal entities, you must determine the type of entity—partnership or corporation—and its nationality—U.S. or foreign—to know how the entity and its owners will be taxed, and the scope of any U.S. reporting, filing, and withholding tax requirements.

Prior to 1997, whether a legal entity was a partnership (unincorporated entity) or corporation for tax purposes was determined by applying a four-factor test set out Old Reg. §301.7701-2(a)(1).⁶ These factors, which derive from *Morrissey v. CIR*, 296 U.S. 344 (1935), were continuity of life, centralized management, limited liability, and free transferability of interest. An entity was a corporation if it possessed more corporate characteristics than noncorporate characteristics. These tests were applied not only to U.S. entities, such as limited partnerships and limited liability companies (LLCs), but also to foreign entities. See Rev. Rul. 88-8, 1988-1 C.B. 403 (all foreign entities were “unincorporated organizations” for purposes of the regulations requiring application of the four-factor test).

The four-factor test generated much criticism. The regulations required a detailed examination of the entity’s organizational documents and local law. Although taxpayers could apply for a ruling that an entity would be treated as a partnership or corporation, the ruling process was costly, especially for foreign entities, as local counsel was often required to be retained. The IRS also had to devote resources to review and process the rulings and to draft, review, and issue guidance in the form of revenue rulings. In addition, obtaining a ruling often took many months, which caused delays in transactions going forward because of tax risks of the entity classification issue.

The emergence of new entities such as LLCs, limited liability partnerships (LLPs), and limited liability limited partnerships (LLLPs), placed additional strains on IRS resources. With the enactment of new business regimes that granted limited liability to partnerships and other unincorporated entities, partnership status could be obtained for entities that were virtually identical to traditional corporations. Entity classification was therefore becoming elective in most cases. In Notice 95-14, 1995-14 IRB 1, the IRS announced that it was considering abandoning the four-factor approach in favor of a regime

⁶There were six factors, but two of the factors, associates and profit motive, were common to both profit-oriented partnerships and corporations and were therefore irrelevant to distinguishing between them.

that permitted taxpayers to elect the tax status of unincorporated entities. Regulations were proposed and finalized in 1996, and the so-called “check the box” regime became effective January 1, 1997.

2.5.1 Check the Box Regulations

Classifying an entity as either a partnership or corporation under the check-the-box (CTB) regulations requires first establishing that a separate entity exists for federal tax purposes. In limited instances, a separate entity exists for state law purposes but not for federal tax purposes. Reg. §301.7701-1(a). If a separate entity exists, it is either a *business entity* or trust, which generally does not have associates or an objective to carry on business for profit. Special rules apply to trusts. See Reg. §301.7701-4.⁷

A business entity that formed pursuant to a state incorporation statute is classified as a corporation for federal tax purposes. Also treated as corporations are associations, joint-stock companies, insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State, and organizations that are taxable as corporations under a specific provision of the IRC. The regulations list entities formed under foreign law that are treated as corporations for federal tax purposes. These entities, referred to as *per se corporations*, generally possess attributes similar to U.S. corporations, *e.g.*, limited liability, separation of ownership and management, free transferability of shares, and oftentimes are the entity of choice for public offering of interests. Per se entities include the Spanish Sociedad Anónima, the French Societe Anonyme, the German Aktiengesellschaft, and the U.K. Public Limited Company. Reg. §301.7701-2(b)(1); (b)(8).

Corporations and per se corporations may *not* elect their federal tax status.

Eligible entities may elect their tax status. An entity with 2 or more members can be a partnership or an association. A single member entity is either an association or disregarded entity.

A business entity that is not a corporation under Reg. §301.7701-2 may elect its tax status. Reg. §301.7701-3(a). An entity that can generally elect its tax status is referred to as an *eligible entity*. An eligible entity with two or more members can be classified as either a partnership or an association (taxed as a corporation). An eligible entity with a single member—single member entity or SME—can be classified as an association (taxed as a corporation) or can be disregarded as an entity separate from its owner. If the single owner of a disregarded entity is a corporation, the disregarded entity will be a branch of the owner; if the owner is an individual, the disregarded entity is a sole proprietorship. It is important to note that the status of being disregarded applies only for federal tax purposes; for state law purposes, the entity continues to exist, *i.e.*, it can hold property, sue, be sued, *etc.*

The regulations simplify the election process by providing default rules that assign a tax status to an entity in the absence of an explicit election. For a domestic entity, such as an LLC, with at least two members, the default

Default classification rules for domestic and foreign entities

⁷The CTB regulations do not apply to certain legal entities, such as Qualified Settlement Funds (§1.468B-1(b)) or Real Estate Mortgage Investment Conduits (REMICs) (§860A(a)).

classification is partnership; if the domestic entity has only one member, it is disregarded. Reg. §301.7701-3(b)(1).

The default classification of a foreign eligible entity, such as a GmbH (Germany) or Private Limited Company (United Kingdom), turns on the limited liability⁸ of its owners. Reg. §301.7701-3(b)(2). If all members of a foreign entity have limited liability, it will be an association. For a foreign entity with more than one member, if at least one member does not have limited liability, it will be a partnership. Finally, a foreign entity will be a disregarded entity if it has a single owner that does not have limited liability. An entity's default classification continues until an election is made to change its classification.

The members of an eligible entity may check the box—affirmatively elect a different tax classification than the default classification—by filing Form 8832, Entity Classification Election. If an election is made to change a classification, the entity cannot change its classification again for the succeeding sixty months. Reg. §301.7701-3(c)(1)(iv). Furthermore, a change in the tax classification may trigger unpleasant tax consequences. For example, if an association elects to be a partnership, the association is deemed to liquidate and distribute its assets and liabilities to its owners, who contribute the assets and liabilities to a new partnership. *See* Reg. §301.7701-3(g).

A taxpayer can elect a different tax classification than the default classification. In tax argot, this is known as *checking the box*.

Once the tax classification—corporation or partnership—of entity is determined, the entity's residence or nationality must be determined. A corporation or partnership is a U.S. person if it is created or organized as any type of entity in the United States. §7701(a)(4). If an entity is not created or organized in the United States as any type of entity, it is foreign. Reg. §301.7701-5(a). The United States looks solely to the entity's place of formation or where its charter was issued in determining residence. Many other countries, however, determine a legal entity's residence by where it is managed and controlled—where its effective management is located. Thus, a corporation formed in the United Kingdom will be treated as a Spanish corporation if it is managed and controlled in Spain.

An entity's tax status is first determined and then its nationality or residence.

The U.S. regime, while virtually eliminating any dispute over a legal entity's residence or nationality, has been criticized as being easy to manipulate and played a key role in certain highly publicized inversion transactions. In an inversion transaction, a U.S.-based multinational “inverts” its corporate structure so that the parent of the corporate chain is now a foreign corporation rather than a U.S. corporation, but the shareholders of the foreign parent corporation are the same as the shareholders of the former U.S. parent. The goal of an inversion transaction is to lower the entity's worldwide tax rate by removing the earnings of the foreign subsidiaries from any residual U.S. tax when the earnings are distributed.

As a result of these inversion transactions, Congress enacted section 7874,

⁸Limited liability is determined under foreign law or the entity's organizational documents. Reg. §301.7701-3(b)(2)(ii).

which treats the new top-tier foreign corporation in an inversion transaction as a U.S. corporation for all federal tax purposes if at least 80% of the stock is held by former shareholders. Serious consideration has been given to amending the U.S. rules to treat any foreign corporation as a U.S. person if it is managed and controlled in the United States, thereby aligning the U.S. and European rules. For example, in 2005, Congress considered, but ultimately rejected a bill that treated any publicly-traded foreign corporation as a U.S. person if its primary place of management and control was in the United States. *See Options to Improve Tax Compliance and Reform Tax Expenditures*, Joint Committee on Taxation (JCS-02-05) (Jan. 27, 2005).

One sometimes overlooked consequence of the check-the-box regulations, especially among non-tax specialists, is that separate legal entities under state or foreign law, including tiers of entities, may not be separate entities for federal tax purposes. Rev. Rul. 2004-77, 2004-2 C.B. 119, confirms that a state or foreign law partnership whose partners consist of a disregarded entity and the disregarded entity's sole member is not a partnership for federal tax purposes. It is also important to remember that the foreign law treatment may be different than the U.S. tax treatment.

Rev. Rul. 2004-77
2004-2 C.B. 119

FACTS

Situation 1. X, a domestic corporation, is the sole owner of L, a domestic limited liability company (LLC). Under §301.7701-3(b)(1), L is disregarded as an entity separate from its owner, X. L and X are the only members under local law of P, a state law limited partnership or LLC. There are no other constructive or beneficial owners of P other than L and X. L and P are eligible entities that do not elect under §301.7701-3(c) to be treated as associations for federal tax purposes.

Situation 2. X is an entity that is classified as a corporation under §301.7701-2(b). X is the sole owner of L, a foreign eligible entity. Under §301.7701-3(c), L has elected to be disregarded as an entity separate from its owner. L and X are the only members under local law of P a foreign eligible entity. There are no other constructive or beneficial owners of P other than L and X.

LAW AND ANALYSIS

Section 7701(a)(2) of the Internal Revenue Code provides that the term partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial

operation, or venture is carried on, and which is not a trust, estate, or corporation.

Section 301.7701-1(a)(1) provides that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under §301.7701-3) that is not properly classified as a trust under §301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more owners is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. Section 301.7701-2(c)(1) provides that, for federal tax purposes, the term “partnership” means a business entity that is not a corporation under §301.7701-2(b) and that has at least two owners. Section 301.7701-2(c)(2)(i) provides, in general, that a business entity that has a single owner and is not a corporation under §301.7701-2(b) is disregarded as an entity separate from its owner. Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes. An eligible entity with at least two owners can elect to be classified as either an association (and thus a corporation under §301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(b)(1) provides generally that in the absence of an election otherwise, a domestic eligible entity is (a) a partnership if it has at least two members, or (b) disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701-3(b)(2) provides generally that, in the absence of an election otherwise, a foreign eligible entity is (a) a partnership if it has two or more owners and at least one owner does not have limited liability, (b) an association if all its owners have limited liability, or (c) disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

Situation 1. Under §301.7701-2(c)(2), L is disregarded as an entity separate from its owner, X, and its activities are treated in the same manner as a branch or division of X. Because L is disregarded as an entity separate from X, X is treated as owning all of the interests in P. P is a domestic entity, with only one owner for federal tax purposes, that has not made an election to be classified as an association taxable as a corporation. Because P has only one owner for federal tax purposes, P cannot be classified as a partnership under §7701(a)(2). For federal tax purposes, P is disregarded as an entity separate

from its owner.

Situation 2. Under §301.7701-3(c), L is disregarded as an entity separate from its owner, X, and its activities are treated in the same manner as a branch or division of X. Because L is disregarded as an entity separate from X, X is treated as owning all of the interests in P. Because P has only one owner for federal tax purposes, P cannot be classified as a partnership under §7701(a)(2). For federal tax purposes, P is either disregarded as an entity separate from its owner or an association taxable as a corporation.

HOLDING

If an eligible entity has two members under local law, but one of the members of the eligible entity is, for federal tax purposes, disregarded as an entity separate from the other member of the eligible entity, then the eligible entity cannot be classified as a partnership and is either disregarded as an entity separate from its owner or an association taxable as a corporation. ❖

Comments

1. Some commentators have suggested that the Treasury may have exceeded its regulatory authority in issuing the check-the-box regulations on the basis that the statutes that define corporation, association, and partnership do not permit an elective regime. To date, courts, following the framework set forth in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), have rejected such arguments on the grounds that the relevant statutes are ambiguous and the check the box regulations are not arbitrary or capricious. The Supreme Court, in *Mayo Foundation v. United States*, 131 S. Ct. 704 (2011), affirmed that the validity of treasury regulations, both those issued under the Treasury’s general regulatory authority in §7805 and under a specific statutory grant, is determined under *Chevron*. Revenue rulings and revenue procedures, however, are probably not entitled to *Chevron* deference. The excerpt below from *Littriello v. U.S.*, 484 F.3d 372 (6th Cir. 2007), demonstrates how the Chevron framework is applied.

The first two arguments raised by Littriello are intertwined. He contends that the statute underlying the “check-the-box” regulations is unambiguous and that the district court’s invocation of Chevron was, therefore, erroneous. Under Chevron, a court reviewing an agency’s interpretation of a statute that it administers must first determine “whether Congress has directly spoken to the precise question at issue.” 467 U.S. at 842.

If congressional intent is clear, then “that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.” *Id.* at 842-43. However, “if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency’s answer is based on a permissible construction of the statute.” *Id.* at 843; see also *Barnhart v. Thomas*, 540 U.S. 20, 26 (2003) (when a statute is silent or ambiguous, the court must “defer to a reasonable construction by the agency charged with its implementation”).

Littriello argues, first, that *Chevron* has been modified by the Supreme Court’s recent decision in *National Cable & Telecommunications Ass’n v. Brand X Internet Services*, 545 U.S. 967 (2005), which “seems to revise the *Chevron* formula by substituting as the second agency requirement ‘reasonableness’ for ‘permissible construction of the statute.’” But this argument overlooks the fact that the *Chevron* opinion uses the terms “reasonable” and “permissible” interchangeably in reference to statutory construction. See, e.g., 467 U.S. at 843, 845. Second, and more substantially, he posits that the regulations run afoul of *Morrissey*, “the seminal case on section 7701,” which he reads to hold that the IRS is legally required to determine the classification of a taxpayer-business within the definitions set out in the statute and may not “abdicate the responsibility of making that determination to the taxpayer itself” by permitting an election of classification such as a “check-the-box” option.

Although the plaintiff’s *Morrissey* argument is not a model of clarity, it seems to depend on the proposition that the terms defined in section 7701 (“corporation,” “association,” “partnership,” etc.) are not ambiguous but “[have been] in common usage in Anglo American law for centuries” and, as a corollary, that “*Morrissey* provides a test of identification [that is itself] unambiguous.” Hence, the argument goes, it is the “check-the-box” regulations that “render whole portions of the Internal Revenue Code ambiguous” and are therefore “in direct conflict with the decision of the Supreme Court in *Morrissey*” in the absence of Congressional amendment to section 7701.

It is unnecessary, in our judgment, to engage in an exegesis of *Chevron* here. The perimeters of that opinion and its directive to courts to give deference to an agency’s interpretation of statutes that the agency is entrusted to administer and to the rules that govern implementation, as long as they

are reasonable, are clear, and are clearly applicable in this case. Moreover, the argument that Morrissey has somehow cemented the interpretation of section 7701 in the absence of subsequent Congressional action or Supreme Court modification is refuted by *Chevron*, in which the Court suggested that an agency's interpretation of a statute, as reflected in the regulations it promulgates, can and must be revised to meet changing circumstances. See *Chevron*, 467 U.S. at 863-64. Even more to the point, the Court in *Morrissey* observed that the Code's definition of a corporation was less than adequate and that, as a result, the IRS had the authority to supply rules of implementation that could later be changed to meet new situations. See 296 U.S. at 354-55. Finally, we note that our interpretation is buttressed by the opinion in *National Cable*, on which the plaintiff relies to support the proposition that the "check-the-box" regulations are impermissible in light of *Morrissey*. In that case, the Supreme Court noted that "[a] court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion." *Nat'l Cable*, 545 U.S. at 982 (emphasis added).

In short, we agree with the district court's conclusions: that section 7701 is ambiguous when applied to recently emerging hybrid business entities such as the LLCs involved in this case; that the Treasury regulations developed to fill in the statutory gaps when dealing with such entities are eminently reasonable; that the "check-the-box" regulations are a valid exercise of the agency's authority in that respect; that the plaintiff's failure to make an election under the "check-the-box" provision dictates that his companies be treated as disregarded entities under those regulations, thereby preventing them from being taxed as corporations under the Internal Revenue Code; and that he is, therefore, liable individually for the employment taxes due and owing from those businesses because they constitute sole proprietorships under section 7701, and he is the proprietor.

2. The contours of judicial review of the validity of Treasury regulations is still a moving hand. In *Altera v. CIR*, 145 T.C. No. 3 (July 27, 2015), the Tax Court struck down the provisions in cost-sharing regulations under §482 that require taxpayers to include stock-based compensation costs in the cost pool. The Tax Court held that the regulations did not satisfy §706(a)(A) of the APA, under which a court can set aside

agency actions that are “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.” In particular, the Tax Court found that the regulations did not satisfy the “reasoned decisionmaking standard” set forth in *Motor Vehicle Manufacturers Assoc. of the United States v. State Farm*, 463 U.S. 29 (1983). The Tax Court determined that the Treasury failed to conduct any factfinding, failed to support its position that unrelated parties would share stock-based compensation in the context of a cost-sharing arrangement, and failed to respond to significant comments. The 9th Circuit, however, reversed the tax court and upheld the validity of the regulations. *Altera v. CIR*, 926 F.3d 1061 (9th Cir. 2019), *cert. denied* 141 S. Ct. 131 (2020). Following a *Chevron* analysis, the court found that the statute (§482) was ambiguous regarding the sharing of stock-based compensation and the Treasury’s adoption of a methodology that followed actual economic activity and not uncontrolled cost sharing agreements was reasonable.

Given the haste with which the TCJA was enacted, there were inevitable statutory snafus that Treasury has attempted to fix via regulations. In *See, e.g., Liberty Global Inc. v. United States*, 2022 WL 1001568 (D.C. Col., Apr. 4, 2022), the Colorado district court struck down Treasury regulations limiting the §245A deduction on the grounds that the regulation didn’t satisfy the notice and comment requirement of the APA, and Treasury’s invocation of the good cause requirement was insufficient. *See also Mann Construction, Inc. v. United States*, No. 21-1500 (6th Cir. 2022) (IRS’s failure to follow notice and comment rulemaking when issuing a listed transaction notice invalidates failure to disclose penalty under §6707A).

3. During the early 2000’s, questions arose regarding the classification of an entity that was organized in more than one country. This could be accomplished pursuant to a domestication or continuance statute such as DGCL §388. An entity with more than one charter is referred to as a dual chartered entity. The tax status of a dual chartered entity was not entirely certain because it could be a corporation in one country but a passthrough entity in another. Which classification should prevail? Did the order in which the charters were acquired matter?

Amendments to Reg. §301.7701-2(b)(9) issued in 2004 clarify that the tax status and residence of a dual chartered entity is determined under a two-step process. First, a dual chartered entity will be a corporation if it is a corporation under the entity classification rules of Reg. §301.7701-2(b) in any country, regardless of its status in another country and the order in which it acquires its charters. Thus, a Spanish sociedad anónima with two owners that is dually chartered as a Delaware LLC will be a corporation, even though the default classification for the LLC under

U.S. law would be partnership. The residence or nationality of the entity is then determined. The entity will be a U.S. entity if it is created or organized in the United States or under the laws of the United States or of any state, again regardless of the order of formation. Reg. §301.7701-5. The preamble to the regulations states that these rules do not apply for determining an entity's residence for purposes of an income tax treaty.

2.5.2 Treaties and Business Entities

Under Article 4, a resident includes any corporation that is liable to tax because of its place of incorporation or its place of management. Note, however, that for a corporation, merely being a resident under Article 4 is necessary but not sufficient to avail itself of treaty benefits. It must also be a qualified resident under Article 23, which is discussed below in Chapter 6.

Under U.K. law, a corporation is a U.K. resident if it is either formed or controlled and managed in the U.K. A company is generally managed and controlled where the board of directors meets. A corporation formed in the United States but managed and controlled in the United Kingdom can also be a U.K. corporation. When a corporation is a dual resident, its residence for treaty purposes must be determined by agreement of the competent authorities. Article 4(5).

The treatment of partnerships under tax treaties has historically presented many challenges. In particular, since partnerships are generally not subject to tax, they would generally not be a resident under Article 4. The partners of a partnership, however, are generally subject to tax on their distributive share of the partnership's income, but the partners may be residents of different countries than the partnership. The issue thus is how should treaties apply to partnerships, at the partner level or at the partnership level?

Under Article 1(8), the income of an entity that is treated as a partnership under the domestic laws of *either* country is considered to be derived by a resident of a treaty country only if the resident is treated under the tax laws of the country of residence as deriving the income. For example, if a U.K. corporation pays a dividend to an entity that is treated as a partnership under U.S. law and has a U.S. partner, since under U.S. law the U.S. partner is treated as receiving a portion (or all) of the dividend, the partner will be entitled to treaty benefits, provided that the partner is a U.S. resident. The result would be the same even if the entity receiving the dividend were treated under U.K. law as a corporation instead of a partnership. As another example, if IBM pays a dividend to a U.S. entity that is treated for U.K. purposes as a corporation, under the Treaty, the income is treated as derived by the U.S. entity and not the U.K. partner even if it is treated as fiscally transparent under U.S. law. The Technical Explanation to Article 1(8) contains some helpful examples.

As Rev. Rul. 2004-76 below illustrates, it is sometimes not sufficient to know how an entity is treated for U.S. purposes, but it is necessary to know

how the entity is treated under the laws and treaties of other countries in order to determine how the entity will be taxed in the United States.

Rev. Rul. 2004-76
2004-2 C.B. 111

ISSUE

If Corporation A, a resident of both Country X and Country Y under the laws of each country, is treated as a resident of Country Y and not of Country X for purposes of the X-Y Convention and, as a result, is not liable to tax in Country X by reason of its residence, is it entitled to claim the benefits of the U.S.-X Convention as a resident of Country X or of the U.S.-Y Convention as a resident of Country Y?

FACTS

Situation 1. Corporation A is incorporated under the laws of Country X. Its place of effective management is situated in Country Y. Corporation A does not have a fixed place of business in Country X. Under the laws of Country X, prior to application of any income tax convention, Corporation A is liable to tax as a resident. Under the laws of Country Y, prior to application of any income tax convention, Corporation A is liable to tax as a resident. Corporation A receives U.S.-source income during the taxable year, with respect to which it seeks benefits under either the U.S. income tax convention with Country X (U.S.-X Convention) or the U.S. income tax convention with Country Y (U.S.-Y Convention).

The relevant articles of the U.S.-X Convention and the U.S.-Y Convention each provide:

Except as provided in this paragraph, for the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. *

* *

The term “resident of a Contracting State” does not include any person who is liable to tax in that State in respect only of income from sources in that State.

There is in force an income tax convention between Country X and Country Y (the X-Y Convention) that contains the following article with respect to residence:

For purposes of the Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. * * *

Where by reason of the above paragraph, a person other than an individual is a resident of both Contracting States, the person shall be deemed to be a resident only of the State in which its place of effective management is situated.

Situation 2. The facts are the same as in Situation 1 except that Corporation A has a fixed place of business in Country X, to which the income is attributable.

LAW AND ANALYSIS

In Situation 1, before application of the X-Y Convention, Corporation A would be a resident of both Country X and Country Y under the domestic laws of each of Country X and Country Y. After the application of the relevant article of the X-Y Convention, Corporation A is treated as a resident of Country Y and not a resident of Country X because its place of effective management is situated in Country Y.

Accordingly, Corporation A continues to be liable to tax in Country Y by reason of residence. Therefore, under the relevant article of the U.S.-Y Convention, Corporation A is a resident of Country Y. Corporation A will be entitled to claim benefits under the U.S.-Y Convention as a resident of Country Y with respect to the U.S.-source income if it satisfies the requirements of the applicable limitation on benefits article, if any, and other applicable requirements in order to receive benefits under the U.S.-Y Convention.

Because Corporation A is treated as a resident of Country Y for purposes of the X-Y Convention, Corporation A is not subject to comprehensive taxation in Country X as it would be if it were liable to tax by reason of residence. Therefore, Corporation A is not a resident of Country X under the relevant article of the U.S.-X Convention and is not entitled to claim benefits under the U.S.-X Convention as a resident of Country X.

In Situation 2, after the application of the X-Y Convention, Corporation A continues to be liable to tax in Country Y by reason of residence. Therefore, under the relevant article of the U.S.-Y Convention, Corporation A is a resident of Country Y. Corporation A will be entitled to claim benefits under the U.S.-Y Convention as a resident of Country Y with respect to the U.S.-source income if it satisfies the requirements of the applicable limitation on benefits article,

if any, and other applicable requirements in order to receive benefits under the U.S.-Y Convention. Because Corporation A is treated as a resident of Country Y for purposes of the X-Y Convention, Corporation A's fixed place of business in Country X is treated as a permanent establishment within the meaning of the X-Y Convention. Thus, Corporation A is liable to tax in Country X in respect of profits attributable to its permanent establishment, but is not subject to comprehensive taxation in Country X as it would be if it were liable to tax by reason of residence. Therefore, Corporation A is not a resident of Country X under the relevant article of the U.S.-X Convention and is not entitled to claim benefits under the U.S.-X Convention as a resident of Country X.

Rev. Rul. 73-354, 1973-2 C.B. 435, provided that a bank incorporated in Switzerland, managed and controlled in the United Kingdom, and engaged in the conduct of a business in both Switzerland and the United Kingdom, could choose to apply the provisions of either the United States-Swiss Confederation Income Tax Convention then in force or the United States-United Kingdom Income Tax Convention then in force to interest arising in the United States. Under those conventions, which are no longer in force, the determination of whether a corporation was a resident did not depend on whether the corporation was liable to tax in that country.

HOLDING

If Corporation A is treated as a resident of Country Y and not of Country X for purposes of the X-Y Convention and, as a result, is not liable to tax in Country X by reason of its residence, it is not entitled to claim benefits under the U.S.-X Convention, because it is not a resident of Country X under the relevant article of the U.S.-X Convention. However, Corporation A is entitled to claim benefits under the U.S.-Y Convention as a resident of Country Y, if it satisfies the requirements of the applicable limitation on benefits article, if any, and other applicable requirements in order to receive benefits under the U.S.-Y Convention.

This holding is applicable in interpreting income tax treaties that contain provisions that are the same as or similar to the relevant articles of the U.S.-X Convention, the U.S.-Y Convention, and the X-Y Convention. . . .

Rev. Rul. 73-354, 1973-2 C.B. 435, is obsolete.



Comments

1. Since the enactment of the check-the-box rules, it has become relatively easy to create an entity that is treated as a passthrough (no tax at the entity level) for U.S. tax purposes and a corporation for foreign tax purposes. These entities are referred to as *hybrid entities*. In contrast, a

reverse hybrid is an entity treated as a passthrough under foreign law and a separate or opaque entity under U.S. law. For example, if an Irish subsidiary of Google creates a wholly owned German company that is not a per se corporation, Google can elect to treat the German entity as a disregarded entity. For U.S. tax purposes, interest or royalty payments between the two entities will have no tax significance because the United States views the two entities as a single Irish entity with a German division or branch, and the payments between the two entities are treated as intra-company transfers. If the entity is treated as a corporation under German law, however, the interest or royalty payments will have significance for German tax purposes, *i.e.*, the Germany entity may deduct them and reduce German tax, but for U.S. purposes will not be treated as income to the Irish company.

2. The use of hybrids and reverse hybrids in international tax planning has flourished over the last decade and is a significant part of the BEPs project. See OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements*, Oct. 5, 2015. The voluminous report focuses on payments that generate a deduction for the payer but that are not included in the payee's income and payments that generate more than one deduction.
3. In response to perceived abuses of hybrids in tax planning, Congress has enacted various Code provisions to limit the use of hybrids. Section 894(c), enacted in 1997, denies treaty benefits to certain hybrid entities. This provision is discussed in Chapter 7. In the TCJA, Congress enacted §§267A and 245A(e). Section 267A denies deductions for certain hybrid arrangements, and 245A(e) denies a dividends-received deduction for certain hybrid dividends. These provisions will be discussed below.
4. The foreign law treatment of U.S. LLCs is unsettled. Sometimes LLCs are viewed as passthroughs, but other times they are treated as separate (opaque) entities. The tax consequences to foreign holders of these entities when two countries treat them differently for tax purposes can be catastrophic. In *HMRC v. Anson*, (2015) UKSC 44, the U.K. Supreme Court ruled that a Delaware LLC was a passthrough for U.K. tax purposes. Anson was a VC who set up a Delaware LLC to act as an investment manager to some VC funds. The funds paid management fees to the Delaware LLC, which were distributed to the members, including Anson. Anson argued that he should be able to credit the U.S. tax (about 45%) against his U.K. tax liability. Under U.K. law, a credit is available if the U.K. and U.S. tax were computed on the same profits. The Supreme Court found that a provision in the LLC agreement requiring all profits to be currently distributed was sufficient to ensure that U.S. and U.K. tax were computed on the same profits. The Supreme Court had overturned a Court of Appeal decision that had treated the LLC as

opaque, which would have subjected Anson to an additional U.K. of 22% on the LLC's distributed profits (after-U.S. tax) for an effective tax rate of 57.1%.

2.6 Trusts and Estates

Code: 7701(a)(30) and (31)
Regulations: 301.7701-4(a) and (b); 301.7701-7(c)(5), Ex. 2; (d)(1)(v),
Ex. 2
Treaty: Articles 3 (definitions of person); and 4

Under regulations, trusts are classified as either ordinary trusts or business trusts. An ordinary trust, which is generally formed to protect or conserve property, is subject to the general Subchapter J rules for taxation of trusts. *See* §641 *et seq.* Business trusts, in contrast, are generally created by the beneficiaries to carry on for-profit activities and are treated as eligible entities under the check-the-box regulations. Reg. §301.7701-4(a) and (c).

Prior to 1997, the residence of a trust or estate was determined under (former) sections 7701(a)(30)(D) and (E), which basically provided that a trust or estate was a U.S. person unless it was taxed as a foreign person. In particular, the residence of a trust or estate was determined by applying the former residence rules applicable to individuals under Reg. 1.871-2(b). These rules are virtually impossible to apply to legal entities as they require, *inter alia*, an examination of physical presence and intent. In response to some perceived abusive transactions involving U.S. persons and foreign trusts, Congress amended section 7701(a)(30) in 1996 to provide guidance for determining the residence of a trust.

Under section 7701(a)(E), a trust is a U.S. person if a U.S. court is able to exercise primary supervision over the administration of the trust, and one or more United States persons have the authority to control all substantial decisions of the trust. A court has primary supervision if the court can determine "substantially all issues regarding the administration of the entire trust," including maintaining the books and records, filing tax returns, managing and investing the assets of the trust, and defending the trust from suits by creditors, and determining distributions. Reg. §301.7701-7(c)(3)(iv) and (v). Substantial decisions include whether and when to distribute income or corpus, the amount of any distributions, the selection of a beneficiary, and whether to terminate the trust. Reg. §301.7701-7(d)(1)(ii). The scope of both of these tests are further fleshed out in Reg. §301.7701-7.

When Congress amended section 7701(a)(30)(E) to provide rules for determining the residence of a trust, it did not address the residence of an estate, which is still determined under the principles of the former residence regulations as interpreted by the courts and IRS. In reading Revenue Ruling 81-112 below, what advice would you give to a client regarding the location of invest-

ment property, such as stocks and bonds? Should these assets be held directly or indirectly by the estate? Is this sound policy?

Under the Treaty, both trusts and estates are treated as “persons.” Article 3(1)(a). Thus, if a trust or estate is liable to tax as a resident of a treaty country, it will be a resident for treaty purposes.

Rev. Rul. 81-112

1981-1 C.B. 598

FACTS

A, a United States citizen by birth, was a resident of Country X for 20 years prior to dying in 1978. At the time of A’s death A’s spouse, who was the primary beneficiary of A’s estate, was a citizen of Country X. A’s children, who are equal residuary beneficiaries of A’s estate, were citizens and residents of the United States. A’s last will and testament was executed in Country X.

Upon A’s death, A left an estate that consisted of several businesses incorporated and operated in Country X. The estate’s assets also included certificates of deposit and accounts in foreign banks. A had no business interests or assets in the United States.

A company and a bank, both incorporated and operating under the laws of Country X, were granted letters of administration and letters testamentary and hold legal title to all the assets of A’s estate. The estate is not subject to ancillary administration in the United States or any other country. The administrator and executor are each represented by local counsel. All the income of the estate is from foreign sources.

LAW AND ANALYSIS

Section 7701(a)(31) of the Code provides that the terms foreign estate and foreign trust mean an estate or trust, as the case may be, the income of which, from sources without the United States that is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A.

Section 641(b) of the Code provides that the taxable income of an estate or trust shall be computed in the same manner as in the case of an individual.

Section 872(a) of the Code provides that in the case of a nonresident alien individual, gross income includes only—(1) gross income that is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States; and, (2) gross income which is effectively connected with the conduct of a trade or business within the United States.

Section 1.871-2(a) of the Income Tax Regulations provides that the term nonresident alien individual means an individual whose residence is not within the United States, and who is not a citizen of the United States.

In determining whether an estate is a foreign estate under section 7701(a)(31) of the Code, the question is whether the estate is comparable to a nonresident alien individual. Thus, it must be decided whether the estate is alien and nonresident in the United States. Rev. Rul. 62-154, 1962-2 C.B. 148, concludes that the standards that have been developed for making these determinations in the case of trusts are equally applicable to estates. This ruling cites and relies on the case of *B. W. Jones Trust v. Commissioner*, 46 B.T.A. 531 (1942), aff'd, 132 F.2d 914 (4th Cir. 1943), which sets forth standards for determining the alienage and residency of a trust.

B. W. Jones Trust concluded that the trust in question there was an alien entity. In reaching this conclusion, the Board of Tax Appeals considered 1) the country under whose law the trust was created, and 2) the alienages of the settlor, the trustees, and the beneficiaries.

Applying these standards in the instant case indicates that the estate is an alien entity. The assets of the estate are located in country X and are administered under the laws of that country. The company and the bank that hold legal title to the assets of the estate are both incorporated and operating under the laws of country X. Only the alienage of the decedent and the two residuary beneficiaries weigh against alien status for the estate. These factors by themselves, however, do not prevent the estate from being considered an alien entity.

With respect to the residency question, *B. W. Jones Trust* concluded that the trust in question there was a United States resident. In reaching this conclusion the United States Court of Appeals relied upon the following facts: 1) 90% of the trust property was securities of United States corporations, 2) these securities were held in the United States by a trustee who was a United States citizen, 3) these securities were traded by that trustee on United States exchanges, and 4) these securities returned income collected by the trustee in the United States and handled from an office maintained in the United States for that purpose.

The estate in the instant case had none of the indicia of residency that were present in *B. W. Jones Trust*. The assets of the estate are held in country X and their management involves no contact with the United States.

HOLDING

A's estate is a nonresident alien entity and, therefore, is a foreign estate for purposes of section 7701(a)(31) of the Code. Thus, the estate is only subject to federal income tax on income that is derived from sources within the United States or income that is effectively connected with the conduct of a trade or business within the United States.

However, for federal estate tax purposes, since A was a United States citizen, the value of all of A's property situated in foreign countries is includible in A's gross estate. See section 2001(a) and section 2031(a) of the Code. ✕

2.7 Residence Problems

1. Stu P. Id, a U.S. citizen, goes to Cancun on spring break in 1980, and having ingested lots of peyote, performs an expatriating act. The State Department issues a certificate of loss of nationality to Stu. In 2008, after the effects of the peyote have long worn off, Stu applies to have his citizenship restored, claiming that he never intended to renounce his citizenship. If it is restored in 2008, what are the U.S. tax consequences to Stu from 1980 to 2008?
2. Ana is a citizen of the U.K. She has a U.S. "green card" permitting her to live permanently in the U.S., but she chooses to live year round in the U.K. Under the Code, is Ana a resident alien?
3. Paul is a British citizen working for a law firm in London but spends some time working for his firm's New York office. Under U.S. immigration law, Paul may work in the United States for temporary periods but may not establish permanent residence. Paul owns a house in London; while in New York, Paul typically stays at a hotel. Paul enjoys New York, but his family is in London, and he has no intention of applying for a green card. In 2018, Paul spends 180 days in the U.S.; in 2019 he spends 30 days in the United States, and in 2020 he spends 143 days in the U.S. Under the Code, is Paul a resident alien in 2018, 2019, or 2020? Are there any procedural requirements Paul must satisfy? [Reg. §301.7701(b)-8(a)(1), (d)]
4. Same facts as previous question, except that Paul is present in the U.S. for 183 days in 2020. Under the Code, is Paul a resident alien in 2020?
5. Same facts as the previous question. Under the Treaty, is Paul a resident alien in 2020, assuming that Paul is taxable by the U.K. on a residence basis? [Article 4 and Reg. §301.7701(b)-7.]
6. Ana's sister, Elizabeth, entered the U.S. on an F visa to study in New York and is present in the U.S. for the entire year. Under the Code, is she a U.S. resident? Are there any procedural requirements Elizabeth must satisfy? What are the consequences of not complying with the procedural requirements? [Reg. §301.7701(b)-8(a)(2) and (d).]

7. Terrance and Phillip, two funny-looking Canadians, sneak over to Detroit to sell illegally copied DVDs every day (even on July 1, Canada Day) and return to their frigid homeland every night. Under the Code, are they U.S. residents in 2020? [Reg. §301.7701(b)-3(e).]
8. An alien can elect §7701(b)(4) under certain circumstances to be treated a resident alien even though he does not satisfy the day count test. Under what circumstances would it be advantageous to be taxed on a residence rather than source basis? *Hint*: What deductions are available to a resident alien that are not available to a nonresident alien? *See* §873 and Reg. §1.873-1(a)(1)-(5).
9. When a nonresident alien becomes a resident alien, the basis of any property acquired prior to becoming a resident is determined by treating the property as if it had always been subject to U.S. tax jurisdiction. What tax planning strategies would you recommend for an alien owning property *before* becoming a resident alien?
10. John, a U.S. citizen, resides in London and is a U.K. resident for tax purposes. John receives interest on a bond from a U.S. corporation. He examines the Treaty and discovers that U.K. residents (Article 4) are exempt from U.S. tax on U.S. source interest (Article 11). John comes to you to confirm that he can use the Treaty to lower his U.S. tax on the interest under Article 11. What do you tell John? Is it possible that John will be subject to double taxation, assuming that the U.K. would tax John on a residence basis? Under the Code and Treaty, would the U.S. grant relief? [§904(a); Articles 1(4); 11; and 24(6)(b)-(d) (skim very lightly the Technical Explanation for Article 24(6))]
11. John, a U.S. citizen, resides in Argentina and receives a dividend from a U.K. corporation. Assuming that the U.K. generally taxes dividends paid to a foreigner at 30%, under the Treaty would the U.K. 30% tax be reduced? [Treaty, Articles 1(4); 4(2); and 10(2).]
12. Can IBM elect to be taxed as a partnership?
13. John owns an interest in Sodor, a U.K. Public Limited Company (PLC). Can Sodor elect to be taxed as a partnership? What if Sodor were a Private Limited Company (Ltd) with 100 members? (The creditors of a private limited company can reach only the assets of the company to satisfy any unpaid debts.) [Reg. §301.7701-1, -2, and -3]
14. John forms a Delaware LLC and is its sole shareholder. What's the default tax status of the LLC? [Reg. §301.7701-1, -2, and -3]

15. X is organized in the U.K. as a public limited company and in Delaware as an LLC. How is it taxed, and what's its residence? What if X were a Ltd? [Reg. §§301.7701-2(b)(9) and 301.7701-5]
16. X, owned by 2 U.S. persons, US1 and US2, is organized as a U.S. LLC and receives a dividend from UKCO. Is the dividend treated as being received by LLC or US1 and US2 if the U.S. treats the LLC as a partnership? What if the U.K. views LLC as a corporation? What if the LLC is treated under U.S. law as a corporation? [Read carefully and slowly the Technical Explanation to Article 1(8).]
17. What are the basic tests under which the validity of a regulation is determined? [Littriello]
18. Amendments to Reg. §301.7701-5 removed from the definitions of domestic and foreign business entities, the definition of resident foreign corporation, nonresident foreign corporation, resident partnership and nonresident partnership "because these terms have become obsolete due to statutory changes since the final regulations were published in 1960." Is there still a need to know the *residence* of a partnership? See §861(a)(1) and Reg. 1.861-2(a)(2).

Chapter 3

The Taxation of Investment Income of Foreign Persons

This chapter addresses the U.S. taxation of the investment income of foreign persons. Foreign persons not engaged in a U.S. trade or business are taxed at a flat 30% rate on U.S. source investment income such as interest, dividends, rents, and royalties, unless a treaty provision applies. The 30% tax is collected by the U.S. person who pays the income to the foreign investor. This chapter also discusses the source of income rules for non-investment income. The source of income rules are also important for U.S. persons who earn foreign income as the rules determine the U.S. person's foreign tax credit limitation. Finally, the U.S. withholding rules are briefly mentioned, and the applicable treaty provisions are also discussed.

Foreign persons—both individuals and corporations—not engaged in a U.S. trade or business are taxed on U.S. source income that is fixed, determinable, annual or periodical (“FDAP”) at a flat, 30% rate. §§871(a)(1) (individuals) and 881(a)(1) (corporations). FDAP includes most categories of periodic investment income, such as interest, dividends, rents, and royalties, as well as once-in-a-lifetime income, such as lottery winnings. Importantly, most U.S. source interest, such as interest on bank deposits and “portfolio interest,” is exempt from U.S. tax. In addition, most capital gains arising from the sale of U.S. assets by foreigners, except for gains from U.S. real estate, are not FDAP and are therefore exempt from U.S. tax. The tax on FDAP income is collected by the last U.S. payor withholding the statutory percentage (generally 30%) from the income. §§1441(a) and 1442(a)(1). Treaties significantly reduce or eliminate source basis taxation on FDAP income. For example, in almost all U.S. treaties, source country tax on interest and royalties is reduced to 0%, and source country tax on dividends is reduced to a maximum of 15%.

Foreign persons are taxed on U.S. source FDAP at a flat 30% rate.

The statutory regime requires the following analysis to determine the substantive tax liability of a foreign person not engaged in a U.S. trade or business:

Tax algorithm: character, source, taxation under the Code, and application of a treaty.

First, the character of the income must be determined, *e.g.*, dividend, interest, or royalty. This is done under U.S. tax principles. Note, the income may have a different character under U.S. law than under the law of the residence country. Next, the income's source must be determined. The source rules—found in §§861, 862, 863, and 865—assign a source, U.S. or foreign, to most common categories of income, gains, deductions, and losses for both U.S. and foreign persons. If the income is U.S. source FDAP, the income will be subject to a flat 30% tax unless the income is exempt, for example, because it qualifies as portfolio interest under §871(h). If the income is not exempt, withholding at 30% will generally be required by the U.S. payor, unless a treaty reduces or eliminates U.S. tax.

The source of income rules are the bedrock of the U.S. international tax regime. For foreign persons, the U.S. generally limits its tax jurisdiction to items that are U.S. source, both for investment and for business income. With respect to U.S. persons, the source rules primarily apply in determining a taxpayer's foreign tax credit limitation. *See* §§901 and 904. U.S. persons are taxed on their worldwide income. If a foreign jurisdiction also taxes a U.S. person's income, the taxpayer may elect to credit foreign taxes paid against his U.S. tax liability, subject to certain limitations. Under §904, the amount of foreign taxes that can be credited against a taxpayer's federal (pre-credit) income tax liability is limited to the ratio of foreign source taxable income to worldwide taxable income times the U.S. tax liability (before any credits):

$$FTC \text{ Limit} = \frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}} * \text{U.S. Tax (Pre-Credit)}$$

Thus, the greater the proportion of foreign source income, the greater the foreign tax credit limit. Treaties may modify the domestic foreign tax credit rules by providing treaty-specific source rules that modify the source rules under the IRC.

The materials that follow in this chapter explore the statutory source rules and FDAP regime. Because the source of income rules also arise in the context of the foreign tax credit of U.S. persons and the taxation of U.S. business income of foreign persons, some materials refer to those provisions.

3.1 Interest and Dividends

Code:	861(a)(1), (2); 862(a)(1); 871(a), (h), (i), and (k); 881(a)(1) and (c); 1441(a); and 1442(a)
Regulations:	1.861-2(a)(2), (7); 1.861-3(a)(6); 1.863-7; 1.871-7(b)(2); 1.871-14(g); 1.894-1(c); 1.1441-1(a) and (b); and 1.441-2(b)(2)(i)
Treaty:	Articles 10 and 11

3.1.1 Interest

Interest paid by a U.S. person is generally U.S. source FDAP. §861(a)(1). Thus, interest paid by U.S. individuals, U.S. corporations, and federal, state, and local governments is generally U.S. source.¹

Interest paid by U.S. persons is generally U.S. source.

Interest paid by a foreign branch of a U.S. commercial bank or savings and loan institution is foreign source. §861(a)(1)(A)(i) and (ii). Since commercial banks generally conduct business through branches, in the absence of this rule, interest paid on deposits would otherwise be U.S. source FDAP potentially subject to U.S. tax. U.S. banks operating abroad would therefore be at a competitive disadvantage vis-a-vis local branches of foreign banks.

Interest paid by a U.S. branch of a foreign corporation is U.S. source. §884(f)(1). In addition, interest paid by a foreign partnership that is engaged in a U.S. trade or business (but predominantly engaged in the active conduct of a trade or business outside of the United States) is U.S. source to the extent that the interest is allocable to income that is treated as effectively connected with the U.S. trade or business. §861(a)(1)(B).

Even if interest is U.S. source, very little U.S. source interest paid to foreign persons is subject to U.S. tax under §871 (or §881) because of the exemptions for portfolio interest and bank deposit interest. §§871(h) and (i)(2); 881(c) and (d). Portfolio interest covers virtually any interest on registered debt except interest on bank deposits and interest received by a shareholder (or partner) owning 10% or more of the vote of the payor corporation (or 10% or more of the capital or profits of the partnership). Bearer (unregistered) debt issued prior to March 19, 2012, can also qualify for the portfolio interest exemption, provided that it was issued abroad to foreign persons. §871(h)(1)(2)(A). In addition, certain categories of contingent interest, such as interest tied to an obligor's cash flow, sales, or income, do *not* qualify as portfolio interest. §871(h)(4).

U.S. source portfolio interest and bank deposit interest is exempt from tax.

¹Prior to 2010, if 80% or more of the gross income of a resident alien or U.S. corporation was *active foreign business income*, the interest paid was foreign source. Former §861(a)(1)(A). This rule, known as the 80/20 company rule, was repealed in 2010 in P.L. 111-226 (Education Jobs and Medicaid Assistance Act). Certain existing 80/20 companies were grandfathered under §871(l), and the active foreign business percentage of any interest paid by such companies is exempt under §871(i)(2)(B)(ii).

Because interest is deductible by the debtor and not taxable in the hands of foreign creditors, the portfolio interest exemption permits returns on U.S. business income paid out as interest to escape U.S. tax. This rule may encourage U.S. businesses funded by foreign capital to be more highly leveraged than they would be otherwise. Although such interest would not qualify as portfolio interest (if it's paid to a 10%-or-greater shareholder), under almost all U.S. treaties, interest is not subject to source basis taxation regardless of the ownership percentage of the recipient.

To protect the U.S. tax base from excessive debt held by foreign creditors, Congress enacted former §163(j), which restricted the deduction of interest paid by highly leveraged U.S. entities to certain foreign persons (and other tax-exempt entities). Former §163(j). In the TCJA, Congress replaced former §163(j) with new §163(j), which limits the business interest deduction of U.S. corporations and foreign corporations doing business in the United States to 30% of a taxpayer's *adjusted taxable income* plus business interest income. (Query: why does Congress use the same section number as a repealed section for an entirely new section?) Also in the TCJA, Congress enacted §59A, the *Base Erosion Anti-Abuse Tax (BEAT)*, which imposes a 10% tax on the income (redetermined by excluding related party deductible payments) of large corporations. Sections 163(j) and 59A are discussed below in Chapter 6.3.

Treaties generally eliminate source basis taxation of interest.

Under Article 11, interest generally cannot be taxed by the source country. Thus, the 10% shareholder limitation of the portfolio interest rules is eliminated under the Treaty. Contingent interest can be taxed by the source country but only at a maximum rate of 15%. *See* Article 11(5).

The portfolio interest rules were originally enacted in 1984. One issue that subsequently arose in conjunction with the growth of hedge funds and the expansion of their investing activities was whether in the case of debt held by a partnership, the 10% shareholder rule would apply at the partner or partnership level. In 2007 (some 23 years later), the Treasury issued final regulations that apply the 10% shareholder test at the partner level rather than partnership level. Reg. §1.871-14(g)(3). For example, if a partnership has 20 equal unrelated partners and the partnership owns 100% of the U.S. payor corporation, all of the interest will be portfolio interest because no partner will own indirectly more than 10% of the payor corporation. The rationale for this treatment is that since the foreign partner is the beneficial owner of the interest, the portfolio interest rule should be tested at the partner level.

3.1.2 Dividends

Dividends from U.S. corporations and some foreign corporations are U.S. source.

Dividends paid by U.S. corporations are U.S. source FDAP. §861(a)(2)(A). Dividends paid by a *foreign* corporation can also be U.S. source. In particular, if 25% or more of a foreign corporation's gross income over the three years preceding the year in which the dividend is paid is effectively connected income

under §864, a dividend from the corporation will be U.S. source in the same proportion as the effectively connected income. §861(a)(2)(B).

The goal of this provision was to equalize the aggregate tax paid on U.S. business profits whether the business was operated directly through a U.S. branch or indirectly through a U.S. subsidiary. Congress revised the taxation of U.S. branches of foreign corporations in 1986 with the enactment of the branch profits tax (*see* §884), but did not repeal the secondary level withholding tax of §861(a)(2)(B). Since the enactment of the branch profits tax, U.S. business income earned by a branch is taxed when earned at graduated rates and again at a flat 30% when the business profits are deemed distributed. Thus, U.S. business income is taxed twice whether earned by a branch or U.S. subsidiary. Dividends paid by a foreign corporation subject to the branch profits tax, however, are not taxed again as FDAP. §884(e)(3)(A). The branch profits tax is discussed below in Chapter 4.3.

Foreign countries did not take kindly to the United States attempting to tax dividends paid by their corporations to their residents, and if a country had a tax treaty with the United States, the treaty invariably exempted such dividends from U.S. tax. Furthermore, given the administrative difficulties in collecting U.S. tax on dividends paid by foreign corporations, it is probably not too much of a stretch to assume that this tax raised very little revenue. Consequently, Congress eliminated in 2004 the 30% FDAP tax on such dividends but left intact the dividend sourcing rule. §§871(i)(2)(D); 881(d).²

Under the Treaty, source basis taxation of dividends is generally not entirely eliminated. Under Article 10(2), dividends are taxed at 15% unless the beneficial owner owns directly or indirectly at least 10% of the voting power of the corporation paying the dividend, in which case the rate drops to 5%. Notably, Article 10(3) provides for a 0% rate on dividends received by either: (1) a company owning 80% or more of the dividend paying corporation for the 12-month period ending on the dividend declaration date; or (2) a pension plan.

Treaties reduce the 30% rate to 15%, 5%, and sometimes 0%.

A corporation is eligible for treaty benefits only if it is a *resident* under Article 4 and a *qualified person* under Article 23 (Limitations on Benefits). The Limitation on Benefits article is discussed in more detail below at Chapter 6.2. A company can satisfy the qualified person requirements in various ways. A company can be a qualified person if its shares are traded on an exchange of one of the treaty signatories (publicly traded test). A corporation can be a qualified person if other qualified persons own 50% or more of the vote and value of the corporation and less than 50% of the company's gross income is payable as a deduction to non-treaty residents (ownership-base erosion test). A

²Prior to 2011, certain dividends paid by a 80/20 company, although U.S. source, were exempt from U.S. tax under §871. Former §§871(i)(2)(B); 881(d). In P.L. 111-226 (Education Jobs and Medicaid Assistance Act), the 80/20 rules were repealed, but certain existing 80/20 corporations are grandfathered. The active foreign business percentage of any dividend paid by these corporations are exempt from tax. *See* §§871(i)(2)(B)(i) and (l).

corporation can also be a qualified person if 95% or more of its vote and value is owned by 7 or fewer persons who are residents of the EC, EEA, Canada, or Mexico (derivative benefits test). Finally, a corporation not satisfying any of the above tests can obtain treaty benefits with respect to income or gain arising in the other contracting state if the corporation is engaged in the active conduct of a trade or business in the other state (active business test).

To prevent companies from inappropriately restructuring their operations to become eligible for the 0% inter-company dividend rate, the Treaty imposes additional restrictions beyond those of Article 23. In particular, if the company receiving the dividend is a qualified resident under only the *active trade or business* or *ownership-base erosion* test, the dividend recipient must have acquired the 80%-or-more ownership interest before October 1, 1998. This was the first U.S. tax treaty to provide for a zero rate of tax on inter-company dividends; subsequent treaties generally provide for a zero rate in similar circumstances. A few other treaties had previously provided for a zero rate on dividends, but only for dividends paid to pension plans.

3.1.3 Withholding on U.S. Source Interest and Dividends

Under §§1441 and 1442, withholding is generally required for payments of FDAP to a foreign person. If a U.S. person does not withhold, he can be held liable for the tax not withheld. §§1461-1463. The precise contours of the withholding tax rules are set out in very detailed regulations under §§1441 and 1442.

No withholding is required for certain payments to foreign persons, such as portfolio interest, bank deposit interest, and effectively connected income. §1441(c)(1), (9), and (10). To claim a reduced withholding rate under an income tax treaty, a foreign person must apprise the withholding agent of his foreign status and the applicable treaty provision. IRS Form W-8BEN is generally used for these purposes.

The following tax disclosure, excerpted from a prospectus for a medium term note issuance by The Bank of New York Mellon, gives a brief overview of the U.S. tax rules applicable to portfolio foreign investors, including the documentation required for treaty purposes.

**The Bank of New York Mellon Corporation, Prospectus
Supplement for Medium Term Notes
Dec. 12, 2021**

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Consequences to Non-U.S. Holders

This subsection describes the tax consequences to a Non-United States holder. The discussion below does not address the tax consequences to a Non-United States holder of an investment in a Note that references directly or indirectly the performance of United States equities. The tax treatment of any such Note will be discussed in the applicable pricing supplement. You are a Non-United States holder if you are the beneficial owner of a Note and are, for United States federal income tax purposes:

- a nonresident alien individual,
- a foreign corporation, or
- an estate or trust that in either case is not subject to United States federal income tax on a net income basis on income or gain from a Note.

Interest

This discussion assumes that the Note is not subject to the rules of §871(h)(4)(A) of the Internal Revenue Code, relating to interest payments that are determined by reference to the income, profits, changes in the value of property or other attributes of the debtor or a related party.

Subject to the discussions of FATCA withholding and backup withholding below, interest (including OID) on a Note that is not effectively connected with your conduct of a trade or business in the United States will generally be exempt from United States federal income and withholding tax under the “portfolio interest exemption,” provided that (i) you do not, actually or constructively, own stock possessing 10% or more of the total voting power of the Company’s outstanding stock, (ii) you are not a controlled foreign corporation that is related to the Company, actually or constructively and (iii) either (a) you provide to the applicable withholding agent an IRS Form W-8BEN or W-8BEN-E (or other applicable form), signed under penalties of perjury, that includes your name and address and that certifies your non-United States status in compliance with applicable law and regulations, or (b) a securities clearing organization, bank or other financial institution that holds customers’ securities in the ordinary course of its trade or business provides a statement to the applicable withholding agent under penalties of perjury on which it certifies that an applicable IRS Form W-8BEN or W-8BEN-E (or other applicable form) has been received by it from you or a qualifying intermediary and furnishes a copy to the applicable withholding agent. This certification requirement may be satisfied with other documentary evidence in the case of a Note held in an offshore account or through certain foreign intermediaries. The applicable withholding agent for purposes of the certification requirement described above is generally the last U.S. payor (or a non-U.S. payor that is a qualified intermediary or a U.S. branch of a foreign person) in the chain of payment before payment to you.

If you cannot satisfy the requirements of the portfolio interest exemption described above, then payments of interest (including OID) made to you generally will be subject to United States federal withholding tax at the rate of 30%, unless either (i) you provide the applicable withholding agent with a properly executed IRS Form W-8BEN or W-8BEN-E establishing an exemption from or reduction of the withholding tax under the benefit of an applicable income tax treaty or (ii) the interest is effectively connected with your conduct of a trade or business in the United States and you provide an appropriate statement to that effect on a properly completed and duly executed IRS Form W-8ECI.

If you engaged in a trade or business in the United States and interest (including OID) on a Note is effectively connected with the conduct of that trade or business, you will be subject to United States federal income tax on such interest on a net income basis in generally the same manner as a United States holder, unless an applicable income tax treaty provides otherwise. If you are a Non-United States holder that is treated as a foreign corporation for United States federal income tax purposes, you may also be subject to a branch profits tax at a 30% rate (or lower applicable treaty rate) on your effectively connected earnings and profits, subject to adjustments.

Purchase, Sale and Retirement of the Notes

Subject to the discussion of backup withholding below, you generally will not be subject to United States federal income or withholding tax on any gain realized on a sale, exchange, redemption, retirement or other taxable disposition of a Note (other than any amount representing accrued but unpaid interest or OID on the Note, which will be treated as interest and will generally be subject to the rules discussed above under “Interest”) unless:

- you are an individual who was present in the United States for 183 days or more in the taxable year of the disposition and certain other conditions are met; or
- the gain is effectively connected with your conduct of a trade or business in the United States.

If you are described in the first bullet point above, you generally will be subject to United States federal income tax at a flat rate of 30% (unless a lower treaty rate applies) on your gain from the disposition, which may be offset by certain United States-source capital losses. If you are described in the second bullet point above, you will be subject to United States federal income tax on such gain on a net income basis in generally the same manner as a United States holder, unless an applicable income tax treaty provides otherwise. If you are a Non-United States holder that is treated as a foreign corporation for United States federal income tax purposes, you may also be subject to

a branch profits tax at a 30% rate (or lower applicable treaty rate) on your effectively connected earnings and profits, subject to adjustments.

FATCA Withholding

Pursuant to sections 1471 through 1474 of the Code, commonly known as the Foreign Account Tax Compliance Act (“FATCA”), a 30% withholding tax (“FATCA withholding”) may be imposed on certain payments to you or to certain foreign financial institutions, investment funds and other non-U.S. persons receiving payments on your behalf if you or such persons fail to comply with certain information reporting requirements. Payments of interest that you receive in respect of the Notes could be affected by this withholding if you are subject to the FATCA information reporting requirements and fail to comply with them or if you hold Notes through a non-U.S. person (e.g., a foreign bank or broker) that fails to comply with these requirements (even if payments to you would not otherwise have been subject to FATCA withholding). These requirements may be modified by the adoption or implementation of an inter-governmental agreement between the United States and another country or by future U.S. Treasury Regulations. Documentation that you provide in order to be treated as FATCA compliant may be reported to the IRS and other tax authorities. You should consult your own tax advisors regarding the relevant U.S. law and other official guidance on FATCA withholding.

Depending on your circumstances, you may be entitled to a refund or credit in respect of some or all of this withholding. However, even if you are entitled to have any such withholding refunded, the required procedures could be cumbersome and significantly delay the holder’s receipt of any amounts withheld.

Backup Withholding and Information Reporting

In general, if you are a noncorporate United States holder, we and other payors are required to report to the IRS all payments of principal, any premium and interest on your Note, and the accrual of OID on a discount Note. In addition, we and other payors are required to report to the IRS any payment of proceeds of the sale of your Note before maturity within the United States. Additionally, backup withholding would apply to any payments, including payments of OID, if you fail to provide an accurate taxpayer identification number, or (in the case of interest payments) you are notified by the IRS that you have failed to report all interest and dividends required to be shown on your federal income tax returns.

In general, if you are a Non-United States holder, we and other payors are required to report payments of interest on your Notes on IRS Form 1042-S. Payments of principal, premium or interest, including OID, made by us and other payors to you would otherwise not be subject to information reporting

and backup withholding, provided that the certification requirements described above under “–Non-United States Holders–Interest” are satisfied or you otherwise establish an exemption. In addition, payment of the proceeds from the sale of Notes effected at a United States office of a broker will not be subject to backup withholding and information reporting if (i) the payor or broker does not have actual knowledge or reason to know that you are a United States person and (ii) you have furnished to the payor or broker an appropriate IRS Form W-8, an acceptable substitute form or other documentation upon which it may rely to treat the payment as made to a non-United States person.

In general, payment of the proceeds from the sale of Notes effected at a foreign office of a broker will not be subject to information reporting or backup withholding. However, a sale effected at a foreign office of a broker could be subject to information reporting in the same manner as a sale within the United States (and in certain cases may be subject to backup withholding as well) if (i) the broker has certain connections to the United States, (ii) the proceeds or confirmation are sent to the United States or (iii) the sale has certain other specified connections with the United States.

You generally may obtain a refund of any amounts withheld under the backup withholding rules that exceed your income tax liability by filing a refund claim with the IRS.

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3.1.4 Synthetic Dividends

Hedge funds supply an increasing amount of investment capital to the U.S. capital markets. Hedge funds typically use a master-feeder structure: the investors invest in a feeder fund, which in turn, invests in the master fund. The master fund implements the hedge fund’s investment strategy. To accommodate the tax and privacy concerns of investors, the hedge fund establishes separate feeder funds for U.S. taxable investors and foreign and U.S. tax-exempt investors. The master funds are generally formed in countries that will not tax the investment returns of the master fund, such as the Cayman Islands or Bermuda. These countries do not have tax treaties with the United States and any U.S. source dividends received by the master fund would be taxed at 30%.

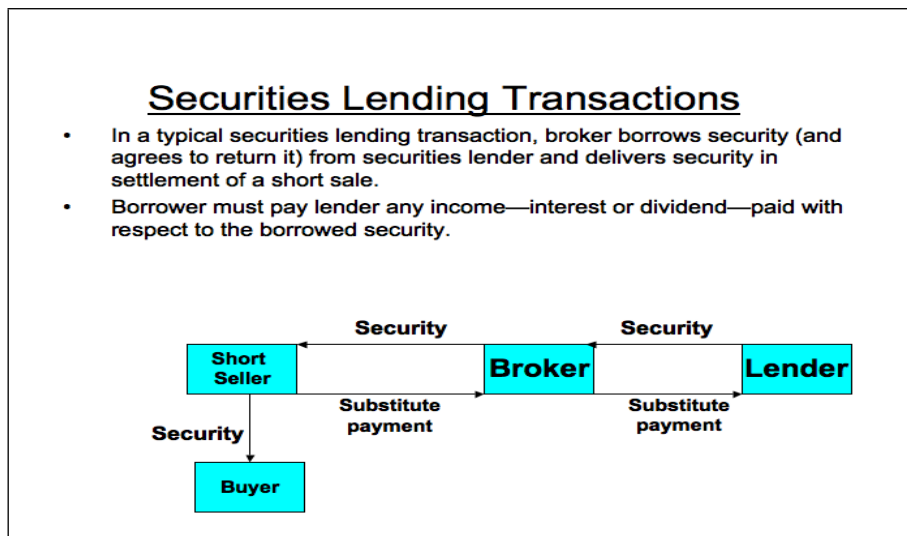
Hedge funds historically have sought to avoid the 30% dividend tax in a variety of ways. First, a fund could (and still can) opt to hold only non-dividend paying stocks. Second, it could (and still can) sell the stock immediately before the record date—the date on which a person must be a shareholder to receive the dividend—and then repurchase shortly thereafter. Third, it could *loan* its U.S. shares to a broker over the record date for the broker to deliver the borrowed shares in a short sale transaction. The broker would be required

to eventually return the shares and pay the lender the amount of any dividends paid with respect to the stock during the borrow period. These payments are called “in lieu” or “substitute” dividends. Finally, until March 18, 2012, it could enter into an equity swap with a bank that would give it the same return it would have had it owned the stock(s) directly.

The first option may severely limit the hedge fund’s potential investment universe. Implementing option two may cause the hedge fund to miss out on any investment gains during the period the fund does not own the stock. Under regulations, the substitute dividends of option three have the same source and character as the underlying dividends and thus are subject to the same withholding treatment as the underlying dividends. Ever the resourceful taxpayers, hedge funds began to resort to combining options two and four to eliminate U.S. tax on dividends. With the enactment of §871(m) in 2010, Congress has eliminated this gambit.

In a securities lending transaction, a broker borrows a security (stock or bond) and agrees to return it to the securities lender when requested. The borrowed security is typically delivered as part of a short sale. Under the

Figure 3.1: Securities Lending Transactions



securities lending agreement, the borrower must pay the lender any income, such as interest or dividends, paid with respect to the borrowed security. Under U.S. law, the substitute, or in-lieu dividend was not treated a “dividend” for U.S. tax purposes, but rather as a fee or rent for the borrowing. Foreign taxpayers would loan their U.S. stock over the record date and argue that the substitute dividend was not a dividend for FDAP purposes. In addition, treaty residents argued that the income was exempt under the *Other Income* article

(Article 22 of the Treaty) and therefore not taxable in the source state.

In response to these transactions, the IRS issued regulations that adopt a look-through treatment for substitute interest and dividend payments in securities lending transactions. Under this approach, substitute interest and dividends are sourced in the same manner as the interest or dividends accruing on the transferred security. Reg. §§1.861-2(a)(7) (source of substitute interest); 1.861-3(a)(6) (source of substitute dividends); 1.871-7(b)(2) (character of substitute payments); and 1.894-1(c) (treatment of substitute payments under treaties). The regulations provide that if a substitute dividend or substitute interest payment is received by a *foreign person*, it has the same character as the underlying interest or dividend to which it relates for FDAP and treaty purposes. This rule has the effect of treating substitute dividends payments with respect to U.S. stock as U.S. source dividends subject to FDAP tax, but it also preserves the portfolio interest exception for substitute interest payments.

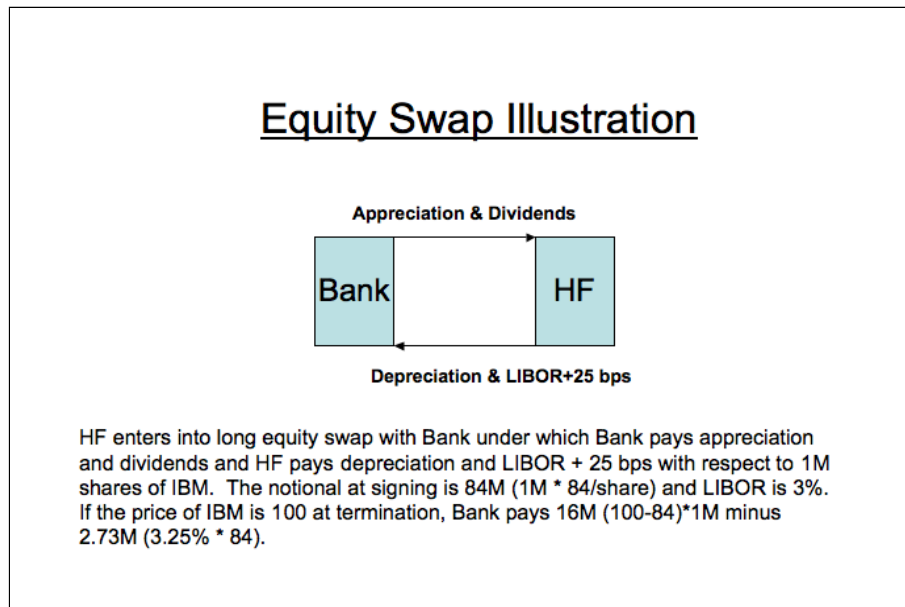
Substitute interest and dividend payments have the same character and source as the underlying interest or dividend.

The final option employs an equity swap to avoid withholding tax. An equity swap is a bilateral contract with a bank pursuant to which one party (for example, a bank) agrees to pay the economic appreciation with respect to a notional amount of shares of one or more companies, including both capital gain and dividends, and the other party (for example, the hedge fund) agrees to pay any depreciation with respect to the same notional amount of shares. The party that receives the appreciation and pays depreciation is called the *long party*, and the counterparty is the *short party*. The long party must also pay a financing cost that is calculated by applying an interest rate, typically LIBOR (or IBOR) plus an additional amount, to the notional amount of the shares. The long party thus is in the same economic position as if it had borrowed to purchase the referenced shares: it benefits by any dividend and appreciation but bears any depreciation and the financing cost of the position.

Assume that the swap payment received by a foreign hedge fund represents economically (mimics) the appreciation and dividends (less a financing charge) of a notional amount of shares of a U.S. corporation. How should the payment be treated under §871 or §881? Should the gross payment be disaggregated into separate portions and the U.S. tax rules applied to each portion? Should some portion of the swap income be U.S. source FDAP? One issue that arises is that the payment that represents the dividend portion is generally not a dividend for U.S. tax purposes as the equity swap party does not actually own the shares and receive the payment from the dividend paying company. Yet another issue that arises is if there is no capital gain and the financing charge offsets the notional dividend amount so that no amount is paid or received. Also, if the swap is between two foreign parties, on what basis should the United States be able to assert tax jurisdiction over any of the payments? Finally, would your conclusions to the questions above change if the bank had actually purchased and held the underlying shares during the term of the swap?

To encourage swap activity by U.S. banks, the IRS issued regulations in 1991 that source swap income by reference to the residence of the recipient.

Figure 3.2: Equity Swap



Reg. §1.863-7(b)(1). Consequently, regardless of the character of swap income, under these regulations swap income received by a foreign investor is foreign source and exempt from tax. That swap income representing dividends from U.S. companies was exempt from U.S. tax while the actual dividends were taxable was not lost on investment banks, who aggressively promoted swap transactions as a way for foreign hedge funds to avoid U.S. withholding tax without forgoing economic exposure to the underlying stocks. In response to the press reports of these transactions, in 2010, Congress added new §871(m), which provides that “dividend equivalent payments” are treated as a U.S. source dividend for sourcing and withholding tax purposes. A dividend equivalent payment includes substitute dividends and swap payments that are contingent upon or determined by reference to the payment of a U.S. source dividend.

Section 871(m) is described below in an excerpt from Joint Committee Report JCX-4-10. The drafting of regulations implementing §871(m) has been an arduous process because of the difficulty of finding and taxing U.S. dividend returns that are embedded in complex financial contracts, such as options and swaps. Final regulations were issued on October 13, 2015, Reg. §1.871-15 and -15T. The 871(m) regulations have been subsequently revised. The most recent is T.D. 9887 (Dec. 17, 2019). Treasury has issued various notices that have delayed the effective date of portions of the regulations. The most recent one is Notice 2022-37.

Swap income is generally sourced by the residence of the recipient.

**Technical Explanation of the Revenue Provisions Contained in
Senate Amendment 3310, the “Hiring Incentives to Restore
Employment Act,” under Consideration by the Senate February
23, 2010.**

Explanation of Provision

The provision treats a dividend equivalent as a dividend from U.S. sources for certain purposes, including the U.S. withholding tax rules applicable to foreign persons.

A dividend equivalent is any substitute dividend made pursuant to a securities lending or a sale–repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States or any payment made under a specified notional principal contract that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. A dividend equivalent also includes any other payment that the Secretary determines is substantially similar to a payment described in the immediately preceding sentence. Under this rule, for example, the Secretary may conclude that payments under certain forward contracts or other financial contracts that reference stock of U.S. corporations are dividend equivalents.

A specified notional principal contract is any notional principal contract that has any one of the following five characteristics: (1) In connection with entering into the contract, any long party transfers the underlying security; (2) in connection with the termination of the contract, any short party transfers the underlying security to any long party; (3) the underlying security is not readily tradable on an established securities market; (4) in connection with entering into the contract, any short party to the contract posts the underlying security as collateral; or (5) the Secretary identifies the contract as a specified notional principal contract. For purposes of these characteristics, for any underlying security of any notional principal contract (1) a long party is any party to the contract that is entitled to receive any payment under the contract that is contingent upon or determined by reference to the payment of a U.S.-source dividend on the underlying security, and (2) a short party is any party to the contract that is not a long party in respect of the underlying security. An underlying security in a notional principal contract is the security with respect to which the dividend equivalent is paid. For these purposes, any index or fixed basket of securities is treated as a single security.

For payments made more than two years after the provision’s date of enactment, a specified notional principal contract also includes any notional principal contract unless the Secretary determines that the contract is of a type that does not have the potential for tax avoidance.

No inference is intended as to whether the definition of specified notional principal contract, or any determination under this provision that a trans-

action does not have the potential for the avoidance of taxes on U.S.-source dividends, is relevant in determining whether an agency relationship exists under general tax principles or whether a foreign party to a contract should be treated as having beneficial tax ownership of the stock giving rise to U.S.-source dividends.

The payments that are treated as U.S.-source dividends under the provision are the gross amounts that are used in computing any net amounts transferred to or from the taxpayer. The example of a “total return swap” referencing stock of a domestic corporation (an example of a notional principal contract to which the provision generally applies), illustrates the consequences of this rule. Under a typical total return swap, a foreign investor enters into an agreement with a counterparty under which amounts due to each party are based on the returns generated by a notional investment in a specified dollar amount of the stock underlying the swap. The investor agrees for a specified period to pay to the counterparty (1) an amount calculated by reference to a market interest rate (such as the London Interbank Offered Rate (“LIBOR”)) on the notional amount of the underlying stock and (2) any depreciation in the value of the stock. In return, the counterparty agrees for the specified period to pay the investor (1) any dividends paid on the stock and (2) any appreciation in the value of the stock. Amounts owed by each party under this swap typically are netted so that only one party makes an actual payment. The provision treats any dividend-based amount under the swap as a payment even though any actual payment under the swap is a net amount determined in part by other amounts (for example, the interest amount and the amount of any appreciation or depreciation in value of the referenced stock). Accordingly, a counterparty to a total return swap may be obligated to withhold and remit tax on the gross amount of a dividend equivalent even though, as a result of a netting of payments due under the swap, the counterparty is not required to make an actual payment to the foreign investor.

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Comments

1. This chapter introduced the source of income rules of sections 861 and 862 for interest and dividends. The source rules assign a source—foreign or U.S.—to items of income and expenses. They are relevant for nonresidents because nonresidents are generally not taxed on foreign source income and for citizens and residents for purposes of the foreign tax credit rules.
2. During the 2000’s, Congress became concerned with U.S. persons holding assets in foreign bank and brokerage accounts and not declaring the

income from those assets. We've seen above in Chapter 2.2 that the Treasury requires U.S. persons to report annually any foreign bank accounts with a value greater than \$10,000. Congress became aware of organized schemes by foreign banks to encourage U.S. persons to hold assets in foreign accounts and avoid declaring the income and gains from the assets in the accounts.

Congress believed that the FinCEN bank reporting was insufficient, and in the HIRE Act of 2010, Congress enacted the Foreign Account Tax Compliance Act (FATCA) to combat tax evasion by U.S. persons. As part of FATCA, Congress enacted §6038D, which requires U.S. persons to report annually information about *specified foreign financial assets* such as bank accounts and interests in foreign securities and foreign corporations. Also as part of FACTA, in §§1471-1474, Congress enacted sweeping reporting requirements for foreign financial institutions (FFIs), such as banks, mutual funds, investment entities, and certain insurance companies, to report financial assets held by U.S. account holders or be subject to a 30% tax on withholdable payments (FDAP payments).

To avoid withholding, an FFI must enter into an FFI Agreement with Treasury or be covered by an Intergovernmental Agreement (IGA).³ Withholdable payments to non-financial foreign entities (NFFEs) are also subject to the 30% tax, unless the NFFE provides information on substantial U.S. owners (U.S. persons owning more than 10% of the passive NFFE). Certain entities, such as publicly traded companies, foreign central banks, and active NFFEs (50% or less of income and assets are passive income and assets) are excluded.

3. The source rules do not impose any substantive tax liability, as do, for example, §§1 and 871. Some shady promoters and return preparers take the position that §861 and the regulations thereunder permit a U.S. taxpayer to avoid tax on U.S. source income. Taxpayers, even famous ones, who take such a position on a return face severe penalties and possibly imprisonment. See Rev. Rul. 2004-30, 2004-1 C.B. 622.

Snipes' Sentence a Big Win for Tax Officials

Action star Wesley Snipes' three-year sentence on tax charges is a big win for prosecutors. As Forbes reported earlier this week,⁴ officials are increasingly concerned about a growing number of so-called "tax defiers."

³For a list of IGAs and Understandings, see FACTA Agreements and Understandings.

⁴Forbes Article on Snipes. A copy of the Snipes's amended 1997 tax return can be found at Snipes Tax Return.

Prosecutors pushed hard for a tough sentence in the Snipes case, worrying that anything less risked emboldening the movement.

Tax defiers—or “tax protesters” as they’ve traditionally been known—glom onto one kooky, discredited theory or another as to why the income tax is illegal or doesn’t apply to them personally or doesn’t cover their normal sources of income. (Example: Only foreign income, or only earnings of federal employees are taxable.) They typically file returns showing zero income or simply stop filing. Sometimes they also put in claims for refunds on taxes they paid before their conversions, as Snipes did.

Snipes was the highest-profile criminal tax target in years, and prosecutors called for a heavy sentence to deter others from trying to impede the IRS. The government alleged Snipes earned at least \$13.8 million in income for the years in question, on which he owed \$2.7 million in back taxes.

Snipes was acquitted in February of five additional charges, including felony tax fraud and conspiracy. Snipes’ co-defendants, Douglas P. Rosile and Eddie Ray Kahn, were convicted on both those counts. Kahn, who refused to defend himself in court, was sentenced to 10 years, while Rosile received 54 months. Both will serve three years of supervised release. Snipes will serve one year of supervised release.

In court Thursday, Snipes read from a statement, apologizing for his “costly mistakes,” but never mentioned the word “taxes.” ❖

Interest and Dividend Problems

First determine the source of the item of income (§§861-865), the taxation of the item (§871 or §881), and finally whether the payor of the item must withhold (§1441 or §1442). Answer each of the problems below first assuming that the recipient is not entitled to the benefits of any income tax treaty, and then determine whether your answer would be modified by the Treaty. Dividends and interest are addressed in Articles 10 and 11.

1. Interest paid to a U.K. citizen and resident:
 - a) on a corporate bond issued by Coca Cola. The bond holder doesn’t own any stock. [§1441(c)(9); Reg. §1.1441-1(b)(4)(i); and the BNY prospectus]
 - b) on a CD issued by the New York branch of Citigroup Inc., a U.S. corporation.[§871(i)(2)(A); §1441(c)(10); Reg. §1.1441-1(b)(4)(ii), - (e)(3)]

- c) on a CD issued by a U.K. branch of Citigroup. [Reg. §1.1441-1(b)(4)(iii)]
 - d) on a tax-exempt NYC municipal bond [Reg. §1.861-2(a)(1)] (Regardless of the source of interest, why shouldn't foreigners generally buy U.S. tax-exempt bonds?)
 - e) For each of the above questions, very briefly describe what documentation, *if any*, the U.K. resident should provide to the U.S. payor.
2. A U.K. resident holds a bond of DC, a Delaware corporation, that pays annual interest of \$100. Assume alternatively:
 - a) The bondholder owns 15% of DC's voting stock.
 - b) Same as previous question, except that the U.K. resident owns 5% of DC's voting stock.
 - c) Same as previous question, except that the bond was guaranteed by DC's parent, a Cayman corporation. DC defaults on an interest payment, and the Cayman corporation pays as guarantor. [Reg. §1.861-2(a)(5)]
 3. A U.K. bank loans money to a U.K. branch of IBM, which pays interest on the loan to bank. [§881(a), (c)]
 4. A U.K. parent corporation loans money to its wholly owned U.S. subsidiary, which pays interest to the parent.
 5. UKPS, a U.K. partnership, owns 50% of the stock and 20% of the debt of USCo, a U.S. corporation. UKPS has 100 equal partners. USCo makes an interest payment to UKPS. [Reg. §1.871-14(g)]
 6. PS, a partnership organized under U.S. law, borrows money from a Brazilian citizen. PS carries on a trade or business in the U.S., but this business produces only a small portion of PS's income (5%), and the borrowing has nothing to do with the U.S. business. The Brazilian owns 15% of PS. Note, partnerships compute their income in the same way as individuals (§703). [§861(a)(1), (a)(1)(B); Reg. §1.861-2(a)(2)]
 7. PS, a partnership organized under U.S. law, has only U.S. partners, and invests in start-up companies. (Under U.S. law, such a partnership would probably *not* be considered to have a U.S. trade or business.) It borrows money from Citigroup. What is the source of the interest paid? [Reg. §1.861-2(a)(2)]
 8. U.K. resident receives a dividend from IBM.

9. U.K. resident purchases debt issued by IBM that promises a fixed interest rate of 6% per annum plus 1% of IBM's preceding year's cash flow. U.K. resident receives an interest payment of \$80, of which \$60 is attributable to the fixed interest rate and \$20 to the cash flow. [§871(h)(4)]
10. U.K. parent corporation receives a dividend from its wholly owned U.S. subsidiary.
11. A U.K. pension fund receives a dividend from IBM.
12. USP, a partnership formed in the U.S. that is not engaged in a U.S. trade or business, receives a dividend from IBM. Paul, a U.K. resident is a 10% partner in USP. [Reg. §1.1441-5(b)(1), (2)(i)(A); Article 1(8)]
13. UK Ltd. is a UK entity treated as a corporation for U.K. purposes but as a partnership for U.S. purposes. This is a hybrid entity. Paul, a U.K. resident owns 10% of UK Ltd. UK Ltd. receives a dividend from IBM. [Reg. §1.1441-5(c)(1)(i), (ii), and (iii); Article 1(8)]
14. USP, a U.S. citizen residing in London, owes money to U.K. bank and has given an interest bearing note to evidence the obligation to repay. Now, assume that USP moves back to the U.S. and continues to pay interest on the note. [Reg. §301.7701(b)-1(a).]
15. UKP, a U.K. citizen and resident, owns a share of IBM. UKP loans the stock to B, a U.S. broker/dealer, under a securities lending transaction, who sells it to C, a U.S. institutional investor. B posts with UKP the sales proceeds as cash collateral. This amount is adjusted daily to reflect changes in the value of the IBM stock. Thus, if IBM rises, B pays UKP, and vice versa. UKP pays interest on the cash collateral equal to the market rate less 50 basis points. A dividend of \$100 per share is paid by IBM on the stock, and, pursuant to the lending agreement, \$100 is remitted to UKP as a substitute dividend payment. What are the U.S. tax consequences to UKP? [§871(m); Reg. §1.894-1(c); and Article 22.]
16. Same initial facts as previous question, except that UKP sells the stock directly to C and enters into an equity swap with B, under which B pays to UKP any increase in the value of IBM stock (daily, quarterly, or yearly) and any dividends paid during the period of the swap, and UKP pays to B an amount reflecting the market rate of interest on a notional principal amount equal to the value (measured daily, quarterly or yearly) of the IBM stock, and any decrease in the value of the stock. A \$100 dividend is paid by IBM and B pays UKP \$100 less \$5 of financing costs. (It would be a very fruitful exercise to compare the economic returns UKP would earn if the stock went up or down by \$100 assuming that (1) he actually owned it; (2) he was a party to the above swap contract; (3)

or he loaned out the stock in a securities lending transaction.) Assume the current price is \$300 per share. What are the U.S. tax consequences to UKP? [§871(m); Reg. §1.894-1; and Article 22.]



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