International Taxation:
A Transactional Approach

Jeffrey M. Colón

Last Revision: 2 Jan 2022

Table of Contents

Preface **iii**

1 Introduction to U.S. International Taxation **1**
1.1 Overview Source and Residence Basis Taxation 3
1.2 Overview of Income Tax Treaties 5
1.3 Overview of Text 7

2 Residence, Nationality, and U.S. Tax Jurisdiction **9**
2.1 Citizens and Residence Basis Taxation 9
2.1.1 Taxation of Citizens and Residents under U.S. Law . . . 9
Cook v. Tait 10
Comments 12
2.1.2 Tax Treaties and U.S. Citizens and Residents 13
2.2 Dual Citizens 15
Citizenship Regained 16
Comments 18

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 trading partners.

Surprisingly the TCJA left intact many of pillars of the U.S. international tax regime applicable to U.S. multinationals, including the subpart F and passive foreign investment companies (PFIC) provisions. Consequently, 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 modernize many of the long-standing international tax norms that have guided international capital flows over the last 80 years. These initiatives have been driven by the digitalization of the economy and have begun to be enacted into law by OECD signatories, including the United States. In November, 2021, the OECD put forth an initiative (Pillar Two) to require a minimum 15% tax on large multinationals.

It's virtually certain the current U.S. international tax regime will continued to be revised in 2022, 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.

Last modified: 2 Jan 2022; *preface_ Jan1_ 22.tex*

Chapter 1

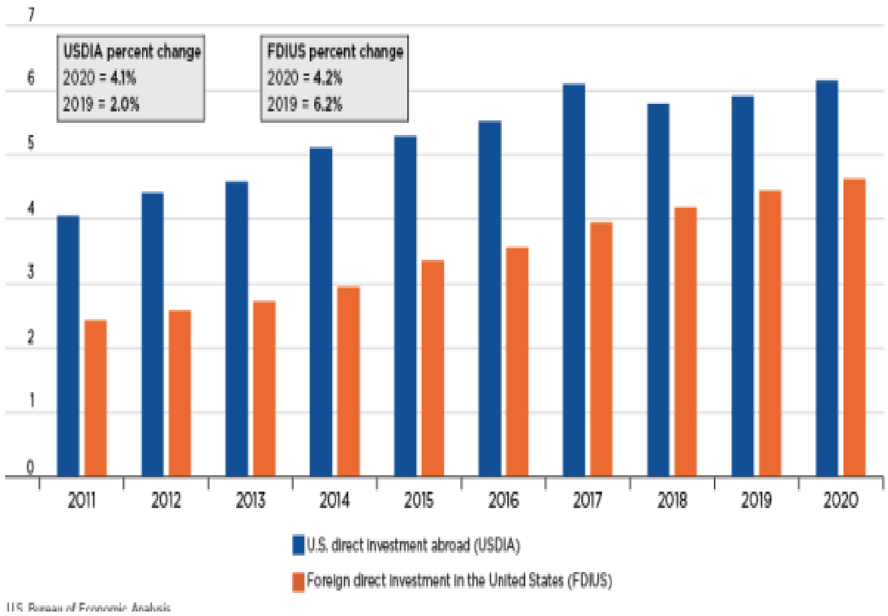
Introduction to U.S. International Taxation

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 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. 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.

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 pro-

[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 34 members from around the world, with Chile, Estonia, Israel, and Slovenia becoming the most recent countries to join.

visions 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 headquarters or where they operate.[6] On 20 December 2021, the OECD published detailed Pillar Two model rules.[7].

Individual countries, including the United States, have already begun to implement some of the action items. We'll visit these topics throughout the

[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

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

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. 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

It's virtually certain that we'll see in 2022 some significant changes to the U.S. international tax regime, even to those provisions enacted a mere 4 years ago.

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.

Last revised: 2 Jan 2022

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 $112,00 for 2022) 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 (§245A) 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 (§250), which permanently excludes from U.S. tax the 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 series of tie breaker rules that generally result in the determination of a *single*

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

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 sense that taxpayer contends. It is sufficient that the government's

[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).

> 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 restored retroactively? If such persons should not be taxed because they did

[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).

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

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

Comments

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

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

The benefits and burden rationale once again.

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 the receipt 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.

   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 disclosure annually on FinCEN 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). For some inexplicable reason, the FBAR must be filed separately from a taxpayer's tax return.

Last updated on 3 Jan 2022; residence_1_3_Jan22