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 books 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. international 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 began 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 continued 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

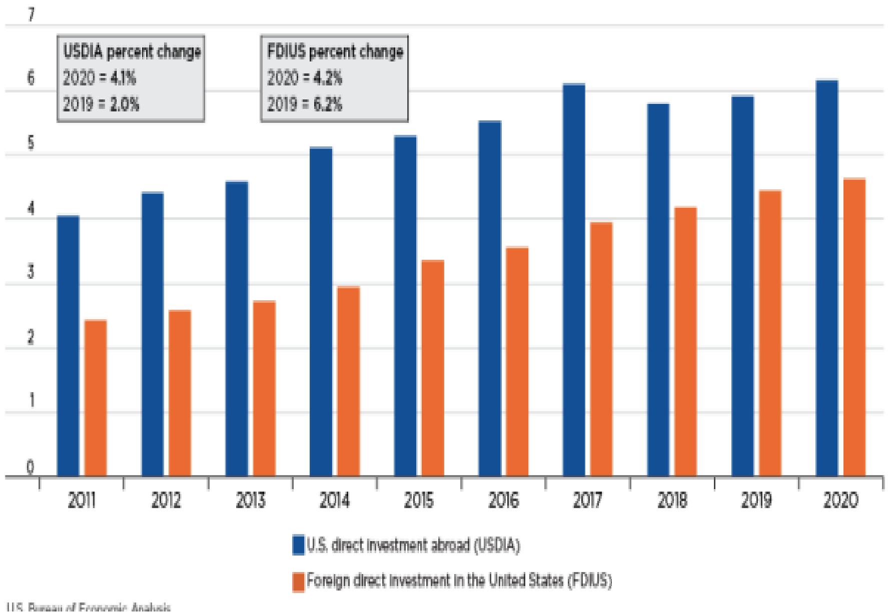
Introduction to U.S. International Taxation

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 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



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.

foreign corporation that is not subject to the CFC, PFIC, or GILTI regime is generally not taxed by the United Sates 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.

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

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

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.

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.

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 reports [4] 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

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

[3] OECD, *BEPS Actions*

[4] OECD, BEPS Digital Economy Reports

[5] OECD, *Tax Challenges Arising from Digitalisation–Report on Pillar One Blueprint*

[6] OECD, *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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[7] OECD, *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 McKennna 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."

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.

The benefits and burden rationale.

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).

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

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 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 US. 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.

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

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.

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 inicio*. 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

[1] For 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 become 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

The benefits and burden rationale once again.

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 Enforement 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 Sates–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 $1/3$; and each day present in the second preceding year counts as $1/6$.

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 (2020) + 90 × $1/3$ (2019). A is a resident alien in 2021 because he is present for 185 days, determined as follows:

Year	(a) Days in US	(b) Weight	(a) × (b) Counted Days
2021	120	1	120
2020	150	$1/3$	50
2019	90	$1/6$	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

[4]Most 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 hithertofore 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

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 been 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 plexis.

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 = €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 = €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,

[5] For 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. Relaying 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

[6]There 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.

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.

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.

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

[7] The 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 liability[8] of it 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,

[8] Limited 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 Delware 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) §§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 §7701(a)(30) in 1996 to provide guidance for determining the residence of a trust.

Under §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 §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 investment 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).

Last revised 2 Jan. 2022; *residence_3_2Jan_23*

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:

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.

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

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):

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

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:	2(d); 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.

[1]Prior 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

[2]Prior 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

. . .

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 intergovernmental 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.

✠

3.1.4 Synthetic Dividends

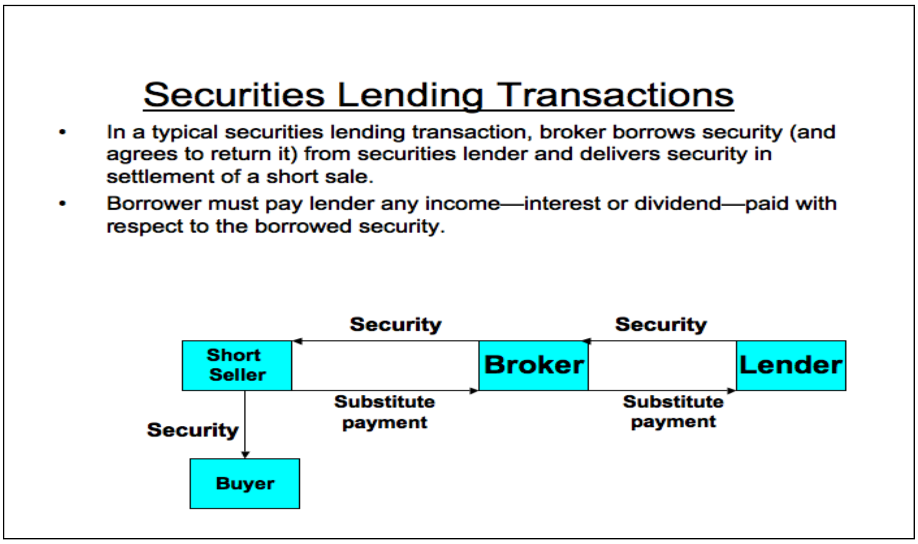
Hedge funds supply an increasing amount of investment capital to the U.S. capital markets. Hedge funds typically use a master-feeder structure: the investors invest in a feeder fund, which in turn, invests in the master fund. The master fund implements the hedge fund's investment strategy. To accommodate 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.

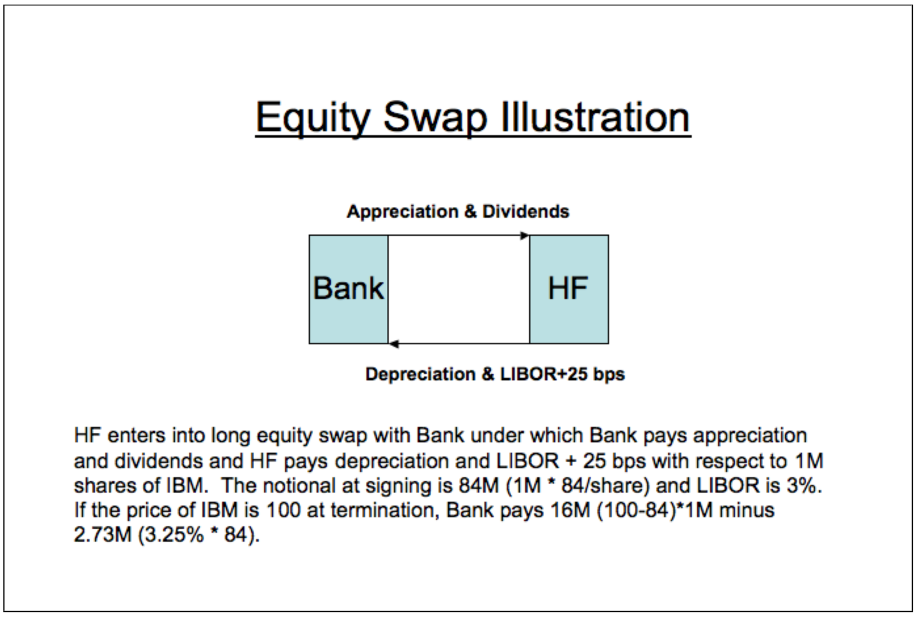
Substitute interest and dividend payments have the same character and source as the underlying interest or dividend.

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.

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

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 regualtions. The most recent one is Notice 2022-37.

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 transaction 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 §§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 become 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."

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

[4] Forbes 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 buxssiness 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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Last revised 7 Jan 23; source_IntDiv_7Jan_23

3.2 Compensation for Services

Code:	861(a)(3); 863(b)(1); 864(b)(1); 864(c)(6); 871(a)(1); 881(a)(1); 1441(b)(1) and (c)(1); and 1442(b)(2)
Regulations:	1.861-4(b)(1), (2)(i), (2)(i)(A), (2)(E), and (F); 1.864-4(c)(6); Prop. 1.861-4(b)(2)(ii)(G); 1.1441-1(a) and (b); and 1.441-2(b)(2)(i)
Treaty:	Articles 7, 14, 15, 16, 17-19 (skim lightly), and 20

Compensation for services performed in the United States is generally U.S. source income. §861(a)(3). If services are performed solely in the United States or abroad, determining the source of compensation for those services is straightforward. There is a *de minimis* exception for compensation not exceeding $3,000 performed by a nonresident alien who is present for 90 days or less in the United States and works for either a foreign person not engaged in a U.S. trade or business or for a U.S. person if the services are performed in connection with the U.S. person's foreign place of business. §§861(a)(3)(A)-(C); 864(b)(1)(A)-(B). As the $3,000 limit has not been adjusted for inflation since the provision was enacted over 60 years ago, the rule probably affects very few persons.

$3,000 in 1936 is equivalent to $64,057 in 2023.

If a person receives compensation for performing services both in the United States and abroad, the compensation must be allocated between U.S. and foreign sources. §863(b)(1). Since an employee who performs services inside and outside of the United States will often not receive separate compensation for the U.S. and foreign services, is it necessary to allocate the income between U.S. and foreign sources by examining the employee's employment contract or another method. Regulations under §861 provide that the allocation is to be made "on the basis that most correctly reflects the proper source of that income under the facts and circumstances of the particular case. In many cases, the facts and circumstances will be such that an apportionment on a time basis. . . will be acceptable." Reg. §1.861-4(b)(2)(i). The same regulation also provides rules for sourcing certain benefits, such as housing, education, local transportation, tax reimbursements, hazardous pay, and moving expenses. Reg. §1.861-4(b)(2)(ii)(D)(1)–(6).

The *Stemkowski* case below illustrates how this determination is made in the absence of a specific allocation in an employment contract. Compensation received by athletes and artists presents particular challenges. The event(s) for which an athlete or artist is ultimately compensated may represent the culmination of much preparation, rehearsals, and training performed in locations different than the final performance(s). Some had argued that an athlete or artist could allocate compensation between the countries where he performed and trained or rehearsed. In 2007, the IRS issued proposed regulations under §861 that provide that compensation received for performing services at a specific event should be allocated entirely to where the event occurs. The preamble to the proposed regulations states that it is probably improper to allocate any of the compensation for services received to the place where the artist or athlete prepares for the performance. *See* Prop. Reg. §1.861-4(b)(2)(ii)(G), (4)(c), Ex. 10 (player contract compensation not allocated to preseason or postseason unless athlete receives additional compensation). The proposed regulations thus would overturn the portion of *Stemkowski* that allocated a portion of the contract income to the preseason and postseason.

Although compensation is listed as FDAP under §871(a), if U.S. source compensation is received in a year in which the service provider is engaged in a U.S. trade or business, it will not be taxed at a flat 30%, but instead is taxed as effectively connected income at graduated rates. Performing services in the United States for even one day constitutes a U.S. trade or business, thereby subjecting the U.S. source income to graduated rates. §864(b); Reg. §1.864-4(c)(6). There is a narrow exception in §864(b)(1)(A) that parallels the exception in §861(a)(3) for minor amounts of compensation paid to nonresidents temporarily present in the United States.

Prior to 1986, deferred compensation paid in a year in which a nonresident was not engaged in a U.S. trade or business could be subject to tax under §871 if it were U.S. source. If the recipient resided in a treaty country, however, the deferred compensation may have escaped U.S. tax entirely. To prevent this gambit, Congress, in 1986, enacted §864(c)(6), which treats deferred compensation of a nonresident received in a year in which he is not engaged in a trade or business, but which is attributable to services performed in the U.S. in another year, as if it had been received in the other year. Thus, only in very rare circumstances will compensation be taxed as FDAP.

Treaties take a much more nuanced approach to compensation than the Code. Compensation performed as an independent contractor, *e.g.*, an attorney, accountant, or engineer, is governed by Article 7. Compensation for services rendered as an employee working for an employer of the other treaty country is not subject to source basis taxation, provided the employee is present in the source country for not more than 183 days. Article 14. On the other hand, directors's fees for services performed for a company resident in one country can be taxed by the source country, regardless how many days the director is present in the source country. Article 15. Separate articles apply to income of sportsmen and entertainers, income from pensions, income from government services, and income of students and teachers. *See* Articles 16-20.

Stemkowski v. CIR
690 F.2d 40 (2nd. Cir. 1982)

Oakes, Circuit Judge ...

FACTS

Taxpayer was traded prior to the beginning of taxable year 1971 to the New York Rangers, who play their home games at Madison Square Garden in New York City. He had previously signed a two-year NHL Standard Player's Contract with the Detroit Red Wings, and this contract was assigned to and assumed by the Rangers. The contract provided for compensation of $31,500 in the 1970-71 season and $35,000 in the 1971-72 season plus various NHL bonuses, including a $1500 bonus for each round won in the play-offs. The player agreed to give his services in all "league championship" (i.e., regular season), exhibition, and play-off games, to report in good physical condition to the club training camp at the time and place fixed by the club, to keep himself in good physical condition at all times during the season, and to participate in any and all promotional activities of the club and the league that in the opinion of the club promoted the welfare of the club or professional hockey.

They didn't make much then: $35,000 in 1972 is about $248,5141 in 2023.

In addition to their rights under this contract, NHL players in 1971 were entitled under the NHL's Owner-Player Council Minutes and Agreements to receive $25 per exhibition game plus $25 per week of training camp unless they had played fifty or more games in the previous season, in which case they received $600 in lieu of payments for exhibition games and training camp allowances other than transportation, food, and lodging. The players were also provided with medical and disability coverage, per diem expenses while traveling during the regular season, and various other benefits.

An NHL player's year is divided into four periods: (1) training camp, including exhibition games, beginning in September and lasting approximately thirty days; (2) the "league championship" or regular season of games beginning in October and lasting until April of the following year; (3) the play-off competition, which ends in May; and (4) the off-season, which runs from the end of the regular season for clubs that do not make the play-offs, or from a club's last play-off game, to the first day of training camp. Stemkowski lived in Canada during all of the off-season and most of the training camp period and played in Canada fifteen days out of 179 during the regular season and five out of twenty-eight days during the play-offs. When he was not living in

Canada or travelling to games elsewhere, he lived in Long Beach, New York, near New York City, where he shared a rented house with other professional hockey players.

On his tax return, Stemkowski reported $44,271 in income, of which he initially excluded $10,625 as earned in Canada...

The less time Stemkowski was in the United States during the period covered by his contract, the less United States tax he owes. Thus, Stemkowski could reduce his tax liability either by showing that he was in Canada for a longer period during the time covered by the contract or, as is at issue here, that the contract covered a time during which he was in Canada. The Tax Court held that the total number of days for which Stemkowski was compensated under his contract was not 234 (all but the off-season) as he had claimed on his tax return, or 365 as he had claimed before the Tax Court, but only 179, the number of days in the regular season. The Tax Court held that Stemkowski could not use days spent in Canada during training camp, the play-offs, or the off-season in calculating his foreign-source exclusion from income. The Tax Court further found that Stemkowski's off-season physical conditioning expenses, because incurred solely in connection with his contractual obligation to show up in good condition at training camp in Canada, were not connected to income from the conduct of a trade or business within the United States and thus were not deductible. ...

DISCUSSION

1. Allocation of Income

The first issue is the Tax Court's determination of the portion of Stemkowski's compensation under the NHL Standard Player's Contract that was drawn from United States sources. As a nonresident alien, Stemkowski was taxable on income connected with the conduct of a trade or business, including the performance of personal services, within the United States. I.R.C. §§871(b), 864(b). Where services are performed partly within and partly outside the United States, but compensation is not separately allocated, Treas. Reg. §1.861-4(b) (1975) allocates income to United States sources on a "time basis":

> (T)he amount to be included in gross income will be that amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.

This regulation applies to Stemkowski because the NHL Standard Player's Contract does not distinguish between payments for services performed within and outside the United States.

Any possible planning ideas for future contracts?

The parties disagree on what components of a hockey player's year are covered by the basic compensation in the NHL Standard Player's Contract, and therefore on how to compute the time-basis ratio. The taxpayer contends here as he did before the Tax Court that the contract salary compensates him for training camp, play-off, and even off-season services. The Commissioner argues and the Tax Court held that the contract salary covers only the regular season, and therefore that contract salary should be allocated to United States income in the same proportion that the number of days played in the United States during the regular season (164) bears to the total number of days in the regular season (179).[4] We agree with the Commissioner and the Tax Court that the contract does not cover off-season services, but we hold that the Tax Court's finding that the contract does not compensate for training camp and the play-offs as well as the regular season is clearly erroneous.

The Tax Court's holding was premised on provisions in the NHL contract and other players' agreements, and on the testimony of league and club officials. The first paragraph of the NHL Standard Player's Contract provides that if a player is "not in the employ of the Club for the whole period of the Club's games in the National Hockey League Championship Schedule," i.e., for the entire regular season, then he receives only part of his salary, in the same ratio to his total salary as the "ratio of the number of days of actual employment to the number of days of the League Championship Schedule of games." Paragraph 15 provides that if a player is suspended, he will not receive that portion of his salary equal to the ratio of "the number of days (of) suspension" to the "total number of days of the League Championship Schedule of games." The Tax Court concluded from these two paragraphs, and from the NHL's further agreements to pay players separate bonuses for participating in the play-offs and flat fees plus travel, room, and board for participating in training camp and pre-season exhibition games, that the basic contract salary did not cover play-off or training camp services. ...

We cannot uphold that finding, as we believe it clearly erroneous. The formulas for docking salary given in the contract's first and fifteenth paragraphs are not persuasive evidence that the salary compensates only for the regular season. These formulas may well use the number of days in the regular season in their denominators for administrative convenience (e.g., because the number of days to be spent in the play-offs cannot be known in advance) or to maximize the salary penalty per day lost. As to the testimony relied upon by the Tax Court, to a certain extent the owners and league officials have an interest in having the contract cover the shortest possible timespan so as to maximize loss to suspended or striking players. Furthermore, two of the league and club officials, Leader and McFarland, testified that at least training camp time was

[4] Although the Tax Court did not discuss separately the component of Stemkowski's total reported income representing play-off bonuses, the Commissioner concedes that Stemkowski's play-off compensation should be allocated separately from his contract salary, according to a ratio whose numerator contains the number of Ranger play-off days in the United States (23), and whose denominator contains the total number of Ranger play-off days in 1971 (28).

included in the contract. The contract's plain language, moreover, requires in Paragraph 2(a) that a player "report to the Club training camp ... in good physical condition," and a player who fails to report to training camp and participate in exhibition games is subject under Paragraph 3 to a $500 fine, deductible from his basic salary. True, experienced players were paid $600 plus room and board for training camp under the Owner-Player Council minutes and Agreements, but we read those Agreements as providing that amount merely to cover the additional expenses of being away from home at training camp.

Paragraph 2 of the contract also plainly requires a player's participation in play-off games in exchange for basic contract salary. While it is true that bonuses are provided for play-off games won, these are simply added incentives, above and beyond salary, to get into and win the play-offs. In this respect, they are just like other incentive bonuses the contract provides to influence conduct during even the regular season,*e.g.*, bonuses for the club's finishing in third place or better ($2500 in this case), or for the number of goals a player scores per season above certain minimums (at least $100 per goal over 20). Furthermore, players are required to participate in all play-off games for which they are eligible. Players may be terminated for failure to participate in the play-offs, but players receive nothing for the play-off games that they lose. Thus, we hold that the basic contract salary covered both play-off and training camp services.

We agree, however, that the off-season is not covered by the contract. During the off-season, the contract imposes no specific obligations on a player. Stemkowski argues that the obligation to appear at training camp "in good condition" makes off-season conditioning a contractual obligation. Fitness is not a service performed in fulfillment of the contract but a condition of employment. There was no evidence that Stemkowski was required to follow any mandatory conditioning program or was under any club supervision during the off-season. He was required to observe, if anything, only general obligations, applicable as well throughout the year, to conduct himself with loyalty to the club and the league and to participate only in approved promotional activities.

. . . ✠

The source of income received for *not* performing services, for example as pursuant to a non-compete contract, is addressed in *The Korfund Company, Inc. v. CIR*. The *Korfund* court concludes that payments to a nonresident for agreeing *not* to compete in the United States are U.S. source because had the nonresident violated the contract not to compete, the place of performance would have been the United States. Is this conclusion sound, especially today? Would the nonresident have had to have been present in the United States to violate the non-compete agreement? Also, why is the IRS going after Korfund instead of the nonresidents? Can U.S. persons use *Korfund* to generate untaxed foreign source income?

The Korfund Company, Inc. v. CIR
1 T.C. 1180 (1943)

DISNEY, JUDGE . . .

FINDINGS OF FACT

[Korfund] is a New York corporation organized in 1924, . . . [and it manufactures and sells] foundation material, such as cork plates and vibration absorbers. [The shareholders at formation were] Hugo Stoessel, a nonresident alien and citizen of Germany [925 shares] and Siegfried Rosenzweig [75 shares] . . .

The Emil Zorn Aktiengesellschaft [Zorn] is a nonresident foreign corporation engaged in the same business as petitioner, with its principal office in Berlin, Germany. In 1928 its stock was held equally by Stoessel and Werner Genest, a nonresident alien and citizen of Germany. In 1932 or 1933 Stoessel became the sole owner of stock of Zorn.

On October 22, 1926, petitioner entered into a written contract in the United States with Zorn whereby Zorn agreed (a) not to compete with petitioner in this country and Canada or to form, or give any data for the purpose of forming, a competitive company in that territory until the end of 1945, and (b) to give technical and business advice to petitioner upon its request, and petitioner agreed (a) not to furnish material, for the isolation of noise and vibration, outside of the United States and Canada prior to December 31, 1945, except specified territory outside of European countries. Each party agreed to turn over inquiries received from territory of the other and to exchange without charge improvements, inventions, and patents involving isolation against noise and vibration. Zorn was to receive from petitioner quarterly "a royalty of 1 1/2% for the year 1926 and 2% thereafter of the sale of all cork plates with iron frames and of 4% of the sale of all vibration absorbers," computed in a specified manner, with a minimum payment of $400 for 1926, $1,000 for 1927, and $1,250 thereafter through 1940. Zorn did not own any patents at that time. One of the purposes of the contract was to eliminate competition.

On September 21, 1928, the stock of petitioner was held as follows: Stoessel and Genest each 250 shares, Herman Hoevel 299 shares, and Siegfried Rosenzweig 201 shares. . . .

. . .

On September 21, 1928, petitioner entered into a written agreement with Stoessel in the United States whereby Stoessel undertook to act as consultant and adviser of petitioner in matters relating to the business of petitioner and to communicate to it information of value to petitioner's business until December 31, 1939, for 10 percent of the net earnings of petitioner payable at the end of each year. He also agreed not to act in a similar capacity for any other person, association, or corporation in the United States engaged in the same or a similar business. One of the purposes of the agreement was to eliminate competition.

...

Zorn and Stoessel faithfully performed their agreements not to compete with petitioner and not to give advice to its competitors. On about January 1, 1933, petitioner canceled the contracts of September 21, 1928, and October 22, 1926, with Stoessel and Zorn, and refused to make further payments to them. The contract with Stoessel was canceled on account of his failure to communicate technical information relating to petitioner's business as required by the agreement.

...

On July 30, 1934, Zorn assigned to Bernard Voges, New York City, all sums due it from petitioner under the agreement of October 22, 1926, and Stoessel assigned to the same individual salary in the amount of $1,984.04 alleged to be payable by petitioner for services rendered prior to October 1, 1932, and the balance of $2,227.60 payable to him from surplus account, plus interest on the claims of each, with power to recover the amount, plus interest on the claims of each, with power to recover the amounts for the account of the assignors. Voges instituted suit against petitioner in August 1934 under the assignments. An understanding was reached in 1934 to settle the claims by a payment of $2,750 to Stoessel and $3,250 to Zorn. The claim of Zorn for $3,250 and the claim of Stoessel for $2,227.60 were allowed in full. The remaining amount allowed Stoessel was for demands made under the agreement of September 21, 1928. The total amount was placed at interest and earned interest of $80, pending approval of the settlement by the German Government. Final settlement was made in 1938 when $2,508 was paid to Stoessel and $2,964 to Zorn and $608 was withheld for payment of withholding taxes.

OPINION

In his determination of the deficiency the respondent held that the allowance of $2,786.67 to Stoessel and $3,293.33 to Zorn, which amounts include the proportionate share of each in the interest of $80, constituted income from sources within the United States on which petitioner, as withholding agent, should have paid a tax equal to 10 percent of the former amount and 15 percent of the latter amount in accordance with the provisions of sections 143 and 144 of the Revenue Act of 1938. The item of $2,786.67 includes the principal sum of $2,227.60 representing Stoessel's share of petitioner's old surplus of $24,910.40. Respondent admits that, of the total amount paid to Stoessel in 1938, $2,227.60 represented the dividend and the remainder compensation under the contract. The parties differ only on whether this item of $2,227.60 was received by Stoessel in the taxable year. ...

...

Under their contracts Zorn and Stoessel agreed, in general, to act as consultants to petitioner. In addition Zorn agreed not to compete with petitioner or give any information for the formation of a competitive company and Stoessel agreed not to act as consultant to a competitor of petitioner. All of the amount paid to Zorn and the amount paid to Stoessel in excess of the surplus item were paid for these two general classifications of undertakings without any segregation of the amount paid for each. The respondent subjected the entire amounts to withholding tax, presumably in the absence of any basis of segregation, for he does not contend that the income from services performed as consultants is subject to the tax. Not only was no evidence offered on which to make an apportionment, but petitioner does not, upon brief, suggest or request an allocation. Under the circumstances, no apportionment is possible and we will regard all of the amounts in question under this point as having been earned by the nonresident aliens for obligations under the contracts other than service as consultants. See Estate of Alexander Marton, 47 B.T.A. 184.

Was this a mistake? It seems so.

The sole point of difference between the parties as to this income is whether it was earned from sources within the United States within the meaning of section 119 of the Revenue Act of 1938, and that, as already indicated, turns upon the source of the income derived from agreements not to compete with petitioner in the United States and Canada or give advice for the organization of, or to, a competitor.

The petitioner's contention is based upon the theory that the income was paid for agreements to refrain from doing specific things–negative acts. No defaults occurred and during the period of compliance the promisors were residents of Germany. Petitioner's contention is that negative performance is based upon a continuous exercise of will, which has its source at the place of location of the individual, and that, as the mental exertion involved herein occurred in Germany, the source of the income was in that country, not in the United States where the promise was given. The respondent's view of the question is, in short, that, as the place of performance would be in the United States if Zorn and Stoessel had violated their contractual obligations, abstinence of performance occurs in the same place. Petitioner relies upon Piedras Negras Broadcasting Co., 43 B.T.A. 297; affd., 127 Fed.(2d) 260.

In the Piedras Negras Broadcasting Co. case the taxpayer, a Mexican corporation, owned and operated a radio broadcasting station in Mexico, from which it broadcast programs primarily for listeners in the United States, for which it received compensation in the United States from citizens thereof. In holding that the source of such income was not within the United States, we pointed out that the studio and broadcasting plant were located, and operated by the employment of capital and labor, in Mexico; that the source of the income was, accordingly, in such studio and power plant, and that the reception of the radio impulses in receiving sets in this country was secondary, not the primary source. The court in affirming the decision said that "the source of income is the situs of the income-producing service" and that the source of the income was "the act of transmission." This reasoning is said to be equally applicable to the situation here.

In Sabatini v. Commissioner, 98 Fed.(2d) 753, the taxpayer was an author and a subject of Great Britain. He was not in the United States before, nor during, the taxable years. By contract executed outside the United States he gave to a publisher in this country, among other rights, the right to publish certain books, as to some of which copyrights were not obtainable. As to these the taxpayer, by the contract above mentioned, agreed not to authorize any other publisher to publish the books in the United States so long as the publisher left in print its editions of the books. The taxpayer was to receive under the contracts amounts determinable from the number of volumes sold. In holding that the income paid based upon the sale of these books was derived by the taxpayer from sources within the United States, the court said:

> The payments were received in consideration of his granting the publisher the exclusive right to publish here. To be sure, that may not have been of great value but the parties did value it and the author received the payments as agreed. We are not now concerned with the quality of the consideration he gave but only with the taxability of that which he received. The payments were made to him for foregoing his right to authorize others for a time to publish the works here. Though others may, perhaps, lawfully have published them they could not do so under his express authority. The rights he granted were an interest in property in the United States, in the one instance the statutory copyrights obtainable and in the other the exclusive right to publish with his permission.

In Ingram v. Bowers, 47 Fed.(2d) 925; affd., 57 Fed.(2d) 65, Enrico Caruso, a nonresident alien, entered into a contract in the United Stated to sing for the Victor Talking Machine Co. for the purpose of making phonograph records of selections rendered by him. The agreement contained a provision that Caruso would not permit any records of his voice to be made by any other concern. He was to receive under the contract a specified amount of the selling price of records sold, with a minimum yearly payment. In holding that the income received by Caruso under the contract from foreign sales constituted income from sources within the United States, the court pointed out that the decisive feature was the fact that the services were rendered in the United States and that those services were the source of all income derived from the contracts. No point appears to have been made of the fact that some part of the income was paid for the promise to refrain from singing for others, as it is not discussed in the opinion. Under petitioner's theory here, such part would not have been taxable.

We think the question here is governed by the principles laid down in the Sabatini, Ingram and Ferro-Enamel Corporation cases. Zorn had a right to compete with petitioner in the United States and Canada and for that purpose to form a competitive company or to assist others in forming one. Likewise, Stoessel had a right to serve other corporations or individuals in the United States engaged in a business similar to petitioner's as a consultant and to furnish them information of value to their business. They were willing to and did give up these rights in this country for a limited time for a consideration payable in the United States, just as did Sabatini in "foregoing his right to authorize others for a time to publish the works here." The Circuit Court in that case calls the exclusive right to publish an interest in property in the United States; so here, in our opinion, the rights of Stoessel and Zorn to do business in this country, in competition with the petitioner, were interests in property in this country. They might have received amounts here for services or information, but were willing to forego that right and possibility for a limited period for a consideration. What they received was in lieu of what they might have received. The situs of the right was in the United States, not elsewhere, and the income that flowed from the privileges was necessarily earned and produced here. Petitioner is merely using it, so to speak, for a specified time, subject to periodical payments to the owners of the rights. Upon the termination of the contracts the rights reverted to Zorn and Stoessel, and they were then free to exercise them independent of the agreements entered into with petitioner. These rights were property of value and the income in question was derived from the use thereof in the United States.

The Piedras Negras Broadcasting Co. case is distinguishable. It involved employment of capital and labor in a foreign country in connection with the rendition of service–not the foregoing, for a consideration, of a right to transact business in the United States.

We find and hold that the source of all of the income in question was in the United States and is subject to withholding tax in the taxable year. Accordingly,

Decision will be entered for the respondent. ✠

In *CIR v. Piedras Negras Broadcasting*, the court was faced with determining the source of income from a Mexican radio station transmitting into the United States in exchange for payments from U.S. advertisers, which constituted 95% of its income. What were the U.S. advertisers paying for: broadcasting, or broadcasting to the U.S. audience? Fast forward 80 years. For what medium is this case potentially relevant?

CIR v. Piedras Negras Broadcasting Co.
127 F.2d 260 (5th Cir. 1942)

Holmes, Circuit Judge The respondent is a corporation organized under the laws of the State of Coahuila, Republic of Mexico, with its principal office and place of business at Piedras Negras, Mexico. Its business is the operation of a radio broadcasting station located at Piedras Negras, just across the Rio Grande from Eagle Pass, Texas. The decisive question presented by this petition for review is whether the respondent, from the operation of its business in 1936 and 1937, derived any income from sources within the United States subject to taxation by the United States.

The taxpayer conducted its affairs in the familiar manner. Its income was derived from the dissemination of advertising over the radio and from the rental of its facilities to customers, referred to as the sale of "radio time." All of its income-producing contracts were executed in Mexico, and all services required of the taxpayer under the contracts were rendered in Mexico. The company maintained a mailing address at Eagle Pass, Texas, and used a hotel room there in which it counted and allocated the funds received in the mails each day.

Contracts with advertisers in the United States were handled through an advertising agent, an independent contractor. The majority of the taxpayer's responses from listeners came from the United States, and ninety-five per cent of its income was from advertisers within the United States. Bank accounts were maintained in Texas and in Mexico. The books and records of the corporation were in Mexico, its only studio was there, and all of the broadcasts by the station originated in Piedras Negras. The broadcasts were equal in volume in all directions, and were heard by listeners in this country and elsewhere.

Section 231(d) of the Revenue Act of 1936 provides that the gross income of a foreign corporation includes only the gross income from sources within the United States. If this taxpayer, a foreign corporation, had no income from sources within the United States, no income tax was levied upon it. The Board of Tax Appeals concluded that none of the respondent's income was derived from sources within the United States, and we agree with that decision. In Section 119 of the Revenue Act of 1936, Congress classified income, as to the source thereof, under six heads. . . . Since the taxpayer's income was derived exclusively from the operation of its broadcasting facilities located in Mexico, or from the rental of those facilities in Mexico, its income therefrom was either compensation for personal labor or services, or rentals or royalties from property, or both, under the statutory classification. Section 119(a)(3) provides that compensation for personal services performed in the United States shall be treated as income from sources within the United States. By Section 119(c)(3), income from such services performed without the United States is not from sources within the United States. Likewise, rentals from property located without the United States, including rentals or royalties for the use of or for the privilege of using without the United States franchises and other like properties, are considered items of income from sources without the United States. Section 119(c)(4) of the Revenue Act of 1936.

We think the language of the statutes clearly demonstrates the intendment of Congress that the source of income is the situs of the income-producing service. The repeated use of the words within and without the United States denotes a concept of some physical presence, some tangible and visible activity. If income is produced by the transmission of electromagnetic waves that cover a radius of several thousand miles, free of control or regulation by the sender from the moment of generation, the source of that income is the act of transmission. All of respondent's broadcasting facilities were situated without the United States, and all of the services it rendered in connection with its business were performed in Mexico. None of its income was derived from sources within the United States. . . .

The order of the Board of Tax Appeals is affirmed.

McCORD, Circuit Judge, (dissenting).

I am unable to agree with the majority opinion.

Prior to March, 1935, many programs broadcast over the Mexican station originated in a remote control studio located in Eagle Pass, Texas. After the Communications Commission denied application for continuance of the studio, programs no longer originated in the United States, but the broadcasting company continued its business operations in much the same way that it always had. While the mere broadcasting of electromagnetic waves into this country may not constitute the doing of business which produces income derived from sources within the United States, I do not think the case is as simple as that. The actual broadcasting of messages was not the only act, and the facts should be viewed as a whole, not singly, to see what was actually being done.

Various advertising contracts provided that the service to be rendered was to be from the station at Piedras Negras, but these contract provisions do not establish that the company was not taxable in this country. The programs of the Piedras Negras Broadcasting Company were primarily designed for listeners in the United States. Ninety per cent of its listener response came from this country, and ninety-five per cent of its income came from American advertisers. Through agents the broadcasting company solicited advertising contracts in this country, and it is shown that contracts were entered into by the company in the name of the Radio Service Co., an assumed name which for reasons beneficial to the company had been registered in Texas. The contracts also contained a provision that venue of any suit on such contracts would be Maverick County, Texas. Moreover, the company used Eagle Pass, Texas, as its mailing address, and its constant use of the United States mails was most beneficial to the company if not absolutely essential to the success of its operation. Money was deposited in American banks, obviously for convenience and to avoid payment of foreign exchange. Agents of the broadcasting company made daily trips to Eagle Pass where they met in a hotel room with advertising representatives and opened the mail and divided the enclosed money according to their percentage contracts with advertisers, and it is shown that the company received much of its income in this manner. It was, therefore, receiving income by broadcasting operations coupled with personal contact in this country.

I am of opinion that all the facts taken together establish that Piedras Negras Broadcasting Company was doing business in the United States, was deriving income from sources within this country, and was taxable. I think the decision of the Board should be reversed. I respectfully dissent. ✠

Comments

1. ***Athletes and Entertainers*** The compensation of athletes and entertainers presents many challenges. When performances occur in different countries and the contract does not separately break out the fees for U.S. and foreign performances, it is necessary to allocate the fees between U.S. and foreign sources. In addition, athletes can receive many types of compensation. In *Stemkowski*, we saw an example of compensation received pursuant to a standard player's contract. In Rev. Rul. 74-108, the IRS addressed the tax issues relating to a sign-on fee received by a foreign soccer player–widely believed to be Pele. According to the ruling, "a sign-on fee is paid to induce the player to sign and become bound by the provisions of the agreement. The agreement does not require the player actually to play for the club; it is merely a preliminary agreement that is separate and distinct from a 'uniform player" contract which binds a player to play soccer for a salary. When a player enters into an agreement, the taxpayer places him on its reserve list thereby protecting such player from recruiting efforts of any other club and preventing him from negotiating to play or playing for any other professional soccer club. No part of the sign on fee is attributable to future services, but the team anticipates the agreement and fee will induce the player to sign and become bound by the uniform player contract if the club wishes to use his services and a separate employment contract is negotiated for this purpose."

   Based on Rev. Rul. 58-145, which had held that a baseball signing bonus was not compensation for employment withholding tax purposes, Rev. Rul. 74-108 concluded that sign-on bonus was not service income under §861(a)(3), but rather a payment for a covenant not to compete. In determining how to allocate the payment between U.S. and foreign sources, the IRS stated: "in some cases it may be reasonable to make the allocation on the basis of the relative value of the taxpayer's services within and without the United States, or on the basis of the portion of the year during which soccer is played within and without the United States." How administratively feasible is the basis on which the IRS suggests allocating the sign on fee?

Rev. Rul. 74-108 was revoked by Rev. Rul. 2004-109, 2004-2 C.B. 958, on the grounds that Rev. Rul. 58-145 was incorrectly decided. Consequently, sign-on fees are now to be sourced as compensation under §861(a)(3), but the ruling did not give any guidance on how the fee should be allocated between U.S. and foreign sources.

2. ***Treaty Treatment of Entertainers and Sportsmen*** Article 16 of the Treaty addresses the compensation of entertainers and sportsmen. Once an entertainer's compensation gross receipts exceed $20,000, the source country may tax the entertainer's income. In the absence of Article 16, the income of many entertainers and sportsmen would be exempt from source basis taxation because either they (1) would not have a permanent establishment (in the case of an independent contractor), or (2) would be paid by a foreign employer and not present in the source country for more than 183 days (in the case of an employee). Field Service Advice 199947027, below, addresses the treatment under Article 16 of the income of models who are hired to promote a corporation's products and services.

   Some athletes are able to exploit the goodwill associated with their status by entering into endorsement contracts under which an athlete permits a company to use his name or likeness in advertising and agrees to perform personal services, such as appearance. The issue of whether payments made under such contracts are payments for services or royalties is addressed below in *Goosen v. CIR* and *Garcia v. CIR* in Chapter 3.3.

3. ***Withholding*** Payments to a nonresident of U.S. source compensation that is effectively connected are generally not subject to withholding under §1441 if the income is subject to normal wage withholding rules or specifically exempt from wage withholding or exempt under a treaty. §1441(c)(1); Reg. §1.1441-4(b)(1)(i), (ii), and (iv). To claim exemption under a treaty, the nonresident must file Form 8233 with the U.S. withholding agent. Reg. §1.1441-4(b)(2).

Field Service Advice 199947027
Sept. 30, 1999

...

FACTS

For the years in issue, Taxpayer A is a nonresident alien individual who is a citizen and resident of Country X. Taxpayer A is a model and actor who comes to the United States for assignments as such. According to Form 2106 (Employee Business Expense), attached to Taxpayer A's return, Taxpayer A's occupation is acting. For Year 1 and Year 2, Taxpayer A filed a 1040NR. On each return, Taxpayer A indicated that Taxpayer A was claiming the benefit of the Royalties Article of the U.S.–Country X Treaty. Specifically, the returns indicate that income of X Dollars for Year 1 and Y Dollars for Year 2, while effectively connected with the conduct of a trade or business within the United States, is nevertheless exempt from U.S. income tax because such income qualifies as royalties under the U.S.–Country X Treaty.

Taxpayer A entered into a contract with Corp B on Date C ("the Agreement"). The Agreement is a contract between Taxpayer A and Corp B with respect to Taxpayer A's services:

> as a model and performer in connection with the *advertising, marketing, promotion, publicizing, merchandising, and distribution for [Corp B] products and services* manufactured, sold, offered, furnished, licensed, or distributed, now or in the future, under the [Corp B] trade name (hereinafter collectively referred to as the "Products"). [Emphasis added.]

As a part of such services required by the Agreement, Taxpayer A was required to render services as a spokesperson to Corp B, including appearing at press conferences and granting interviews. Taxpayer A was also required to render services:

> as a performer and model in the production of materials advertising and promoting Corp B and its Products in all forms of media, electronic or otherwise, whether now or later developed, including but not limited to, television (free-t.v., basic cable, premium, pay-per-view, and closed circuit) and radio commercials, consumer and trade print, magazines, newspapers, point of purchase, mailers and mailing inserts, theatrical and cinema advertising, interactive and multimedia programming, home shopping, video for in-store use, video trailers, infomercials, how-to videos, outdoor, collateral, catalogs, packaging, in-store, direct mail, internal company materials, and public relations/press interview kits (hereinafter collectively referred to as the "materials"). Without limiting the foregoing, however, we agree that [Taxpayer A] will not be required to sell or deliver copy offering the sale of any Products on home shopping or in any infomercials, although [Taxpayer A] may be required to discuss the Products in a favorable fashion. In addition, *we shall not have the right to separately sell video tapes or cassettes embodying [Taxpayer A's] performance, our rights in such video tapes and cassettes being limited to broadcast uses and uses as free giveaways or as premium items accompanying Product offers.* [Emphasis added.]

Additionally, the Agreement required Taxpayer A to attend an orientation session with Corp B's senior management to acquaint Taxpayer A with Corp B's products and philosophy. Taxpayer A was further required to grant interviews and make appearances at public relations events each year of the Agreement. The Agreement also required Taxpayer A to use best efforts to promote and endorse Corp B and its products at all Corp B functions attended by Taxpayer A, and to consider promoting and endorsing Corp B and its products in all public and professional appearances attended by Taxpayer A. The Agreement required Taxpayer A to perform the services required thereunder in a competent and "artistic" manner to the best of Taxpayer A's ability.

In addition to the foregoing, the Agreement required that Taxpayer A only use Corp B products for Taxpayer A's Type B Product needs, unless Corp B did not manufacture or distribute such a product required by Taxpayer A. The Agreement further required that, during the term of the Agreement, Taxpayer A use reasonable efforts not to publicly handle any Type B Product other than those manufactured or distributed by Corp B.

In addition to Taxpayer A's services, the Agreement provides that:

> During the term of this agreement, [Taxpayer A] hereby grant to [Corp B] the right to use and to license the use of your performance, name, signature, photograph, voice, picture, likeness, or other indicia of your identity in connection with the materials produced hereunder in such advertising, merchandising, publicizing, promotional and marketing medium as permitted pursuant to this agreement....

LAW AND ANALYSIS

The issue involved in this case is whether Taxpayer A, a model and actor, is an "entertainer," for purposes of the Artistes and Athletes Article of the U.S.–Country X Treaty, with respect to services performed under the Agreement. Paragraph 1 of the Artistes and Athletes Article of the U.S.–Country X Treaty provides, in part, that:

> [I]ncome derived by entertainers, such as theatre, motion picture, radio or television artistes, and musicians, and by athletes, from their personal activities as such may be taxed in the Contracting State in which these activities are exercised....

While the Artistes and Athletes Article of the U.S.-Country X Treaty sets forth examples of "entertainers" falling within its provisions, it does not define the term "entertainer". Further, Taxpayer A's activity as a model under the Agreement is not an enumerated activity under the language of the treaty. Accordingly, it is not clear on the face of the Artistes and Athletes Article of the U.S.–Country X Treaty whether Taxpayer A is an "entertainer" with respect to Taxpayer A's activities under the Agreement.

The Treasury Department Technical Explanation of the Artistes and Athletes Article of the U.S.–Country X Treaty also does not define the term "entertainer," nor does it further describe the types of individuals that would be considered "entertainers" for purposes of the U.S.–Country X Treaty. Where a U.S. treaty and the technical explanations thereto are ambiguous or silent on a point, it may be appropriate to consider comparable provisions of the Organization for Economic Co-operation and Development Model Double Taxation Convention on Income and on Capital (the "OECD Model Convention"), and the official commentaries thereto, in interpreting the U.S. treaty, provided the language of the OECD Model Convention is in substance substantially similar to that of the U.S. Treaty at issue.

The provisions of the OECD Model Convention and the official commentaries thereto are relevant because the United States is an OECD member-country and has incorporated provisions of OECD Model Conventions into its treaties, including the U.S.–Country X Treaty.

Paragraph 1 of the Artistes and Sportsmen Article of the 1998 OECD Model Convention is substantially similar to the language of the Artiste and Athletes provision of the U.S.–Country X Treaty. Paragraph 1 of the Artistes and Sportsmen Article of the 1998 OECD Model Convention provides:

> Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

Paragraph 3 of the Commentary to the Artistes and Sportsmen Article of the 1998 OECD Model Convention, which explains the meaning and purpose of paragraph 1 of the Artistes and Sportsmen Article, provides:

> Paragraph 1 refers to artiste and sportsmen. It is not possible to give a precise definition of "artiste", but paragraph 1 includes examples of persons who would be regarded as such. These examples should not be considered as exhaustive. On the one hand, the term "artiste" clearly includes the stage performer, film actor, actor (including for instance a former sportsman) in a television commercial. The Article may also apply to income received from activities which involve a political, social, religious or charitable nature, *if an entertainment character is present.* On the other hand, it does not extend to a visiting conference speaker or to administrative or support staff (e.g. cameramen for a film, producer, film director, choreographers, technical staff, road crew for a pop group etc.).

> *In between there is a grey area where it is necessary to review the overall balance of the activities of the person concerned.* [Emphasis added.]

Paragraph 6 of the Commentary to the Artistes and Sportsmen Article of the 1998 OECD Model Convention further provides that:

> The Article also applies to income from other activities which are usually regarded as of an entertainment character, such as those deriving from billiards and snooker, chess and bridge tournaments.

Therefore, the commentaries that address the scope of the Artistes and Athletes Article focus on whether there is an entertainment character to the activity performed by the individual and on whether such activity is "usually" regarded as of an entertainment character.

Based on the foregoing, we believe that, in determining whether Taxpayer A is an "entertainer" with respect to Taxpayer A's activities under the Agreement, for purposes of the Artistes and Athletes Article of the U.S.–Country X Treaty, the focus should be on whether the primary purpose of the specific activity being performed by Taxpayer A under the Agreement is entertainment.

The Agreement provides that Taxpayer A's would provide services:

> as a model and performer in connection with the advertising, marketing, promotion, publicizing, merchandising, and distribution for [Corp B] products and services manufactured, sold, offered, furnished, licensed, or distributed, now or in the future, under the [Corp B] trade name (hereinafter collectively referred to as the "Products").

The foregoing language indicates that, generally, the primary purpose of Taxpayer A's activities under the Agreement is the promotion, marketing and sale of Corp B Products, not entertainment. This is further supported by the fact that the provisions of the Agreement setting forth the services to be performed by Taxpayer A also focus on the promotion, marketing and sale of Corp B Products. The fact that the Agreement refers to Taxpayer A rendering services as a model and "performer", or that the Agreement requires Taxpayer A to perform the services required thereunder in an "artistic" manner, does not, in itself, change the primary purpose of Taxpayer A's activities under the Agreement from promotion, marketing and sale or Corp B Products to entertainment, because entertainment is generally not the end sought to be accomplished by the activities required under the Agreement.

Accordingly, based on the foregoing, since the primary purpose of Taxpayer A's activities under the Agreement is generally not entertainment, Taxpayer A is generally not an "entertainer" for purposes of the Artistes and Athletes Article of the U.S.–Country X Treaty, with respect to Taxpayer's activities under the Agreement, despite the fact that Taxpayer A may also be an actor outside of the Agreement. However, if Taxpayer A did in fact perform an activity pursuant to the Agreement, and the primary purpose of such activity was entertainment, then, with respect to such activity, Taxpayer A could be an "entertainer" for purposes of the Artistes and Athletes Article of the U.S.–Country X Treaty.

If Taxpayer A is not an "entertainer" within the meaning of the Artistes and Athlete Article of the U.S.–Country X Treaty, with respect to Taxpayer A's activities under the Agreement, Taxpayer A's income from such activities is not taxable by the United States under that article of the U.S.–Country X Treaty. However, such income may be taxable by the United States under other articles of the U.S.–Country X Treaty. For example, the Independent Personal Services Article of the U.S.–Country X Treaty may apply to the portion of such income attributable to Taxpayer A's personal services under the Agreement if Taxpayer A either had a fixed base regularly available in the United States for the purpose of performing Taxpayer A's services, or was present in the United States for an aggregate of more than 183 days in the respective years at issue. Further, the Independent Personal Services Article of the U.S.–Country X Treaty may apply to royalty income derived by Taxpayer A under the Agreement if Taxpayer A performed independent personal services within the United States from a fixed base and the right or property with respect to which the royalties are paid is effectively connected with such fixed base. If Taxpayer A did not have a fixed base within the United States, taxation of royalties, as defined under the U.S.–Country X Treaty, derived by Taxpayer A under the Agreement would be governed by the Royalties Article of the U.S.–Country X Treaty and, therefore, would be taxable only by County X, Taxpayer A's country of residence.

✠

Compensation for Services Problems

1. John, a U.S. citizen, works in a NYC law firm. As part of a tax controversy matter, he is sent to the U.K. to assist in document review. He works a total of 2 months in the U.K. His total salary paid by his firm is $120,000, but $5,000 is directly deposited into his U.K. bank account.

    a) What is the source of his income?

    b) Assume that he receives a $20,000 bonus for his excellent work in reviewing the documents? (He was able to stay awake.) What's the source of the bonus?

    c) Assume that the firm receives a performance bonus of $1 million for its work on the case. What's the source of the bonus?

d) Assume that under U.K. law, he is also taxed by the U.K. on a portion of his salary. Is there any argument under the Treaty that the income is not subject to U.K. tax? [Article 14]

2. Elizabeth, a U.K. resident and citizen, is CFO of BritCo, a U.K. corporation. She comes here one month per year to supervise the U.S. subsidiary operations of BritCo. Her U.K. salary is $240,000.

   a) How is she taxed by the U.S.? [§§861(a)(3)(C)(ii); 864(b)(1), (c)(2)(B); 871(a), (b); Reg. §1.864-4(c)(6)(ii)]

   b) How does the U.K. treaty change your conclusion? [Article 14]

3. Elizabeth, a U.K. resident and citizen, is CFO of Citigroup's U.K. branch operations. Her duties require her presence in the U.S. for one month per year. Her U.K. salary is $240,000.

   a) How is she taxed by the U.S.?

   b) How does the U.K. treaty change your conclusion? [Article 14]

4. Richard is a U.K. citizen who works 360 days in 2020 in the United States for USCO, a U.S. corporation. He leaves on December 31, 2020, and is not present in the United States in 2021. Prior to coming to the United States, he negotiates with his employer to defer 80% of his salary ($80,000) until 2021, when he will be back in the U.K. (Under U.S. tax principles, this agreement executed before the services are rendered should be sufficient to ensure he isn't taxed on the income until he receives it.) USCO pays him in 2021, when he is a resident of the U.K.

   a) How is he taxed under the Code? [§§1; 864(c)(6) (read slowly and carefully and follow the referenced sections); Reg. §1.864-4(c)(6)(ii); and 871(b)]

   b) Does the Treaty change your answer to the previous problem? [Article 14]

5. Richard is a U.K. citizen and resident who works for Google in the U.K. from 2018 until the end of 2020. Each year during this period he spent two months in the U.S. working on projects. At the beginning of 2018, he was granted compensatory options to purchase 1,000 shares of Google at $100 per share. The options vest at the end of 2020, when the stock is worth $200 per share, and he exercises the options at the end of 2021 when the stock is worth $500 per share. In 2021, he doesn't spend any time in the U.S. Note, under U.S. law, the grant of a compensatory option is generally not a taxable event, but the exercise of the option generates ordinary compensation income equal to the difference between the exercise price and fair market value. *See* §83(a) and (e).

a) What is the source of the option income? [Reg. §1.861-4(b)(2)(ii)(F), (ii)(G), Example 6]

b) How is it taxed under the Code? [§§864(c)(6); Reg. §1.861-4(b)(2)(ii)(F); Reg. §1.864-4(c)(6)(ii); and 871(b)]

c) Does the Treaty change your answer to the previous problem? [Exchange of Notes to Article 14 (found after the Treaty Protocol, which is found at the end of the Treaty).]

6. Richard is a U.K. citizen and resident who works for IBM in the U.S. from 1990 until the end of 2020. He retires and moves back to the U.K. at the end of 2020. Beginning in 2021, he collects a monthly pension from IBM and a monthly social security payment. Assume that 50% of the pension's earnings are U.S. source income.

   a) What is the source of the pension and social security payments? [§871(a)(3); Reg. §1.864-4(c)(6)(ii)]

   b) How are they taxed under the Code? [§§864(c)(6); Reg. §1.864-4(c)(6)(ii); and 871(a)(3) and (b)]

   c) Does the Treaty change your answer to the previous problem? [Article 17]

7. Mary, a U.K. citizen and resident, is a professor at Nothingwhich University in the U.K. Because she has some friends on the faculty, she scores a visiting gig at the FLS for 2020 for which she is paid $100,000. At the end of 2020, she returns home to Nothingwhich.

   a) What is the source of Mary's compensation?

   b) How is it taxed under the Code?

   c) Does the Treaty change your answer to the previous problem? [Article 20A–find it!]

8. Mr. David Spice is a U.K. citizen and resident who is employed as a footballer (soccer player) by B(ad) F(ood) United, a U.K. corporation. He receives a salary for $12 million per year from BFUnited. Under his contract, he is required to play all of the BFU league matches and a series of other "goodwill" games in other countries. In 2020, BFU signs a contract to play six games in the U.S. and receives a fee of $1 million per game. For 2020, Spice plays 30 games in the U.K. and 6 in the U.S.

   a) What is the source of BFU's and Spice's income? [Stemkowski and Prop. Reg. §1.861-4(b)(2)(ii)(G)]

   b) How is it taxed under the Code?

   c) Does the Treaty change your answers above? [Articles 7, 14, and 16]

d) When Spice signed with BFU in 2019, he received a $1 million signing bonus. What is the source and how it taxed by the U.S. Does the Treaty change your answer?

✠

Last Revised 14 Jan 2023; source_Services_14Jan_23

3.3 Royalties

Code:	861(a)(4); 871(a)(1), (a)(1)(D); 881(a)(1), (a)(4); 1441(a) and (c)(5); and 1442(b)(2)
Regulations:	1.871-7(b)(1)
Treaty:	Article 12

Royalties are U.S. source if they are received for the use of property in the U.S. §861(a)(4). Thus, the residence of the payor, the owner of property, and the place of payment are irrelevant for sourcing purposes. U.S. source royalties are FDAP and subject to a flat 30% tax, but are deductible by the payor if the intellectual property is used in a trade or business. As we will see below, in situations where income is derived from intellectual property that is produced by personal services, it is not clear whether the income received is royalties or compensation for services. In addition, it is sometimes difficult to determine whether a transfer constitutes a license producing royalties or a sale producing capital gains. The U.S. tax consequences can vary greatly depending on the characterization of the income. Because the United States has historically been a net exporter of intellectual property, it has championed a low or zero rate of source country taxation of royalties. *See* Article 12.

Since royalties are deductible by the payor if the property is used in a U.S. trade or business, it is possible to reduce source basis taxation by licensing intellectual property into the source country. If the royalties are not taxed by the source country when paid, a significant amount of U.S. income could be extracted tax-free by royalties. Intellectual property is often more difficult to value than other types of property because it is difficult to find property that is comparable: with what would you compare the Nike swoosh trademark or a patent for a novel drug? Consequently, related parties (think parent-subsidiary relation) might choose to set the royalty rate at a level that eliminates much source basis taxation. The same issue arises with inter–company debt, but because there is competition among banks and other suppliers of debt capital, it is much easier to determine if an interest rate is reasonable than if a royalty rate is truly an arm's length rate.

The United States has promulgated detailed regulations under §482 to determine an appropriate arm's length price in dealings between related parties for tangible and intangible property. We'll examine these rules below in Chapter 13. To prevent deductible source country royalty payments between related U.S. and foreign corporations from entirely eliminating U.S. tax, in the TCJA Congress enacted the BEAT rules in §59A, which impose a minimum tax on certain U.S. corporations whose deductible payments, such as interest and royalties, to related parties exceed certain thresholds. We examine BEAT below in Chapter 6.3.

If a payment is properly characterized as a royalty, its source will be determined based on where the underlying intellectual property was used. At times, this determination can be challenging. For example, assume a company licenses a patent to a particular chemical to another company to be used in manufacturing another product. The patent is used where the particular chemical is produced, where the final product is manufactured, where the final product is sold to distributors, and finally, where the final product is sold to consumers. Each of these locations has arguably some economic nexus to the revenues produced by the final sale of the product, and an argument could be made to source some of the revenues to each of these locations. Rev. Rul. 68-443 addresses this issue.

Under Article 12, the source country is generally prohibited from taxing royalties. Such a provision clearly favors countries that develop and export intellectual property, and since the United States has historically been a developer and exporter of intellectual property, most U.S. tax treaties usually have a zero rate on royalties. The argument for prohibiting source basis taxation is that the expenses incurred in creating the property have been deducted in the residence country and therefore the residence country should have primary jurisdiction over the income generated by these expenses. Developing countries where the intellectual property is exploited take a different view. They argue that they should have primary tax jurisdiction over royalty income because the intellectual property is being exploited within their jurisdiction. Even where countries agree on a method for taxing intellectual property, many challenges arise for tax administrators as it is often difficult to determine if the licensing rate is arm's length as required by §482 and Article 12, par. 4.

A major focus of the BEPS initiative is intangible property For instance, Action 8 addresses transfer pricing aspects of intangibles, Action 10 covers transfer pricing and high risk transactions, and Action 13 focuses on transfer pricing documentation.

Rev. Rul. 68-443

1968-2 C.B. 304

. . .
Advice has been requested whether the place of initial sale of a product that bears a trademark is the controlling factor in the determination of the source of the royalties paid for the use of the trademark under the circumstances described.

X, a resident foreign corporation, owns a trademark for certain products in many foreign countries. X corporation entered into a license agreement with Y, a domestic corporation, pursuant to which Y was given the right to place the foreign trademark owned by X on Y's products and sell the trademarked products. The United States trademark for these products is owned by Z, an unrelated party. The license agreement between X and Y is a conventional trademark license agreement for a limited period of time and includes customary provisions to identify and protect the licensor's proprietorship of this mark. Under the terms of the license, Y corporation pays X corporation a royalty measured by a percentage of the initial sales price of the trademarked products.

Y manufactures the trademarked products in the United States and sells them to foreign buyers in the United States for resale and consumption in foreign countries; all rights, title, and interest of Y in the products pass to the foreign buyers within the United States. Thus, the initial sale of the trademarked products is regarded as having taken place in the United States.

The specific question presented is whether, by reason of the initial sale of the products to the foreign buyers in the United States, Y corporation has "used" the foreign trademark in the United States and the royalties paid by Y to X are income from sources within the United States.

Section 861(a)(4) of the Internal Revenue Code of 1954 states, in part, that royalties for the use of or for the privilege of using in the United States trademarks and other like property shall be treated as income from sources within the United States.

Section 862(a)(4) of the Code states, in part, that royalties for the use of or for the privilege of using without the United States trademarks and other like properties shall be treated as income from sources without the United States. The gist of a trademark is its association in the public mind with the product, it being the identifying mark of the trade. Ambrosia Chocolate Co. v. Ambrosia Cake Bakery, Inc., 165 F.2d 693, at 697 (1947).

The function of a trademark is to designate the goods as the product of a particular trader and to protect his goodwill against the sale of another's product as his. J.S. Tyree Chemist, Inc. v. Thomo Borine Laboratory, 151 F.2d 621, at 623 (1945).

In the instant case the character of X corporation's income is royalty income measured by a percentage of the sales of the foreign trademarked products. The initial sale of the trademarked products to foreign shippers is a means of placing the products in the avenues of commerce with a view towards their ultimate consumption outside the United States. Although the amount of the royalty income is measured by the sales of the trademarked products, the place of sale does not necessarily determine the source of such royalty income.

Since Z owns the United States trademark to these products, the products manufactured by Y and identified by the trademark under the license from X cannot be sold in the United States for consumption in the United States. Moreover, the foreign countries do not protect the foreign trademarks in the United States. It is concluded, therefore, that the royalties paid by Y to X are paid for the use of the trademarks in the foreign countries and that the place of initial sale of the trademarked products is not the controlling factor in the determination of the source of income.

Accordingly, in the instant case, where products are ultimately used in the foreign country where their trademark is protected, a royalty, received by X for the use of the foreign trademark, is income from sources outside the United States despite the fact that the initial sale of the trademarked articles took place in the United States. ✠

Cascading Royalties

Consider the case where foreign company A licenses the world-wide rights to a patent to foreign company B, which in turn, sublicenses the U.S. rights to U.S. company C. When company B pays its royalty comprised of the royalties from many sublicenses to company A, should a part of the royalty be considered U.S. source? Remember, section 861(a)(4) treats as U.S. source royalties paid for the use of intellectual property in the United States; the identity of the payor is irrelevant. What if companies A and B are related parties, and company A is not a treaty resident, but company B is? In Rev. Rul. 80-362, the IRS held that the royalties from company C to company B and from company B to company A were U.S. source. Does section 861(a)(4) support this view? What if no treaty applied to the first royalty payment?

In *SDI Netherlands B.V. v. CIR*, 107 T.C. 161 (1996), the Tax Court rejected the IRS's position in Rev. Rul. 80-362. In reading the case, try to find the exact basis on which the court concluded that United States could not tax the second royalty payment. Did they specifically conclude that such royalties are not U.S. source under section 861(a)(4)? If so, on what basis?

Rev. Rul. 80-362
1980-2 C.B. 208

. . .

ISSUE

Are royalties paid for the use of a patent in the United States, under the circumstances described below, subject to United States tax?

FACTS

A, a citizen and resident of a country other than the United States or the Netherlands, licenses the United States rights on a patent to X, a Netherlands corporation. X is a bona fide corporation unrelated to A. X agrees to pay A a fixed royalty each year in return for the patent license. X relicenses the patent to Y, a United States corporation, for use in the United States. Y agrees to pay X royalties based on the number of units produced by Y each year under the patent. X's fixed royalty to A is not contingent upon the receipt of royalties from Y. A's royalty income is not effectively connected with the conduct of a trade or business within the United States within the meaning of section 871(b) of the Internal Revenue Code.

Article IX(1) of the United States–Netherlands Income Tax Convention, T.D. 5778, 1950–1 C.B. 92, as amended by the United States–Netherlands Supplementary Income Tax Convention, 1967–2 C.B. 472, provides that royalties paid to a resident or corporation of the Netherlands shall be exempt from tax by the United States. There is no income tax convention between A's country of residence and the United States.

LAW AND ANALYSIS

Section 861(a)(4) of the Code provides that royalties for the privilege of using a patent in the United States are treated as income from sources within the United States.

In the present factual situations, the royalties from Y to X are exempt from United States tax under Article IX(1) of the Convention. However, the royalties from X to A are not exempt from taxation by the United States because there is no income tax convention between A's country of residence and the United States providing for such an exemption. Since the royalties from X to A are paid in consideration for the privilege of using a patent in the United States, they are treated as income from sources within the United States under section 861(a)(4) of the Code and are subject to United States income taxation under section 871(a)(1)(A).

HOLDING

Royalties paid by X to A are subject to United States tax at the 30–percent rate pursuant to section 871(a)(1)(A) of the Code. X , under section 1441(a), is required to withhold from the royalties paid to A a tax equal to 30 percent of such royalties. ✠

SDI Netherlands B.V. v. CIR
107 T.C. 161 (1996)

TANNENWALD, Judge . . .

Background

Petitioner is a foreign corporation organized in 1974 under the laws of the Kingdom of The Netherlands. . . .

During the years in issue, petitioner was a member of an affiliated group of companies (the SDI Group) whose members designed, manufactured, marketed, and serviced commercial systems software for use on IBM mainframe computers worldwide.

SDI Ltd., a corporation organized under the laws of Bermuda, is the parent company of the SDI Group. During the years in issue, petitioner was a wholly owned subsidiary of SDI Antilles, a Netherlands Antilles corporation, which was a wholly owned subsidiary of SDI Ltd.

The SDI Group also included SDI Bermuda Ltd. (SDI Bermuda), a corporation organized under the laws of Bermuda which, during the years in issue was a wholly owned subsidiary of SDI Ltd.

SDI USA, Inc. (SDI USA), a corporation organized under the laws of the State of California was, during the years at issue, a wholly owned subsidiary of petitioner. . . .

. . .

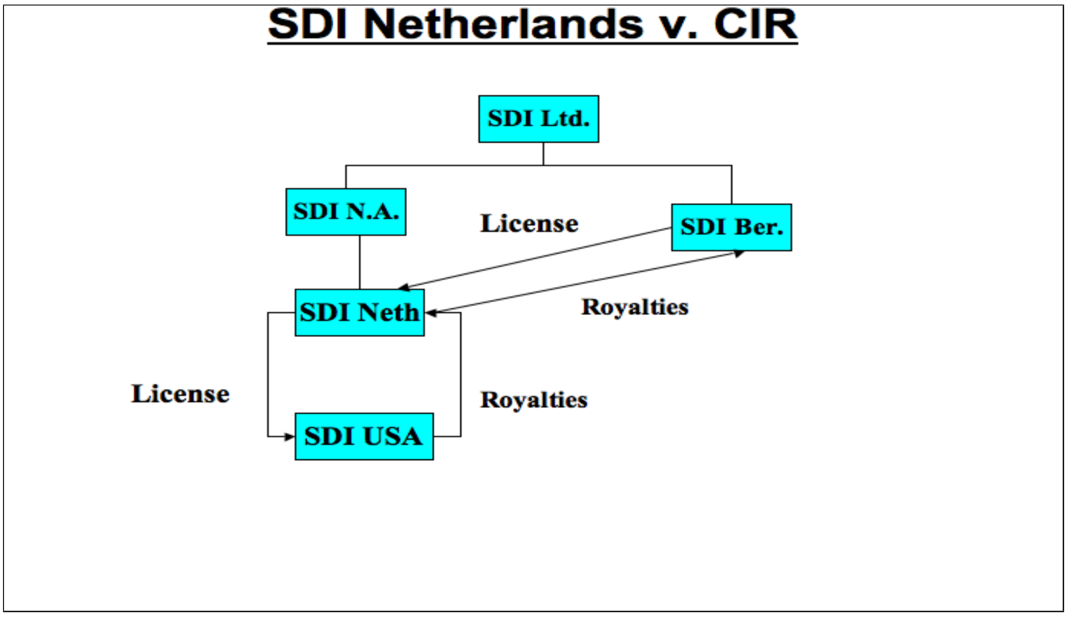
SDI Ltd. provided management services to certain of its direct and indirect subsidiaries for which such subsidiaries paid it management fees.

Royalty Payments Made By Petitioner

During the years in issue, petitioner licensed from SDI Bermuda, pursuant to a license agreement dated November 28, 1986 (Bermuda license agreement), the worldwide rights to certain commercial systems software for use on IBM mainframe computers (the software). The Bermuda license agreement granted petitioner a nonexclusive license to use or to market the use of, on a worldwide basis, all of the software and any and all industrial and intellectual property rights SDI Ltd. had or would acquire from the effective date of the agreement . . . , in exchange for certain royalty payments. The agreement further provided that petitioner "shall specifically have the right to grant sublicenses and Agents for the right to use and to market the use of any and all marketing rights granted to [petitioner] under the terms" of the agreement. The agreement was valid for an indefinite period and could be unilaterally terminated by either party on 3 months' written notice.

The Bermuda license agreement contained no express reference to the United States.

Figure 3.3: SDI Netherlands v. CIR



With respect to royalties, the Bermuda license agreement provided:

> 8.1 The royalties payable to [SDI Bermuda] by [petitioner] under this Agreement are fixed at 93% of the net amount of all of the royalties due to [petitioner] by all persons, entities and institutions which [petitioner] sublicensed any of the rights licensed to [petitioner] under this Agreement ("Sublicensees"). The aforementioned net amount is the amount that remains after the deduction of the withholding tax on royalties to be withheld when the Sublicensees of [petitioner] or Agents of [petitioner] pay the royalties due to the [petitioner].
>
> [The 93% rate was increased to up to 98% if the royalties exceeded certain amounts.]
>
> . . .

[From 1987 through 1990, SDI Netherlands paid between $3.5 million and $5.4 million annually to SDI Bermuda. Those payments constituted roughly 94% of the total worldwide royalty payments received by SDI Netherlands.]

Royalty Payments Received by Petitioner from SDI USA

During the years in issue, petitioner was a party to an exclusive license agreement with SDI USA, dated October 1, 1972, and as modified from time to time, regarding the use and licensing of the software in the United States (the U.S. license agreement). . . . SDI USA was responsible for the direct marketing and sales of the software in the United States.

The U.S. license agreement provided in part:

> 2.1 In consideration for the payment of the royalties provided hereunder and the performance of the other terms and conditions hereof by [SDI USA], [petitioner] hereby grants and transfers to [SDI USA], upon the terms and subject to the conditions hereinafter set forth, the exclusive right and license during the Term hereof, to have disclosed to it by [petitioner] and to exploit, use and lease and otherwise obtain the benefit of [the software] within the Territory.
>
> 2.2 This Exclusive License shall include, (i) the right to sublicense to others the use and lease of [the software] within the Territory, subject, however, to the terms and conditions of this License; and (ii) this License shall also include the right and, as hereinafter provided, the obligation of [SDI USA], to provide or to provide for the exclusive maintenance, servicing and repair of [the software] within the Territory. * * * * * * *
>
> 2.4 The Territory of this License shall mean and be restricted to the continental United States, Hawaii and Alaska.

Petitioner agreed not to license the software for use or to compete directly or indirectly with SDI USA's exploitation of the software in the United States during the term of its license to SDI USA. . . .

Should there have been an allocation to the non-compete?

Until February 1987, the agreement provided that SDI USA would pay to petitioner "an annual royalty equal to fifty percent (50%) of the annual gross revenues of [SDI USA] from leasing and sublicensing of [the software], without any deductions therefrom except rebates, discounts and sales or value added taxes."

The U.S. license agreement was modified in February 1987 to provide that SDI USA would pay petitioner "a royalty equal to (50%) fift[y] percent of the gross billable or invoiced revenues of [SDI USA] with regard to all products licensed herein or further licensed in the future, without any deductions therefrom except rebates, or, sales or value added taxes."

[SDI Netherlands received annual royalty payments from SDI USA from 1987-1990 of roughly $2.5 million annually.]

. . .

Discussion

. . .

Liability for Withholding

. . . There can be no dispute that the royalty payments received by petitioner from SDI USA constitute U.S. source income and were received by petitioner as such within the meaning of section 1442(a). . . . There is no comparable U.S. treaty exemption that would apply to royalty payments from SDI USA to SDI Bermuda.

The parties have locked horns on several aspects of the application of the statutory provisions in light of the impact of the U.S.–Netherlands treaty exemption: (1) Whether the royalties paid by petitioner to SDI Bermuda constitute income "received from sources within the United States by" SDI Bermuda and are thus subject to withholding under section 1441(a);. . .

For reasons hereinafter set forth, we resolve the first issue in petitioner's favor with the result that it is unnecessary for us to address the remaining issues. . . . Before proceeding with our analysis of the first issue, however, it is important to note that respondent does not question the existence of petitioner as a valid Netherlands corporation or the application of the treaty exemption insofar as the payments by SDI USA to petitioner are concerned. Similarly, respondent does not attack the arrangements under which petitioner had a license of the worldwide rights and SDI USA had a license of the U.S. rights, although respondent does ask us to take into account the close relationship of the various corporations involved. . .

Rather, respondent focuses her argument solely on the proposition that, since the royalties paid by SDI USA to petitioner were U.S. source income, they retained that character as part of the royalties paid by petitioner to SDI Bermuda and, as a matter of law, constitute income "received from sources within the United States by" SDI Bermuda under section 881(a). . . . Respondent contends that the fact that such royalties were combined with non–U.S. source royalties received by petitioner to determine the amount of royalties payable by petitioner to SDI Bermuda does not preclude the tracing of the royalties received by petitioner from SDI USA to U.S. sources. To implement such tracing, respondent simply applies the percentage specified in the worldwide license agreement between petitioner and SDI Bermuda and utilized in computing the amount of the required payment by petitioner to SDI Bermuda. . . . In all of [the cases cited by the CIR], however, the payments, upon which a withholding tax was imposed, were directly from a U.S. payor and the U.S. withholding tax was imposed on that payor. None of them address the situation involved herein, where there is a second licensing step under which royalties are being paid and upon which the U.S. withholding tax is sought to be imposed. Thus, these cases provide no guidance in respect of whether the U.S. source characterization of the royalties paid by SDI USA to petitioner flows through to the royalties paid by petitioner to SDI Bermuda.

The IRS argues that royalties do not change source when paid through chains of sublicensees.

Petitioner argues that the royalties paid by SDI USA to petitioner and exempt from tax under the Netherlands treaty became merged with the other royalties received by petitioner from non–U.S. sources and consequently lost their character as U.S. source income. Petitioner submits that, while the royalty payments from SDI USA may be U.S. source income, its royalty payments to SDI Bermuda were made on a separate and independent basis. With respect to the payments to SDI Bermuda, petitioner contends that they were made pursuant to a worldwide licensing agreement between two foreign corporations, and as such do not constitute income "received from sources within the United States" so that no withholding is required under section 1442(a). Pertinent authority on the issue before us is sparse. Indeed respondent relies solely on Rev. Rev. 80–362, 1980–2 C.B. 208, for her "flow–through" position. . . .

We are not persuaded that Rev. Rul. 80–362, supra, provides any significant support for respondent's position herein. It fails to reflect any reasoning or supporting legal authority. This circumstance is particularly relevant in applying the usual rule that, in any event, revenue rulings are not entitled to any special deference. . . .

Note the lack of deference the Tax Court accords revenue rulings.

At this point, we note that respondent has not argued that petitioner was a mere conduit or agent of SDI USA in paying royalties to SDI Bermuda or that SDI Bermuda was the beneficial owner of the royalties petitioner received from SDI USA so that the U.S.–Netherlands treaty exemption should not apply. . . . Presumably such an argument would have produced a situation where SDI USA rather than petitioner would have been targeted by respondent as the taxpayer liable for the withholding tax under section 1442(a). . . .

Although [Aiken and Northern Indiana] involved the conduit concept, we think they provide some guidance for our disposition of the instant case. We take this view because the flow–through characterization concept is, in a very real sense, the conduit concept albeit in a somewhat different garb, i.e., whether the U.S. source income is being received as such, because of the status of the paying entity in one case, and the status of the subject matter of the payment in the other.

In [Northern Indiana], the taxpayer, a domestic corporation, organized a finance subsidiary incorporated in Curacao under the Commercial Code of the Netherlands Antilles, (to which the U.S.– Netherlands treaty applied) for the purpose of issuing notes in the Eurobond market. The finance subsidiary borrowed $70 million at 17–1/4 percent interest in that market and lent that amount to the taxpayer at 18–1/4 percent interest. Respondent argued that the finance subsidiary should be ignored and that the taxpayer was liable for withholding taxes under section 1441 on the interest payments to the foreign Eurobond holders. Finding that the finance subsidiary engaged in substantive business activity that resulted in significant earnings, we held that the finance subsidiary was not a mere conduit or agent.

We think the within situation falls more within the ambit of Northern Indiana than Aiken Industries. In the latter case, there was an identity both in terms and timing between the back to back loans, as well as a close relationship between the parties involved. In the former case, although there was a clear connecting purpose between the borrowing and lending transactions, *i.e.*, to obtain the benefit of the exemption from the withholding tax on interest under the U.S.–Netherlands treaty; there were differences in terms, *i.e.*, in the interest rate (albeit not large); and a close relationship between all the parties was not present since the borrowings by the finance subsidiary were from unrelated parties.

In the instant case, there was a close relationship between the parties. However, although respondent asks us, in passing, to take that relationship into account, she does not pursue the matter to the point where she contends that it is a significant factor. Given the fact that respondent recognizes the existence of all of the parties as valid corporate entities and does not attack the bona fides of the license agreements between SDI USA and petitioner, on the one hand, or petitioner and SDI Bermuda, on the other, we are not disposed to allow the close relationship element to control our decision.

The facts of the matter are that the two license agreements had separate and distinct terms and that petitioner had an independent role as the licensee from SDI Bermuda and the licensor of the other entities, including but not limited to SDI USA. The schedules of royalty payments provides for a spread, not unlike the spread involved in Northern Indiana, which compensated petitioner for its efforts. Like the finance subsidiary in Northern Indiana, petitioner engaged in licensing activities from which it realized substantial earnings. In fact, on a percentage basis, it earned between 5 and 6 percent, compared to the 1 percent earned by that finance subsidiary in Northern Indiana. . . . Under the circumstances herein, we think these arrangements should be accorded separate status with the result that, although the royalties paid by petitioner to SDI Bermuda were derived from the royalties received by petitioner from SDI USA, they were separate payments.

Did the court get side-tracked with the conduit argument?

We find support for our conclusion herein in that respondent's view of the law could cause a cascading royalty problem, whereby multiple withholding taxes could be paid on the same royalty payment as it is transferred up a chain of licensors. . . . But for the U.S.–Netherlands treaty, the royalty payments from SDI USA could be subject to withholding tax twice under respondent's reasoning herein.

Respondent argues that only one withholding tax is being sought herein. However, this ignores the fact that, by treaty, the U.S. agreed to forgo taxing royalties and to allow them to be taxed by The Netherlands. Whether or not The Netherlands actually taxed the royalties is irrelevant. Respondent also infers that she would use her discretion not to apply more than one level of withholding tax on multiple transfers of income that originated as U.S. source income. We think this places an improper exercise of discretion in respondent's hands. To avoid the imposition of interest and additions to tax as determined by respondent herein, each payor in the chain might well feel compelled to file returns and pay withholding taxes. . . . We are not disposed to conclude, in the absence of any legislative expression on the subject, that Congress intended the statutory provisions to permit "cascading" with the question of relief left to the mercy of respondent.

We hold that the payments by petitioner with respect to which respondent seeks to impose liability for the 30 percent withholding tax herein were not "received from sources within the United States by" SDI Bermuda under sections 881(a), 1441(a), and 1442(a).[17]

Decision will be entered for petitioner. ✠

In commercial contracts, it is not uncommon to designate an amount as a royalty if it is determined by reference to future sales. For example, an author can be paid a fixed amount and a "royalty" based on the total sales of his book. This is often an efficient arrangement if the parties cannot agree *ex ante* on the value of the author's service. The tax issue that arises is whether such an amount is truly a royalty or instead a payment for services. The following cases, *Ingram v. Bowers* and *Pierre Boulez v. CIR*, address this issue. What can potentially happen to a taxpayer if one country taxes income as services and the other as royalties?

Ingram v. Bowers
47 F.2d 925 (S. D. N. Y., 1931)

PATTERSON, Judge

...

The case concerns the taxability of income received by Caruso by reason of the sale of phonograph records outside the United States, it being conceded that the singing by Caruso for the manufacture of such records occurred within the United States. The plaintiff contends: First, that Caruso was a nonresident alien, a proposition which the defendant disputes; and, second, that the amounts in question were not income from sources within the United States, which the defendant also disputes.

Caruso was the foremost singer of the world. His fame was international, although the greater part of his singing during the last ten years of his life was done in the United States. He was born in Italy and always remained a subject of that country. For many years prior to his death in 1921, he spent about six months of the year in the United States, singing at the Metropolitan Opera House in New York City and giving concerts at other cities. At the close of the operatic season, he almost always returned to Italy, where he maintained a large estate. His headquarters in the United States were the Knickerbocker Hotel, New York City, where he leased a suite of rooms, and later the Vanderbilt Hotel here. He married the plaintiff here in 1918, and in

[17] We note that changes in the U.S.–Netherlands treaty, applicable to years subsequent to the years before us, may provide a different framework for disposing of this issue. ...

1919 a daughter was born here. His income from opera and concert work in the United States was large and in making income tax returns he always claimed the status of a nonresident alien. During his lifetime, no question seems to have been raised as to this being his real status.

Among his other engagements, Caruso was under contract with the Victor Talking Machine Company, a New Jersey corporation, to sing for the purpose of enabling the Victor Company to make phonograph records of selections rendered by him. By contract dated April 3, 1909, he agreed to sing selections at the Victor laboratories in Camden, the Victor Company to pay him a royalty of 50 cents on each larger record and a royalty of 25 cents on each smaller record of his voice which it should sell. The contract was to continue for twenty–five years and was exclusive in the sense that Caruso bound himself not to sing for the purpose of making phonograph records for any one else. On January 1, 1919, this contract was superseded by a new one, under which Caruso was to render forty selections at the Victor laboratories. The Victor Company bound itself to pay Caruso a royalty equal to 10 per cent. of its list price on all records of his voice which should be sold, and it "guaranteed" a minimum payment of $100,000 a year during his life but not to exceed ten years. (It may be noted here that for the remainder of Caruso's life the royalties on the percentage basis were far in excess of $100,000, so that the "guaranty" did not become operative.) The 1919 contract also contained a provision to the effect that Caruso would not permit any records of his voice to be made by any other concern.

Note the noncompete and failure to allocate any of the payments to the noncompete.

This amount is equivalent to $1.51 million in 2022 dollars.

In performance of these successive contracts, Caruso would go to Camden and sing operatic selections. The sound would be recorded on wax, from which a master matrix would be made. From this master matrix the records for sale in the United States were manufactured. Records of Caruso's voice were also sold in other countries under the Victor contracts, and it is in relation to the royalties measured by sales in these countries that the present case arises. By contracts with companies doing business in Canada and in England, the Victor Company agreed to furnish such companies with matrices of its selections. One of the terms as to payment by the foreign companies was that they should pay the Victor Company all royalties which the latter was called upon to pay the artist. Pursuant to such contracts, the Victor Company sent various matrices of songs by Caruso to the foreign companies, and in due course they credited the Victor Company with sums of money representing the royalty which the Victor Company was obligated to pay Caruso, the amounts depending of course upon the number of records sold by the foreign companies. These sums were credited to Caruso on the Victor books and were paid to him along with the payments for records sold within the United States.

The [source of income from the foreign sales] is not so easy of solution. Did the moneys received by Caruso on account of foreign sales of records constitute income from sources within the United States? I have reached the conclusion that they did. The contracts which Caruso made with the Victor Company were contracts requiring him to render services. They called upon him to sing for Victor and to refrain from singing for any other phonograph company. For this he was to be paid by Victor according to the number of records sold, with a minimum compensation to be paid in any event. The contracts were in no sense contracts of sale or of license. Caruso had no proprietory right, title, or interest in the matrices or in the records. It is true that compensation was measured, in part at least, by the number of records sold and was referred to as a royalty; but the fact remains that the arrangement was one to render services in his capacity as a singer, as thoroughly as if the compensation had been a set sum.

The services rendered by Caruso were rendered in the United States. I think that this is the decisive feature. Those services were the source of all his income derived from the Victor contracts. It cannot be denied that but for the sales abroad part of this income would not have accrued. An event in a foreign country was necessary before the income became payable. But this cannot obscure the fact that the source, the origin of the income was Caruso's singing in Camden, N.J. I cannot see any difference in principle between this case and a case where a lawyer performs services in New York on a lawsuit pending in London, his compensation to be contingent upon success in the lawsuit. No income is realized until the happy issue of the suit in London, but clearly the source of the income, when realized, was the work done in New York. Or suppose a nonresident alien spends a year in New York working as sales manager for a merchandising company, his compensation to be a percentage of the proceeds of sales, and part of the sales are made in Canada and Mexico. Beyond doubt his earnings represent income from sources within the United States, where all his work was done, despite the fact that the amount of his earnings was enhanced by sales which took place in foreign countries. The same is true here. It seems to me that where a singer makes and performs in the United States a contract to sing for a phonograph company, for which he is to be paid a fixed sum for each record sold or a percentage of the list price of the records sold, the compensation so received is income from sources within the United States; the fact that some of the sales were made in foreign countries is immaterial.

. . .

My conclusion is that the income was from sources within the United States and was therefore taxable. A verdict for the defendant is accordingly directed. ✠

Ingram v. Bowers

57 F.2d 65 (2nd Cir. 1932)

L. Hand, Circuit Judge

. . .

The more vital question is whether the contracts were for more than personal services; whether they gave to Caruso some interest in the matrices and records, or, if there was any copyright, in the copyright; and whether the payments can in this wise be looked at as emanating from property. If so, the plaintiff argues, the sums in suit came from the foreign matrices; if not, then at least from the foreign companies. As to both matrices and records the second contract is too clear for question; it provides that Caruso "grants all rights in and to" them. The first contract contained no such words, but we think that the result was the same. In it he only agreed "to make these records," meaning of course, to sing into the recording apparatus, and the Victor Company, to pay him a royalty as records made from the resulting matrices were sold. The company was to manufacture both; prima facie they became its chattels like anything else of its mak[ing]. If it was intended to give Caruso an interest in them, some such reservation was to be expected, and there was none. The fact that his return was called a royalty is immaterial; it was so described in the second contract which was not equivocal. No remedy was created by which he could assert any such rights. It appears to us that the purpose was the same as was expressed later, and if so, he had no proprietary interest in the profits arising out of the records. If there be a copyright under section 1(e) of the Copyright Act (17 USCA §1(e)—which we do not say—it became embodied in the matrices, as a literary composition is embodied in its text. Any putative monopoly would do no more than prevent the copying of these, and it passed with the property in them. It was not impliedly reserved separate from them, for that would have interfered with their full enjoyment which the manufacturer was certainly to have.

Nor can we see how the source of the payments could be the royalties paid by the foreign companies to the Victor Company. They did not promise to pay Caruso, or to assume the obligations of the company.Whether in the event of its insolvency, he could have had recourse to their promises is beside the mark. Assuming as much, it would be only as security for the Victor Company's performance, and that would not change the source of the income while it continued to perform. For argument we may even assume the contrary after default; it never did default; all the payments here in question came from it. This would be equally true, though by a long stretch we were to assimilate the situation to that in Re Waterson, Berlin & Snyder Co., 48 F.(2d) 704 (C.C.A. 2), and hold that Caruso had a lien upon the matrices sent to the foreign companies. That would again be only as security, for under the doctrine of that decision the second assignee does not, by accepting the transfer, become personally liable on the promise of the first. As long as the first assignee performs, the assignor's rights against the second remain in abeyance; if he defaults, they are against the property alone. Thus, on no theory can it be said that the source of this income was outside the United States.

Judgment affirmed. ✠

In the *Boulez* case below, the same issue—whether income related to the sale of property produced by personal services is royalty income or compensation—arises in the context of a well-known conductor who is a treaty resident.

Pierre Boulez v. CIR
83 T.C. 584 (1984)

Korner, Judge
. . .

FINDINGS OF FACT

The petitioner, Pierre Boulez, resided in Paris, France, at the time the petition was filed in this case. Petitioner is a citizen of France, and during the calendar year 1975 was a resident of the Federal Republic of Germany (hereinafter FRG). For the taxable year 1975, petitioner was a nonresident alien of the United States for Federal income tax purposes, and he timely filed a Federal nonresident alien income tax return for that year with the Office of International Operations of respondent.

At all times relevant to this case, petitioner was a world–renowned music director and orchestra conductor. On February 19, 1969, petitioner entered into a contract with CBS Records, a division of CBS United Kingdom, Ltd., which is a subsidiary of CBS, Inc., a U.S. corporation. Said contract was modified as of September 13, 1971, and March 14, 1974, and, as so modified, was in effect during the year 1975. Under date of May 1, 1972, with the consent of CBS Records, the contract was assigned by petitioner to Beacon Concerts, Ltd., of London England, which acted as petitioner's agent and undertook to provide his services to CBS Records under the terms of the basic contract, as amended. As relevant and material herein, the contract between petitioner and CBS Records, as in effect in the year 1975, provided in part as follows:

> 1. We [CBS Records] hereby agree to engage and you [the petitioner] agree to render your services exclusively for us as a producer and/or performer for the recording of musical and/or literary compositions for the purpose of making phonograph records. It is understood and agreed that such engagement by us shall include your services as a producer and/or performer with the New York Philharmonic for the recording of musical and/or literary compositions for the purposes of making phonograph records.

* * * *

3. (a) During the first two contract years of this agreement you will perform for the recording of satisfactory master recording [sic] sufficient in number to constitute two (2) 12 inch long playing 33 1/3 rpm recordings, or their equivalent, and we will record your performances; and during each contract year commencing September 13, 1971, you will perform for the recording of satisfactory master recordings sufficient in number to constitute three (3) twelve inch long–playing 33 1/3 rpm recordings, or their equivalent, and we will record your performances. Additional master recordings will be performed by you and recorded by us at our election.

* * * *

4. During the period of this Agreement you will not for any reason whatsoever give or sell your services under your own or any assumed name or anonymously to any other person firm or corporation but nothing herein contained shall preclude you for [sic] giving or selling your services for films personal appearances and broadcasting (whether or not accompanied by television) provided such services are not reproduced as records for sale to the public and you undertake to have this proviso included in any contract for such services. You will not during the period of five years after the expiration of the term of this Agreement give or sell your services for the purpose of making or assisting in the making of records of any of the compositions or works which you shall have performed under this Agreement. You acknowledge that your services are unique and extraordinary and that we shall be entitled to equitable relief to enforce the provision of this paragraph 4.

Note the existence of a covenant not to compete and the failure to allocate any income to this covenant.

5. All master recordings recorded hereunder and all matrices and phonograph records manufactured therefrom, together with the performances embodied thereon, shall be entirely our [CBS Records] property, free from any claims whatsoever by you [petitioner] or any person deriving any rights or interests from you. Without limiting the generality of the foregoing, we (including other divisions of our company) and/or our subsidiaries, affiliates and licensees shall have the unlimited right, from time to time, to manufacture, by any method now or hereafter known, phonograph records and other reproductions, on any mediums or devices now or hereafter known, of the master recordings made hereunder, and to sell transfer or otherwise deal in the same throughout the world under any trademark, trade names and labels or to refrain from such manufacture, sale and dealing;

* * * *

> 6. We hereby agree to pay the accompaniment costs and studio charges in connection with the master recordings made hereunder.
> * * * *
>
> 13. If, by reason of illness, injury, accident or refusal to work, you fail to perform for us in accordance with the provisions of this agreement, * * * we shall have the option without liability to suspend the application of paragraph 2 and/or paragraph 7 (including the payment of any royalties) of this agreement for the duration of any such contingency by giving you written notice thereof.

Under paragraph 7a of the contract, it was provided "For your services rendered hereunder and for the rights granted to us herein we will pay you the following royalties." There then followed an elaborate formula by which the petitioner was to be paid, based upon a percentage of the retail price derived by CBS Records from the sale of its phonograph records produced under the contract, with said percentage varying depending upon various factors, including, inter alia, whether the musical composition involved was in the public domain, whether the performance conducted by petitioner was made with the New York Philharmonic Orchestra, whether sales were made by direct sales or mail order through what was termed a "Club Operation," whether the record involved was a "re–issue," etc. In all cases, however, the payments or "royalties" which petitioner was to be entitled to receive were dependent upon future sales of recordings by CBS Records.

Pursuant to the February 19, 1969, contract with CBS Records, as amended, petitioner conducted various performances with the Cleveland Orchestra, the New York Philharmonic, and others in the recording of musical compositions for CBS Records. None of these recordings were from "live" performances (i.e., performances before an audience). They were all private performances arranged solely for purposes of recording. CBS, Inc., was responsible for and exercised control over the setting up of the recording session, employing and paying the members of the orchestra, providing and arranging the equipment and engineers and technicians needed to capture and electronically process the sounds rendered by the orchestra, and for compiling and editing the sounds to make master recordings, matrices, and phonograph records. Petitioner exercised control over the manner in which the orchestra transposed into aural form the underlying musical composition which was the subject of each recording. He determined the placement of the musicians and the volume of aural sound to be rendered by the various musical instruments making up the orchestra. In conducting the orchestra, petitioner exercised his individual artistic talents of interpreting the musical work. Such interpretation, which is the function of the conductor, differs from conductor to conductor and is unique to each conductor's recording of a particular work.

Applications for the copyrights of all the master recordings, matrices, and phonograph records embodying the sound recordings of the musical compositions conducted by petitioner pursuant to the contract were filed by CBS, Inc., and all registrations thereof were issued by the U.S. Copyright Office registered in the name of CBS, Inc. As the result of performances conducted by petitioner under the terms of the contract, CBS, Inc., paid to Beacon Concerts, Ltd., as petitioner's agent, the sum of $39,461.47 in the year 1975. Beacon Concerts, Ltd., in turn, paid such sum to petitioner in 1976. In his 1975 U.S. nonresident alien income tax return, petitioner disclosed the receipt of such amount, but excluded it as not being subject to U.S. income taxation. Petitioner reported the identical amount in his 1976 income tax return filed with the FRG as includable income subject to the German income tax, and petitioner paid German income tax thereon.

Upon audit of petitioner's 1975 U.S. income tax return, respondent determined, inter alia, that the entire amount of $39,461 was taxable to petitioner by the United States. Because of an apparent conflict between respondent and the FRG concerning the proper taxation of this income under the existing income tax treaty between the United States and the FRG, competent authority proceedings, pursuant to the provisions of the treaty, were instituted at the request of petitioner and were conducted by the FRG Ministry of Finance and respondent's Office of International Operations in an effort to resolve the issues arising under said income tax treaty.

The competent authorities of the two nations were unable to reach agreement on the correct treatment for income tax purposes of the income here involved. The position of the FRG was that these payments constituted "royalties," within the meaning of article VIII of the treaty, and therefore were taxable exclusively by the FRG. Respondent, on the other hand, took the position that said income was income from performance of personal services in the United States by petitioner, and therefore was taxable by the United States under the provisions of article X of said treaty, except that respondent here concedes that, of the total amount of $39,461.47, the amount of $9,000 was income from sources without the United States and was not subject to taxation by respondent, thus leaving the net amount of $30,461 in issue.. . .

What was Boulez's effective tax rate on this income?

ULTIMATE FINDING OF FACT

The payments of CBS, Inc., to petitioner in 1975 were payments as compensation for personal services rendered by petitioner.

OPINION

Petitioner contends that the payments to him in 1975 by CBS, Inc., were not taxable by the United States, because they were "royalties" within the meaning of the applicable treaty between the United States and the FRG. Respondent, as noted above, contends that the payments in question were taxable to petitioner by the United States because they represented compensation for personal services performed in the United States by petitioner. The parties are in agreement that the outcome of this dispute is governed by the effective income tax treaty between the United States and the FRG. ... Petitioner, a resident of the FRG, was a person within the coverage of the treaty. The relevant portions of the treaty provide, in part [Read Articles 3(2), 12(1) and 12(2)(a), and 14(1) of the Treaty]

Acknowledging that the provisions of the treaty take precedence over any conflicting provisions of the Internal Revenue Code of 1954 (sec. 7852(d); see also sec. 894), we must decide whether the payments received by petitioner in 1975 from CBS, Inc., constituted royalties or income from personal services within the meaning of that treaty. This issue, in turn, involves two facets:

> (1) Did petitioner intend and purport to license or convey to CBS Records, and did the latter agree to pay for, a property interest in the recordings he was engaged to make, which would give rise to royalties?
> (2) If so, did petitioner have a property interest in the recordings which he was capable of licensing or selling?

The first of the above questions is purely factual, depends upon the intention of the parties, and is to be determined by an examination of the record as a whole, including the terms of the contract entered into between petitioner and CBS Records, together with any other relevant and material evidence.

The second question–whether petitioner had a property interest which he could license or sell–is a question of law. The treaty is not explicit, and we have found no cases or other authorities which would give us an interpretation of the treaty on this point. We are therefore remitted to U.S. law for the purpose of determining this question. ...

1. The Factual Question

By the contract entered into between petitioner and CBS Records in 1969, as amended, did the parties agree that petitioner was licensing or conveying to CBS Records a property interest in the recordings which he was retained to make, and in return for which he was to receive "royalties?" Petitioner claims that this is the case, and he bears the burden of proof to establish it.

The contract between the parties is by no means clear. On the one hand, the contract consistently refers to the compensation which petitioner is to be entitled to receive as "royalties," and such payments are tied directly to the proceeds which CBS Records was to receive from sales of recordings which petitioner was to make. Both these factors suggest that the parties had a royalty arrangement, rather than a compensation arrangement, in mind in entering into the contract. We bear in mind, however, that the labels which the parties affix to a transaction are not necessarily determinative of their true nature, and the fact that a party's remuneration under the contract is based on a percentage of future sales of the product created does not prove that a licensing or sale of property was intended, rather than compensation for services.

On the other hand, the contract between petitioner and CBS Records is replete with language indicating that what was intended here was a contract for personal services. Thus, paragraph 1 (quoted in our findings of fact) clearly states that CBS Records was engaging petitioner "to render your services exclusively for us as a producer and/or performer * * * It is understood and agreed that such engagement by us shall include your services as a producer and/or performer." Paragraph 3 of the contract then requires petitioner to "perform" in the making of a certain number of recordings in each year. Most importantly, in the context of the present question, paragraph 4 of the contract (quoted in our findings) makes it clear that CBS considered petitioner's services to be the essence of the contract: petitioner agreed not to perform for others with respect to similar recordings during the term of the contract, and for a period of 5 years thereafter, and he was required to "acknowledge that your services are unique and extraordinary and that we shall be entitled to equitable relief to enforce the provision of this paragraph 4."

Under paragraph 5 of the contract (quoted supra), it was agreed that the recordings, once made, should be entirely the property of CBS Records, "free from any claims whatsoever by you or any person deriving any rights or interests from you." Significantly, nowhere in the contract is there any language of conveyance of any alleged property right in the recordings by petitioner to CBS Records, nor any language indicating a licensing of any such purported right, other than the designation of petitioner's remuneration as being "royalties." The word "copyright" itself is never mentioned. Finally, under paragraph 13 of the contract, CBS Records was entitled to suspend or terminate its payments to petitioner "if, by reason of illness, injury, accident or refusal to work, you fail to perform for us in accordance with the provisions of this agreement."

Considered as a whole, therefore, and acknowledging that the contract is not perfectly clear on this point, we conclude that the weight of the evidence is that the parties intended a contract for personal services, rather than one involving the sale or licensing of any property rights which petitioner might have in the recordings which were to be made in the future.

2. The Legal Question

Before a person can derive income from royalties, it is fundamental that he must have an ownership interest in the property whose licensing or sale gives rise to the income. Thus, in Patterson v. Texas Co., 131 F.2d 998, 1001 (5th Cir. 1942), the Court of Appeals adopted the definition of a "royalty" as "a share of the product or profit reserved by the owner for permitting another to use the property." Likewise, in Hopag S.A. Holding De Participation, etc. v. Commissioner, 14 T.C. 38 (1950), this Court held that in order for a payment to constitute a "royalty," the payee must have an ownership interest in the property whose use generates the payment, citing the definition of royalties in section 119(a)(4) of the Internal Revenue Code of 1939 (section 861(a)(4) in the 1954 Code is the same), which states:

> Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property, * * *

In its definition of royalties, the treaty embodies the same fundamental concept of ownership. Thus, in article VIII(3)(a), "royalties" are defined to mean "amounts paid as consideration for the use of, or *the right to use*, copyrights, artistic or scientific works * * * *or other like property or rights*," and article VIII(3)(b) also states that the term "royalties" "shall include gains derived from the alienation of *any right or property* giving rise to such royalties." (Emphasis supplied.)

It is clear, then, that the existence of a property right in the payee is fundamental for the purpose of determining whether royalty income exists, and this is equally true under our domestic law as well as under the treaty.

Did the petitioner have any property rights in the recordings which he made for CBS Records, which he could either license or sell and which would give rise to royalty income here?[4] We think not.

As noted in our findings, the basic contract between petitioner and CBS Records was executed in 1969. At that time, petitioner had no copyrightable property interest in the recordings which he made for CBS Records under the Copyright Act of 1909 as amended, 17 U.S.C. sec. 1 et seq., and petitioner concedes that this was so.

Petitioner contends, however, that the Copyright Act of 1909 was amended by the Sound Recording Amendment of 1971, Pub. L. 92–140, 85 Stat. 391 (1971), and by virtue of this amendment, petitioner then acquired copyrightable property interests in the recordings which he thereafter made for CBS Records.

We think that petitioner is correct, in that the Sound Recording Amendment of 1971, supra, did amend the Copyright Act of 1909 so as to create, for the first time, copyrightable property interests in a musical director or performer such as petitioner who was making sound recordings of musical

[4]It is to be noted that the treaty classifies as royalty income both the income derived from the licensing of property as well as from the sale thereof. Although this definition is broader than the definition of royalty income for U.S. citizens (cf. secs. 1235, 1253), it corresponds to the treatment given to nonresident aliens by the Internal Revenue Code. Sec. 871(a)(1)(D); sec. 1.871–12(b)(1)(iii), Income Tax Regs. Petitioner herein does not make it clear whether he contends that he licensed a property interest which he had in the records which he made for CBS Records, or whether he sold his entire interest, but in view of the breadth of the treaty definition, it does not matter.

works, a property right which had not existed theretofore. ... In discussing the changes made by the Second Recording Amendment of 1971, and the new property rights therein created in both record producers such as CBS Records and performers such as petitioner, the legislative history contains the following significant statement: "As in the case of motion pictures, the bill does not fix the authorship, or the resulting ownership, of sound recordings, but leaves these matters to the employment relationship and bargaining among the interests involved." H. Rept. 92-487 (1971), 1971 U.S. Code Cong. & Adm. News 1566, 1570.

In spite of this change in the law in 1971, however, petitioner's contractual relationship with CBS Records went on as before. Neither the amendment to that contract of 1971, nor the further amendment in 1974, made any reference to the change of the copyright laws, nor modified the basic contract in any respect which would be pertinent to the instant question. We conclude, therefore, that the parties saw no need to modify their contract because they understood that even after the Sound Recording Amendment of 1971, petitioner still had no licensable or transferable property rights in the recordings which he made for CBS Records, and we think this was correct.

The Copyright Act of 1909, even after its amendment by the Sound Recording Amendment of 1971, describes the person having a copyrightable interest in property as the "author or proprietor" (17 U.S.C. sec. 9), and further provides that "the word 'author' shall include an employer in the case of works made for hire." 17 U.S.C. sec. 26. The above is a statutory enactment of the long-recognized rule that where a person is employed for the specific purpose of creating a work, including a copyrightable item, the fruits of his labor, carried out in accordance with the employment, are the property of his employer. The rule creates a rebuttable presumption to this effect, which can be overcome by express contractual provisions between the employee and the employer, reserving to the former the copyrightable interest.

Here, the petitioner, a musical conductor of world-wide reputation, was employed to make recordings for CBS Records, and in doing so, was to exercise his peculiar and unique skills in accordance with his experience, talent, and best judgment. In these circumstances, we do not think that petitioner was an "employee" in the common law sense, but rather was an independent contractor, with the same relationship to CBS Records as a lawyer, an engineer, or an architect would have to his client, or a doctor to his patient. This, however, provides no grounds for distinction, since the "works for hire" rule applies to independent contractors just as it does to conventional employees.. . .

In the instant case, the application of the "works for hire" rule means that petitioner had no copyrightable property interest in the recordings which he created for CBS Records, even after 1971. Petitioner was engaged for the specific purpose of making the recordings in question; his contract with CBS Records reserved no property rights in the recordings to him, and indeed made it specific that all such rights, whatever they were, were to reside in

CBS Records. Under these circumstances, we do not think that petitioner has overcome the statutory presumption of the "works for hire" rule, nor that he has shown that he had any property interest in the recordings, either before 1971 or thereafter, which he could either license or sell to CBS Records so as to produce royalty income within the meaning of the treaty. This conclusion, in turn, reinforces our belief, which we have found as a fact, that the contract between petitioner and CBS Records was one for the performance of personal services.

It follows that respondent was correct in taxing this income to petitioner under the provisions of article X [Article 14] of the treaty.

. . . ✠

In Rev. Rul. 74-555, the IRS addressed the taxation of payments made by a domestic corporation to a foreign author in exchange for the serial rights—the right to print first either stories or excerpts of a book before publication—to future stories. The IRS concluded that the payments were not for services, but constituted royalties on the basis that the contract "did not prescribe in any manner what the taxpayer was to write or when it was to be written." Is this the strongest basis for the conclusion? Consider services performed by an independent contractor: what control does the principal have over the independent agent? Is the payment still a payment for services? Finally, what rights did the author retain with respect to his writings both in the United States and abroad?

Rev. Rul. 74-555
1974-2 C.B. 202

. . .

Advice has been requested whether payments received by a nonresident alien individual, under the circumstances described below, are rentals or royalties from sources within the United States that are subject to the 30 percent tax imposed by section 871(a)(1) of the Internal Revenue Code of 1954.

The taxpayer, a nonresident alien author, executed a contract with P, a domestic corporation, granting to P the first American serial rights in the taxpayer's exclusive output of both long and short stories for which P was to pay a stipulated sum per story. The contract also provided that P should have the right to publish in the United States all new books of the taxpayer at royalty rates mutually agreeable to the contracting parties. The contract did not prescribe in any manner what the taxpayer was to write or when it was to be written.

The question here is whether payments received by the taxpayer for books and stories written under the contract described above are compensation for labor or personal services, or rentals or royalties for the use of or for the privilege of using copyrights in the United States.

. . .

In Commissioner v. Wodehouse, 337 U.S. 369 (1949), 1949-2 C.B. 62, the Supreme Court of the United States held that sums received by a nonresident alien individual for an exclusive serial or book right throughout the United States were royalties subject to tax under the Revenue Act of 1938 as "fixed or determinable annual or periodical gains, profits or income" from United States sources.

The contract in the instant case does not prescribe in any manner what the taxpayer is to write or when it is to be written. The contract merely provides that if the taxpayer writes any new books or stories, P shall have certain rights to publish them in the United States. The contract is neither a contract of employment nor a contract for the rendition of personal services. Accordingly, payments received by the taxpayer under the contract are not compensation for labor or personal services.

The rights granted to P under the contract constitute licenses for the use of or for the privilege of using copyrights in the United States. Therefore, the payments to the taxpayer are royalties from sources within the United States subject to the tax imposed by section 871(a)(1) of the Code at the rate of 30 percent for which withholding is required under section 1441. ✠

Comments

Treatment of Endorsement Fees The U.S. tax treatment of fees received by athletes pursuant to endorsement contracts has generated a significant amount of controversy. Under an endorsement contract, an athlete agrees to let a company use his name or likeness and in exchange is generally required to participate in a number of competitions, to wear the logo of the sponsoring corporation during competitions, and may also agree to appear in commercials, to participate in creating booklets and videos, and to make personal appearances. In other contracts, the athlete merely licenses his name and likeness in exchange for a payment and a de minimis amount of personal services. The tax issue that arises is whether the payment is a royalty or a payment for services. Once that determination has been made, it is necessary to allocate the payments between U.S. and foreign sources. Oftentimes, there is no allocation in the contracts and where there is, the allocation tends to weight the foreign source portions quite heavily. Why?

Chief Counsel Memorandum 2009-005 analyzed in great detail the U.S. taxation (including the treatment under treaties) of retainer fees and ranking bonuses received pursuant to an endorsement contract by an athlete. The memorandum concluded that retainer fees are payment for services notwithstanding that a player's likeness and name is used. The memorandum also contains a detailed analysis of the application of treaty provisions, in particular whether Article 16 (Entertainers and Sportsmen) rather than Article 7 (Business Profits) should apply to such payments, given that the payments constitute service income for U.S. tax purposes.

In contrast, Field Service Advice, 1999-790 (released May 10, 1993), concluded that payments pursuant to an endorsement contract were royalties. The author of the field service advice, citing *Armour et ux v. CIR*, 22 T.C. 181 (1954) and Rev. Rev. 81-178, 1981-2 C.B. 135, argued that "the passive endorsement of a product (*e.g.*, by allowing one's identifying mark to be placed on it or by allowing the public to witness one using the product while engaged in the active conduct of a trade or business), does not constitute the rendition of a service." The author further argued that the income should be sourced by the place of sales of the products the athlete was endorsing.

In two recent cases, *Goosen v. CIR*, 136 T.C. 547 (2011) and *Garcia v. CIR*, 140 T.C. No. 6 (2013), the Tax Court addressed for the first time the international tax issues arising from fees from endorsement contracts. In reading the cases, attempt to articulate the courts' rationale for their conclusions with respect to the royalty vs. services and the sourcing issues. Finally, assuming that Goosen were eligible for treaty benefits–the court concluded he was not, why?–what would be his U.S. tax liability under the Treaty? How did the Swiss treaty change Garcia's U.S. tax liability?

Goosen v. CIR

136 T.C. 547 (2011)

KROUPA, JUDGE

[Editor: Retief Goosen, a South African citizen and U.K. resident, was a professional golfer and PGA card holder. During the tax years in question, 2002-2003, he played in approximately 36 tournaments annually and divided his time between Europe and the United States. Goosen was managed by IMG, which, to manage his U.K. taxes, directed him to enter into employment contracts two IMG-controlled entities, ESP and ETO. All U.K. income (endorsement income, prize money and appearance fees) was paid to ESP and non-U.K. income to ETO. These entities would pay Goosen a fixed salary and bonus. This structure ensured that Goosen paid U.K. tax only on the U.K. source income.

For UK tax planning purposes, UK income was paid to ESP and non-UK income to ETO.

IMG entered into various endorsement and appearance agreements with TaylorMade, Izod, Acushnet, Rolex, Upper Deck and Electronic Arts (EA). In an endorsement agreement, the sponsor may use the athlete's name and likeness to advertise and promote the sponsor's products for a specified period of time. In an appearance agreement, the sponsor may use the athlete's name

Endorsement agreement: use of name and likeness over period of time. Appearance agreement: use of name and likeness for a specific tournament or event.

and likeness only in connection with the advertising and promotion of a specific tournament or event. The TaylorMade, Izod, and Acushnet endorsement agreements ("on-course" agreements) required Goosen to use their products during golf tournaments, but the Rolex, Upper Deck and EA agreements ("off-course" agreements) didn't.

On course: Athelete required to use products during tournaments; off-course, no.

The TaylorMade agreement allocated annual endorsement fee of $400,000 (with potential bonuses), 75-25 to ETO and ESP, and required a minimum of appearances in U.S. and European tournaments. Goosen was required to use the equipment and provide two days to pose for television commercials and make 6 personal appearance days to promote TaylorMade products. In return, TaylorMade could use Goosen's name and likeness on TaylorMade golf apparel, equipment, and accessories. The Acushnet ($350,000 for 2002) and Izod ($33,750 for 2002) agreements were similar, and the annual fees were allocated similarly.

The Rolex agreement ($50,000 annually) granted Rolex the rights to use Goosen's name and likeness in selling Rolex watches. In return, Goosen was to use all reasonable efforts to wear a Rolex timepiece when featured in any medium or when appearing in public engagements worldwide. The annual fee was also allocated 75-25 between ETO and ESP.

The Upper Deck ($42,500) agreement granted Upper Deck the right to use his name and likeness worldwide in connection with the production, marketing, advertising, promotion and sale of Upper Deck's golf trading cards. Goosen agreed to sign 3,500 trading cards per year as well as provide five shirts, five pairs of gloves, two hats and one golf bag, each of which he used during practice or in a golf tournament.

The EA agreement ($45,000) granted EA the right to use Goosen's name and likeness in the its software products, including the Tiger Woods PGA Tour 2004. The ETO agreement was worldwide except for the U.K., and the ESP agreement was limited to the U.K. The ETO agreement required Goosen to provide two 4–hour product development sessions and to provide nine photographs to enable EA to recreate Goosen's likeness.

On his U.S. returns, Goosen reported directly all of the endorsement income. Goosen reported all tournaments and appearance fees in the U.S. as ECI, and characterized his endorsement fees and bonuses from the on-course endorsements (TaylorMade, Izod, and Acushnet) as 50% royalty and 50% personal services. Goosen reported his on-course endorsement fees and tournament bonuses as 3.4% U.S.–source royalty income. He sourced the personal services income from the on-course endorsement fees and tournament bonuses to the U.S. based on the number of days he played inside the U.S. over the total days he played golf for the year. He sourced the personal services income portion of his ranking bonuses from the on-course endorsement agreements based on a ratio of his U.S. prize winnings to his worldwide prize winnings.

Goosen allocation between US and FS and between royalties and services.

Goosen characterized his endorsement fees from the off-course endorsement agreements as 100% royalty income. Goosen reported 6.8% of endorsement fees from Rolex and EA as U.S. source royalty income and 9.1% of the payments from Upper Deck as U.S. source royalty income.

In a footnote, the court states that Goosen calculated his royalty income percentages using a 12–market model, which allocated 25% of the endorsement fees to the U.K. and and 75% of the endorsement fees evenly among 11 other world markets. According to the court, Goosen "provided few details of the 11 other world markets or how this calculation works."

The IRS allocated the endorsement fees generated from the on-course endorsement agreements based on the number of U.S. tournaments petitioner played in comparison to the number of worldwide tournaments he played. All tournament bonuses from tournaments played in the U.S. were allocated to U.S. sources, and ranking bonuses were allocated based on the ratio of U.S. prize money to worldwide prize winnings.

IRS allocation of Goosen's income.

The IRS characterized the income from off-course endorsement agreements as royalty income, but allocated 25% to U.S. sources, rather than the roughly 10% that Goosen had reported.

The parties stipulated that any income from the on-course endorsement agreements characterized as personal services income should be sourced 41.7% to the U.S. for 2002 and 42.7% for 2003. The parties also stipulated that all tournament bonus income is U.S.-source and all ranking bonus income is U.S.-source based on the ratio of U.S. prize winnings to worldwide prize winnings.]

Stipulations: on-course endorsement service income is 41.7% US source; all tournament income is US source; ranking income is US source based on percentage of US prize winnings.

. . .

Opinion

Petitioner contends that the sponsors paid the endorsement income primarily for the right to use his name and likeness, not for any services he may have provided. He argues that the endorsement income should therefore be taxed as U.S.-source royalty income. Respondent counters that the sponsors paid him the endorsement income primarily for personal services and therefore such income should be taxed as U.S.-source personal services income. The parties also dispute whether petitioner is eligible for any benefits under the U.S.-U.K. tax treaties. . . .

A. Character of Income–Personal Services Income or Royalties

The parties agree that the endorsement fees under the off-course endorsement agreements constitute royalty income. We will therefore examine endorsement income only from the on-course endorsement agreements. . .

Off-course income is royalty.

The characterization of petitioner's on-course endorsement fees and bonuses depends on whether the sponsors primarily paid for petitioner's services, for the use of petitioner's name and likeness, or for both.

The on-course endorsement agreements granted sponsors TaylorMade, Izod and Acushnet the right to use petitioner's name and likeness for advertising and promotional materials worldwide. Petitioner also agreed to wear or use the sponsors' products, make promotional appearances and participate in photo and filming days. The sponsors paid petitioner a base endorsement fee, though the fee would be prorated if he did not play in a specified number of tournaments. The sponsors also paid petitioner tournament and ranking bonuses based on his on-course performance. The endorsement agreements fail to allocate the endorsement income between services petitioner was to provide and the amount paid for the right to use petitioner's name and likeness. As we view the record as a whole, we find that the sponsors paid for both the services provided and the right to use petitioner's name and likeness.

On-course endorsement income is both royalty and service income.
Should the agreement have made an allocation between services and name and likeness?

The record shows that petitioner's name and his associated international reputation had a value beyond his golf skills and abilities. . . .

Charles Prestagacio (Mr. Prestagacio), Senior Vice President of Global Sports Marketing for TaylorMade, testified that TaylorMade paid petitioner to appear at tournaments as well as to use his name and likeness in connection with its products. He stated that TaylorMade viewed petitioner not only as a golfer, but as a brand ambassador. TaylorMade valued its endorsement agreement with petitioner because it appreciated petitioner's image. TaylorMade wanted to be associated with his cool and professional persona.

Acushnet and Izod even included a morals clause and an illegal activities clause in their respective endorsement agreements to terminate the agreements if petitioner compromised his image. Mr. Baugh cited the rise and fall of Tiger Woods as an endorser to illustrate the importance sponsors place on an athlete's image. Mr. Woods built the most powerful, valuable and carefully orchestrated brand and image in sports. He lost most of his sponsorships, however, when his extra-marital affairs made front page news. Sponsors determined that Mr. Woods' image was no longer compatible with their products.

Mr. Baugh's [former president of Wilson Sporting Goods] report also stated that an athlete's image is often more important than an athlete's performance on the course. Mr. Baugh highlighted the contrast between TaylorMade's on-course endorsements with petitioner and those with Sergio Garcia (Mr. Garcia). Petitioner ranked either near or higher than Mr. Garcia on the PGA Tour and World Golf Rankings during the years at issue. Petitioner had won a Major Championship as well as several high-profile tournaments on the European Tour. In contrast, Mr. Garcia had failed to win a Major Championship and had few significant wins. Despite this difference in golf performance, both petitioner and Mr. Garcia entered into substantially similar endorsement agreements with TaylorMade. In addition, Mr. Garcia was paid substantially more than petitioner despite his lesser record. TaylorMade valued Mr. Garcia's flash, looks and maverick personality more than petitioner's cool, "Iceman" demeanor. We find that TaylorMade, Izod and Acushnet valued petitioner's image, and they paid substantial money for the right to use his name and likeness.

The record also shows that the sponsors valued petitioner's play at tournaments. Petitioner agreed to make promotional appearances at tournaments and to wear or use the sponsors' products. Moreover, the sponsors conditioned the full endorsement fee on petitioner's playing in a specified number of tournaments. Otherwise, the sponsors would prorate his endorsement fees. The sponsors could use petitioner's image in all of their advertising campaigns world-wide, but the sponsors would pay petitioner only if he played golf. His tournament bonuses were based solely on how he performed in specific tournaments. If he performed well throughout the year, he could receive a ranking bonus. We find that the performance of services requirement was not de minimis or ancillary to the use of his name and likeness. Accordingly, we find that the income received from the on-course endorsement agreements was part royalty income and part personal services income.

We find it appropriate to allocate the endorsement fees from the on-course endorsements between personal services income and royalty income. While we recognize that precision in making such an allocation is unattainable, we must do the best we can with the evidence presented.

Off-course endorsement income is royalty income; on-course is 50% royalty and 50% services.

The sponsors paid for the right to use petitioner's name and likeness and to be associated with his image. Petitioner's endorsement income depended, however, on his playing in tournaments. The record shows that the performance of services and the use of name and likeness were equally important. We find that 50% of the endorsement fees petitioner received represented royalty income and 50% represented personal services income.

B. Sourcing and Effectively Connected Income

We must next determine what portion of the endorsement income should be sourced to the United States. We accept the parties' stipulations for sourcing the personal services income, tournament bonuses and ranking bonuses to the United States. The parties disagree as to what portion of the royalty income from the on-course and off-course endorsement fees should be U.S. source income. We first consider what portion of the royalty income is U.S.-source income. We then consider whether any U.S. source royalty income was effectively connected to a U.S. trade or business.

1. Sourcing Petitioner's Royalties

Taxpayers must make an appropriate sourcing allocation if the royalty income relates to the right to use property both within and outside the United States. The contracting parties to the transaction have the burden of making a reasonable allocation of the royalty income between the U.S. and foreign sources. Here, petitioner granted his sponsors the right to use his name and likeness worldwide. The contracting parties agreed to source 25% to the United Kingdom and 75% to rest of the world. The contracting parties did not specify, however, how the income should be sourced to the United States. We therefore cannot accept their sourcing allocation for purposes of determining U.S.-source royalty income.

Courts have generally allocated all the royalty income to the United States if the contracting parties failed to make a reasonable allocation, unless the taxpayer can show there is a sufficient basis for allocating the income between U.S. and foreign sources. A sufficient basis exists when a taxpayer establishes that he or she has property rights outside the United States and furnishes evidence on the value of those rights.

Petitioner has established that he owns the rights to his name and likeness outside the United States and that those rights have value. We must therefore determine the value of those rights by examining where the sponsors actually used petitioner's name and likeness. Petitioner's name and likeness were used in magazine and newspaper advertisements, commercials, websites and other promotional materials. The parties have presented little statistical evidence on the use of petitioner's name and likeness. This does not absolve us, however, from valuing rights merely because there is difficulty in fixing their value.

a. Upper Deck and EA Endorsement Fees.

We first consider sourcing petitioner's royalty income from Upper Deck and EA. The record reflects that Upper Deck sold 92% of its golf cards in the United States and 8% outside the United States. The record reflects that EA sold 70% of the video games in the United States and 30% of the video games outside the United States. The parties do not dispute these sales figures.

We recognize that product sales do not necessarily reflect the relative worldwide value of the intangible rights. Here, however, the golf card and video game sales appear to indicate where Upper Deck and EA used petitioner's name and likeness. Petitioner added value to both Upper Deck's and EA's international sales because he was a citizen of South Africa, resided in England and played worldwide. The record shows, however, that the golf cards and the video game were primarily marketed in the United States. Petitioner's name and likeness also were valued greatly in the United States following his 2001 U.S. Open win.

Moreover, petitioner's name and likeness value was inextricably tied to the sales of the video game and golf cards. Petitioner's endorsement agreement granted EA the right to use petitioner's name and likeness only with the video game, and not in advertising or other promotional materials. The parties agree that Upper Deck's golf card sales, rather than its use of petitioner's name and likeness in advertising and promotional material, should be a determining factor in sourcing the Upper Deck endorsement fees. We agree.

Royalty income allocated based on sales of licensee.

We find that the sale of the trading cards and video game provide a sufficient basis for determining where Upper Deck and EA used petitioner's name and likeness rights. We therefore find that petitioner's royalty income from Upper Deck is 92% U.S.-source income and EA is 70% U.S.-source income.

b. On–Course and Rolex Endorsement Fees

Petitioner, Mr. Kinnings and Mr. Prestagacio all testified that petitioner was marketed aggressively in the United States following his 2001 U.S. Open victory. Petitioner testified that the United Kingdom, United States and South Africa were his three largest markets for golf endorsements. We find perplexing, however, that he allocated 25% of his royalty income to the United Kingdom and only 6.4% of his royalty income to the United States. On the evidence presented, we cannot accept petitioner's contention that less than 7% of his royalty income is U.S.-source income.

We look to the rest of the facts. Petitioner has shown that the sponsors paid for the right to use petitioner's name and likeness outside the United States. Petitioner has demonstrated that he had a global image and that he was marketed all over the world. His market includes the United Kingdom, the United States, South Africa, Australia and the Far East. Thus, it would be unreasonable to source all the royalties to the United States. Petitioner testified that the United States is the largest golf market in the world, and it is one of his largest markets for golf endorsements. Taking into account all the evidence, it is our best judgment and we so find that 50% of the royalty income petitioner received from the on-course and Rolex endorsement agreements is U.S.-source income.

On-course royalty income is 50% U.S. source.

2. Effectively Connected Income

. . .

The parties also do not dispute that petitioner's personal services were effectively connected with petitioner's golf play and that the U.S.-source income earned playing golf is taxed at regular graduated rates. We must still determine whether petitioner's U.S.-source royalty income is effectively connected with his U.S. trade or business. U.S.-source royalty income will be effectively connected with a U.S. trade or business if the activities of the trade or business are a material factor in the realizing the royalty income.

We first consider whether petitioner's U.S.-source royalty income from the on-course endorsement agreements was effectively connected with his golf play in the United States. As we previously discussed, petitioner's income from the use of his name and likeness depended on whether he played in a specified number of golf tournaments. In other words, petitioner's participation in a golf tournament was material to receiving income for the use of his name and likeness. We therefore find that such income is effectively connected with a U.S. trade or business, and petitioner will be subject to the graduated tax rates applicable to U.S. residents.

Is this beneficial to Goosen?

We next consider whether petitioner's U.S.-source royalty income from the off-course endorsement agreements was effectively connected with a U.S. trade or business. The income petitioner received from the off-course endorsement agreements did not depend on whether he played in any golf tournaments. He would be paid regardless of whether he played in or won any tournament. Moreover, the off-course endorsement agreements did not require petitioner to be physically present in the United States. We therefore find that the income petitioner received from off-course endorsement agreements was not effectively connected with a U.S. trade or business. Accordingly, a flat 30% tax is imposed on petitioner's gross U.S.-source royalty income from the off-course endorsement agreements.

Effect of U.S.-U.K. Tax Treaties

Goosen is a treaty resident only on remitted income.

... The [Treaty] provide[s] that the United Kingdom will tax a U.K. resident, non-domiciliary on non-U.K. source income only to the extent the income is remitted to or received in the United Kingdom. Art. 1(7). In such a case, the United States may not subject the U.K. resident to tax on specified kinds of income to avoid double taxation. Petitioner may therefore benefit from the U.S.-U.K. tax treat[y] regarding payments made to ESP (U.K.income) and ETO (non-U.K.income) that were remitted to or received in the United Kingdom. The parties agree that the endorsement income ETO (non-U.K.income) received was not remitted to or received in the United Kingdom. Petitioner argues, however, that he should benefit from the U.S.–U.K. tax treaties to the extent ESP (U.K. income) remitted his salary and bonuses to his U.K. bank account.

We now consider whether petitioner's endorsement income was remitted to or received in the United Kingdom. Petitioner's sponsors wired their payments to ESP's (U.K. income) bank account in Liechtenstein. In addition to his endorsement income, ESP (U.K. income) received on petitioner's behalf significant amounts of prize money, bonuses, non-U.S. royalties and appearance fees. ESP (U.K. income) paid petitioner a salary and a bonus that were based on the total amount deposited into the ESP (U.K. income) bank account in Liechtenstein. Petitioner submitted statements from his U.K. bank account showing transfers from ESP (U.K. income) into his U.K. bank account of 495,206 pounds in 2002 and 12,500 pounds in 2003. Petitioner has not established, however, whether these salary and bonus payments constitute endorsement income or another type of income. We find no evidence in the record that any or all of the income received into the account was endorsement income paid by TaylorMade, Izod, Acushnet, Upper Deck, Electronic Arts or Rolex.

What should Goosen have done to show that these payments constituted endorsement income?

Petitioner has failed to meet his burden of proving that endorsement income ESP (U.K. income) received on his behalf has been remitted to or received in the United Kingdom. As such, petitioner is not eligible for benefits under the U.S.-U.K. tax treaties.

IV. Conclusion

In sum, we find that petitioner received 50% royalties and 50% personal services income under the on-course endorsements. We also find that 50% of the royalty income petitioner received under the on-course endorsement agreements and the Rolex agreement is U.S.-source income, 92% of the royalty income petitioner received under the Upper Deck endorsement agreement is U.S.-source income and 70% of the royalty income received under the EA agreement is U.S.-source income. Petitioner has not shown that he is eligible for any treaty benefits.

✠

Garcia v. CIR
140 T.C. No. 6 (2013)

GOEKE, Judge ...

FINDINGS OF FACT

At the time the petition was filed petitioner was a Spanish citizen residing in Switzerland.

1. Background

Petitioner is a professional golfer, having turned professional in 1999 after a highly successful amateur golf career. Since 1999 he has played golf around the world, on both the Professional Golfers' Association of America Tour (PGA Tour) and the European Tour. From 1999 to 2004 his world golf ranking was: 12th at the end of 1999; 16th at the end of 2000; 6th at the end of 2001; 4th at the end of 2002; 36th at the end of 2003; and 7th at the end of 2004.

Petitioner was born in Spain, and his skill at golf and dynamic character attributes have made him a fan favorite and a world-famous celebrity. Nicknamed "El Nino" in his early years as a professional, petitioner is notable for his charismatic and fiery personality which differentiates him from most others who play "the gentleman's game" for a living. Petitioner's personality and his athletic image have helped to make him one of the most marketable golfers in the world, even more marketable than many of those golfers who rank ahead of him or who have won one of golf's four "Major" tournaments. Taken together, petitioner's personality, image, and golf skill make up his personal brand.

2. TaylorMade Endorsement Agreement and Performance

On October 8, 2002, petitioner entered into a seven-year endorsement agreement (commencing January 1, 2003, and ending December 31, 2009) with TaylorMade under which he would become a TaylorMade "Global Icon", around whom TaylorMade would build its brand. At the time the endorsement agreement was signed TaylorMade had endorsements and/or use agreements with nearly 200 professional golfers, but petitioner was the only one who held the Global Icon title. Under the endorsement agreement petitioner would exclusively wear and use golf products produced by TaylorMade and associated brands (TaylorMade products), and TaylorMade would receive the right to use petitioners image, likeness, signature, voice, and any other symbols associated with his identity to promote Taylor–Made products. The associated brands were Adidas (which owned TaylorMade's parent company) and Maxfli (which was acquired by TaylorMade at the end of 2002 and produced golf balls). The endorsement agreement was a "head to toe"[5] deal; products which petitioner was required to use included golf clubs, golf balls, golf gloves, golf bags, shoes, clothing, hats, and essentially any other golf product he would use in a professional event.

. . . As its only Global Icon, petitioner was the centerpiece of TaylorMade's marketing efforts; he featured prominently on TaylorMade's worldwide Web site, in TaylorMade's TV and print advertisements, point-of-sale materials (such as racks holding golf clubs and balls at sporting goods stores), and other forms of advertising.

As previously discussed, under the endorsement agreement petitioner was obligated to exclusively use certain TaylorMade products, both on and off the golf course. TaylorMade also received the right to "fully exploit the Endorsement" and to use petitioner's image rights in doing so (without making a royalty payment each time it used petitioner's image rights). Petition had certain other obligations, including: encouraging cross-promotion of TaylorMade products with his other corporate sponsors; playing in at least 20 professional golf events each year; acting in a courteous and professional manner, including not breaking the law, using performance-enhancing drugs, or committing an act "violating public morality or decency"; completing at least 12 combined service and personal appearance days each year; using "diligent efforts" to be available to test TaylorMade products; and generally supporting TaylorMade products and promoting goodwill toward the TaylorMade brand. There were many other minor obligations petitioner had under the endorsement agree-

[5]In addition to so-called head to toe deals which also involved name and image rights, there are two other primary types of golf endorsement contracts. The most common type of endorsement contract (representing approximately 85-90% of all contracts) is a "wear and carry" contract, in which a golfer is paid to use specific products in one or many tournaments but does not give up his or her image rights. Less common than "wear and carry" contracts (but more common than "head to toe" contracts) are contracts for a golfer to use specific products and to grant a company the right to use the golfer's image rights to promote the products used.

ment, such as using reasonable efforts to ensure his TaylorMade trademarks were visible.

Petitioner would incur various penalties for not fulfilling his obligations under the endorsement agreement. . . .

Petitioner's base remuneration for years 2003 through 2005 was $7 million, after which time his base remuneration depended on his average world ranking at the end of the year,. . . [or sales of products, plus bonuses for winning major tournaments].

. . .

[The endorsement agreement was amended because of a dispute over the brand of golf balls Garcia used. The 2003 amendment] reduced petitioner's 2003 base remuneration to $4 million (from $7 million), . . . and added a provision regarding division of payments for use of petitioner's image rights and his personal services: 15% of remuneration (both base and bonus) would be paid to petitioner for his personal services and 85% of remuneration would be paid to Even Par, LLC (Even Par), which had been granted petitioner's image rights licensed by TaylorMade for use in the United States. . . . [The agreement was amended a second time later in 2003.]

The balls must have been terrible to give up $3MM.

3. Companies Related to Petitioner

[Garcia owned over 99% of two companies, Long Drive, a Swiss company, and Even Par, a Delaware LLC treated as a partnership for US purposes.]

Petitioner sold Long Drive his image rights licensed by TaylorMade for use in the United States under the endorsement agreement (U.S. licensed image rights). In return petitioner received a promissory note from Long Drive payable over seven years. Next, the U.S. licensed image rights were assigned by Long Drive to Even Par, which in return agreed to pay all amounts collected from TaylorMade in connection with those rights directly to Long Drive (which would then pay petitioner in satisfaction of the promissory note).[6] Because of the manner in which the Swiss authorities agreed to tax the payments made to Long Drive from Even Par, the structure created an advantageous system for petitioner; his U.S. royalty payments would not be taxed in the United States and would instead be taxed at lower rates under Swiss law (as per the endorsement agreement between the Swiss authorities and Long Drive).

As previously stated, the first amended endorsement agreement (but not the original) contained a provision assigning 85% of the payments to Even Par (for TaylorMade's use of petitioner's image rights, both within and outside the United States) and 15% to petitioner (for his personal services, both within and outside the United States). TaylorMade made each payment under the

[6]Even Par also received payments for use of petitioner's image right used outside the United States and paid those amounts to a Netherlands company wholly owned by petitioner. The parties agree that remuneration for the non-U.S. image rights is not taxable in the United States and it need not be further addressed.

endorsement agreement to IMG, which would take its expenses and then pay 85% of the remaining amount to Even Par and 15% to petitioner.

On each of his Forms 1040-NR, U.S. Nonresident Alien Income Tax Return, for 2003 and 2004 petitioner reported a portion of the personal service payments as his U.S. source income effectively connected with the conduct of a trade or business within the United States. He did not report any of the royalty payments made to Even Par. Even Par filed tax returns as a partnership, reporting only gross royalty income and matching royalty expenses (which it deducted from the gross royalty income, leaving no taxable income). Even Par's returns stated that the royalty payments were taxable only under Swiss law.

4. Other Information

On March 17, 2010, respondent issued a notice of deficiency to petitioner for 2003 and 2004 determining deficiencies of $930,248 and $789,518, respectively.

OPINION

II. Allocation of TaylorMade Payments–Personal Services and Royalties

A. Stipulated Issues, General Arguments, Allocation in First Amended Endorsement agreement, and Expert Reports

Stipulations regarding allocation of personal service income (68-69% US source) and royalties (50% US source).

The parties have stipulated that during 2003, 69% of petitioner's personal service income was derived from sources within the United States and the remaining 31% was derived from sources outside the United States. The parties have also stipulated that during 2004, 68% of petitioner's personal service income was derived from sources within the United States and the remaining 32% was derived from sources outside the United States. Finally, the parties have stipulated that any portion of the TaylorMade payments which we determine to be royalties paid for the use of petitioner's image rights shall be treated as 50% U.S. source income and 50% foreign source income.

In his notice of deficiency respondent took the position that all payments made by TaylorMade under the endorsement agreement were compensation for petitioner's personal services. Respondent has since abandoned that position and instead argues that "The vast majority of the remuneration * * * is attributable to the personal services Petitioner rendered to Taylor Made." Petitioner claims that the first amended endorsement agreement's 85%-15% allocation between royalty and personal service payments, if anything, understated the royalty allocation.

[The court then concluded that the 85-15 allocation did not comport with the economics of the endorsement agreement.]

B. Discussion of Facts and Law

"Courts have repeatedly characterized payments for the right to use a person's name and likeness as royalties because the person has an ownership interest in the right."' Goosen v. Commissioner, 136 T.C. 547, 559 (2011)....

Multiple witnesses, familiar with the sports advertising industry as a whole and with the practices of TaylorMade specifically, have clearly and credibly testified that both the use of petitioner's image rights and the personal services petitioner provided (especially his use of the TaylorMade products while playing in professional golf events) were crucial elements of petitioner's endorsement agreement.

We concur with the testimony ... that both the use of petitioner's image rights and the personal services he provided were critical elements of the endorsement agreement. However, it does not directly follow that a 50-50 allocation between royalty and personal service compensation is called for simply because both elements were critical.

We have previously decided cases involving sports stars where allocation of payments for personal services and royalties was at issue. In Kramer v. Commissioner, 80 T.C. 768, involving an endorsement agreement between a retired tennis champion and Wilson Sporting Goods Co. during 1975 and 1976, we allocated 70% of payments to royalties and 30% of payments to personal services. However, given the somewhat different facts of that case, combined with its age, we do not give much weight to the 70%-30% allocation reached. In addition, we have a recent case involving a factual situation much more similar to petitioner's which makes for a better comparison.

Goosen v. Commissioner, 136 T.C. 547, involved a prominent professional golfer, Retief Goosen, under a contract with TaylorMade during the years 2002 and 2003 to endorse and use certain TaylorMade products and allow TaylorMade to use his image rights to market those products. Unlike petitioner, Mr. Goosen was not a TaylorMade Global Icon and was not signed to a "head to toe" contract with TaylorMade. Rather, Mr. Goosen was identified as a TaylorMade "brand ambassador" who was required only to use and endorse TaylorMade clothing, headgear, golf clubs, golf club head covers, and golf bags. Mr. Goosen also had to complete eight total service and personal appearance days annually for TaylorMade, as well as an unstated amount of product testing. In addition, Mr. Goosen was required to play in "a minimum of 20 PGA Tour tournaments and 11 European Tour tournaments per year" or his endorsement fees would be prorated. Id. at 553. Mr. Goosen was paid a $400,000 annual endorsement fee by TaylorMade, with bonuses available should he attain a higher world golf ranking or win specified tournaments.

In addition to his TaylorMade endorsement agreement, Mr. Goosen had an endorsement agreement with Acushnet Co. (Acushnet) to use Titleist golf balls and golf gloves which paid him $350,000 and $375,000 in the two years at issue. Mr. Goosen also had an endorsement agreement with Izod Club (Izod) to wear certain clothing while playing golf, which paid him approximately $35,000 annually. Under these two endorsement agreements Mr. Goosen agreed to complete a total of six service and personal appearance days annually, as well as to do product testing for Acushnet.

Considering the specific facts of Goosen, we held that a 50-50 split between royalty and personal service payments was appropriate for Mr. Goosen's TaylorMade endorsement agreement (as well as his Acushnet and Izod endorsement agreements). In doing so, we "highlighted the contrast between TaylorMade's on-course endorsements with" Mr. Goosen and petitioner's TaylorMade endorsement agreement. Id. at 561-562. ...

Considering the facts and prior caselaw, we do not believe a 50-50 split between royalty and personal service payments is appropriate in petitioner's case. Petitioner was TaylorMade's only Global Icon during the years at issue; he was the centerpiece of TaylorMade's marketing efforts and the golfer around whom TaylorMade sought to build its brand. The same cannot be said of Mr. Goosen. We find that petitioner's status as a TaylorMade Global Icon, especially the extent to which Taylor Made used his image rights to sell its products, is strong evidence that his TaylorMade endorsement agreement was more heavily weighted toward image rights than Mr. Goosen's.

Respondent argues that petitioner was paid more than Mr. Goosen primarily because petitioner's TaylorMade endorsement agreement required more personal services than Mr. Goosen's and "Petitioner's charisma and playing style * * * increased the value of his services." We agree with respondent that petitioner's personal services are worth more than Mr. Goosen's, all else being equal. However, we are not convinced that petitioner's TaylorMade endorsement agreement required more personal services than Mr. Goosen's, especially when one considers the relative values of different personal services.

[Although the personal services requirements were similar, there were some notable differences.] Petitioner was required to complete a total of 12 service and personal appearance days each year for TaylorMade, while Mr. Goosen was required to complete only 8. However, Mr. Goosen's TaylorMade agreement was not a "head to toe" deal, and he was required to complete six additional service and personal appearance days for Acushnet and Izod. It thus appears that Mr. Goosen was required to perform more service and personal appearance days per endorsed product than petitioner. In addition, the testimony and other evidence show that service and personal appearance days did not constitute a large portion of the value of petitioner's personal services; TaylorMade did not fully use the 12 service and personal appearance days in either 2003 or 2004 (using 10 or fewer each year),and TaylorMade's CEO, Mark King, testified that any personal appearances petitioner made were "gravy" to TaylorMade. Considering these facts, we find the fact that petitioner's TaylorMade endorsement agreement required him to complete more service and personal appearance days than Mr. Goosen is of nominal importance.

TaylorMade required Mr. Goosen to play in more professional golf events while using endorsed products each year (31) than it required petitioner to play in (20). We believe that petitioner's use of endorsed products during his professional play was by far the most valuable personal service he provided to TaylorMade; his pay was reduced by millions of dollars when he chose not to play a Maxfli golf ball, TaylorMade used shots of petitioner using its products during professional events in its ads, and multiple witnesses testified to the great importance of petitioner's use of TaylorMade products while playing. Respondent agrees that "Petitioner's performance for Taylor Made on the PGA and European golf tours" was of "predominant importance to the parties." Given the facts regarding the high value of petitioner's play while using TaylorMade products, we find the significantly lower number of professional events TaylorMade required petitioner to play in compared to Mr. Goosen is strong evidence that his TaylorMade endorsement agreement was less proportionately weighted toward personal services than Mr. Goosen's.

Petitioner was required to complete two product-testing days for TaylorMade each year, but it is unclear how many such days Mr. Goosen was required to complete for the lesser number of TaylorMade products which he endorsed. In addition, Mr. King gave testimony indicating that petitioner's product-testing days (even if they did have some value to TaylorMade) were of little importance in comparison with other personal services. As a result, we find any differences in required product-testing days between petitioner's and Mr. Goosen's TaylorMade endorsement agreements were not of great significance.

Respondent has cited other personal services not required of Mr. Goosen which were required of petitioner as a TaylorMade Global Icon. Such personal services include "embod[ying] what * * * [TaylorMade] is trying to portray to the marketplace and to the consumers", playing golf "with style and charisma", and representing TaylorMade's values even when petitioner is "walking down the street". However, these are amorphous concepts, and we find they are of negligible importance compared to the other personal services required under the endorsement agreement. We also find that certain other requirements of petitioner (such as the requirement that he encourage cross-promotion of TaylorMade with other brands he endorsed), to be similarly negligible in comparison with the other personal service requirements.

C. Conclusion Regarding the Allocation Issue

. . . Considering all the surrounding facts and circumstances, we find that 65% of the endorsement fees petitioner received represented royalty compensation and 35% represented personal service compensation.

III. Effect of Swiss Tax Treaty

The parties agree that petitioner is a resident of Switzerland and that the Convention applies to him. However, the parties disagree on what portion of petitioner's TaylorMade endorsement income is taxable to him in the United States under that treaty. Petitioner argues that only the personal service income attributable to his wearing TaylorMade products while playing golf is taxable in the United States and that the royalty income as well as the personal service income attributable to his other personal services is taxable only in Switzerland. Respondent contends that all income at issue is taxable in the United States.

Petitioner also notes that respondent may not have properly raised the issue of "How the U.S.-Swiss Treaty Applies to Income Garcia Earns From TaylorMade." However, we find respondent adequately raised the issue regarding application of Article 17, Artistes and Sportsmen, of the Swiss Tax Treaty to petitioner's royalty payments in his second amended answer when he stated that "Any U.S.-source royalties paid under the * * * [endorsement agreement] were paid for Petitioner's personal activities in the U.S. as a sportsman within the meaning of Article 17(1) of the Swiss Treaty."

A. Royalty Income

Respondent argues that the compensation for use of petitioner's U.S. image rights is income to petitioner rather than to Long Drive because petitioner's endorsement agreement with Long Drive under which petitioner sold Long Drive his U.S. image rights licensed by TaylorMade was an impermissible assignment of income. Respondent also argues that petitioner's endorsement agreement with Long Drive lacks economic substance. Respondent claims that we should deem the image right payments to have been made to petitioner directly and then further argues that that income is taxable in the United States under the Swiss Tax Treaty. Because we find that even if the image right payments were income to petitioner (rather than Long Drive) they are not taxable in the United States under the Swiss Tax Treaty, we need not address respondent's arguments regarding assignment of income or economic substance.

Assignment of income issue.

Petitioner argues that the payments he received from TaylorMade for use of his image rights are royalties as defined by article 12(2) and are therefore taxable only in Switzerland under article 12(1).

Respondent disagrees with petitioner that article 12 governs the taxability of the image right payments. Instead, respondent contends that those payments are governed by Article 17, Artistes and Sportsmen. Article 17(1) provides that "income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio, or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State may be taxed in that other State."

In support of his argument, respondent cites the [Technical Explanation to the Swiss Treaty]. Petitioner agrees with respondent that the Treasury Technical Explanation is useful in interpreting the Swiss Tax Treaty, and we concur. . . . Regarding article 17, the Technical Explanation states that "In determining whether income falls under Article 17 or another article, the controlling factor will be whether the income in question is *predominantly attributable* to the

Use of Technical Explanation to interpret treaty.

performance itself or other activities or property rights." (Emphasis supplied.) It further states that–

> Article 17 applies to all income connected with a performance by an entertainer, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived from a Contracting State by a performer who is a resident of the other Contracting State from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this Article, but by other articles of the Convention, as appropriate, such as Article 12 (Royalties) * * *. *For example, if an entertainer receives* royalty income from the sale of live recordings, the royalty income would be exempt from source country tax under Article 12, even if the performance was conducted in the source country, although he could be taxed in the source country with respect to income from the performance itself under * * * [Article 17]. [Id.; emphasis supplied.]

The parties agree that the Treasury Technical Explanation does not define the term "predominantly attributable". Both parties have made arguments regarding how we should interpret that phrase, but we need not delve into them because we find the example involving a sale of live recordings to be highly illustrative of the intent of the Swiss Tax Treaty. Even given the relationship between a live performance and a recording of that performance, the Treasury Technical Explanation states that proceeds from the sale of such a recording may be royalties not taxable in the source country under article 12. In a similar vein, we believe that even though petitioner's golf play and personal services performed in the United States has some connection to his U.S. image rights, income from the sale of such image rights is not predominantly attributable to his performance in the United States. Rather, the image rights are a separate intangible that generated royalties (as defined by article 12(2)) for petitioner when TaylorMade paid him for their use.

We thus find that the income petitioner received from TaylorMade for use of his U.S. image rights was royalty income not taxable in the United States under article 12(1).

B. Personal Service Income for Services Other Than Wearing TaylorMade Products While Golfing

In the first amended endorsement agreement, petitioner and TaylorMade allocated 85% of payments to royalties and 15% to personal services. On his 2003 and 2004 tax returns petitioner included 100% of his U.S. source personal service income under the endorsement agreement in his U.S. taxable income. Petitioner did not raise in the petition the issue that he may have included too much of his personal service income in his U.S. taxable income.

Neither party raised any argument regarding the Swiss Tax Treaty until nearly a year and a half after the petition was filed. Respondent first raised issues regarding the Swiss Tax Treaty, but contended only that (1) petitioner was not a Swiss resident to whom the treaty applied, and (2) if the treaty did apply to petitioner, then amounts paid to petitioner for use of his U.S. image rights were taxable in the United States under article 17 of the treaty. Respondent later conceded that his first argument was incorrect and that petitioner was a Swiss resident to whom the treaty applied.

Neither before or during trial did either party raise the possibility that petitioner's personal service income for services other than wearing TaylorMade products while golfing might not be taxable in the United States under the Swiss Tax Treaty. In fact, petitioner's pretrial memorandum concedes that "Garcia was subject to tax in the U.S. on his U.S.-source personal service income under either U.S. federal income tax law or under Article 17 of the U.S.-Swiss Tax Treaty." Petitioner's counsel also stated at trial that petitioner would "pay the same amount of U.S. tax on all of his personal services income" whether or not respondent's assignment of income and economic substance arguments regarding Long Drive prevailed. He further stated that petitioner "will pay and does pay the full amount of U.S. tax on any tournament winnings or prize money or other service income he receives from the United States" and that "Even if the Court were to find that more of the income should be allocated to personal services * * * [petitioner] will pay the full U.S. tax on that" income.

In his posttrial opening brief petitioner for the first time raised the issue that a portion of his U.S. source personal service income might not be taxable in the United States. Respondent did not address the issue in his posttrial opening brief but noted in his reply brief that petitioner had previously conceded that all U.S. source personal service income was taxable in the United States.

It seems that someone made a big mistake in not at least raising the issue.

We agree with respondent that petitioner previously conceded the issue. By raising the issue when and in the manner he did, petitioner prejudiced respondent in that respondent was unable to introduce testimony and/or other evidence that could have supported his position that all U.S. source personal service income was taxable in the United States. Respondent was also unable to introduce testimony and/or other evidence regarding the allocation of U.S. source personal service income attributable to petitioner's wearing TaylorMade products while playing golf (which petitioner concedes is taxable in the United States) and other U.S. source personal service income (which petitioner now claims is not taxable in the United States). We find that petitioner raised the issue too late, and we will not consider it. As a result, petitioner is liable for U.S. tax on all U.S. source personal service income he received.

IV. Conclusion

We hold that the compensation paid by TaylorMade under the endorsement agreement is allocated 65% to royalties and 35% to personal services. We further hold that none of the royalty compensation is taxable to petitioner in the United States but that all of the U.S. source personal service compensation is taxable to petitioner in the United States. ✠

Royalty Problems

Answer each of the problems below assuming first that no party qualifies for treaty benefits and then determine whether the Treaty would change your conclusions.

1. Dua Lipa, a U.K. tax resident, has received an offer from Sony Music to comes to L.A. to record a new single for a new film Sony is making. Under the contract, Dua would be paid a fixed fee of $1MM and receive a royalty of 0.5% of the worldwide gross box office receipts.

   a) If Sony owns all of the IP of the song, what is the source of the fixed fee and royalty payments?

   b) If you told Dua, *Do Don't It Dua*, how could you alter the contract to reduce her U.S. tax liability? *[Boulez and Bowers]*

2. UKCo, a U.K. corporation, licenses for 3 years from ForCo, an Egyptian corporation, the worldwide rights to a computer program owned by ForCo. UKCo promises to pay 95% of subroyalties it earns with respect to the program to ForCo. UKCo, in turn, sublicenses, the rights to the program to its local subsidiaries, including USCo, a U.S. corporation in exchange for a royalty of $0.75 for each product sold. USCo pays $75,000 to UKCo, which in turn, pays $190,000 to ForCo. The difference represents royalties from other foreign subsidiaries. What is the source of the royalty payments by USCo and UKCo? *[Rev. Rul. 80-362 and SDI]*

3. UKCo, a U.K. corporation, licenses for 3 years from ForCo, an Egyptian corporation, the worldwide rights to a trademark owned by ForCo. UKCo promises to pay a $1 royalty to ForCo for each product sold. UKCo places the trademark on its products that it manufactures in China and sells worldwide. UKCo sells 500,000 items worldwide (200,000 in the U.S.) and pays ForCo $500,000. What is the source of the payment? *[Rev. Rev. 68-443]*

4. William Rich, a UK citizen and resident, is a screenplay writer. He is approached by a famous Hollywood director to write a screenplay for the director's upcoming movie. He is offered and accepts a royalty of 2% of the movie's worldwide gross receipts. Assume alternatively:

a) Rich retains the entire copyright and receives $2 million.

b) The studio that produces the movie retains the copyright in all countries and to all media.

What is (are) the source(s) of the payments, assuming that 20% of the gross receipts arise in the U.S. *[Boulez, Bowers, and Rev. Rev. 74-555]*

✠

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