J.C.T. REPORT ON COMPETITIVENESS – A STEP TOWARD CONSIDERATION OF NEW RULES

Author
Stanley C. Ruchelman

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INTRODUCTION

In a cross-border transaction of any kind, a minimum of three parties are immediate stakeholders with regard to the resulting income taxes, and that number can increase as a transaction increases in complexity. The first party consists of the business entity involved, and by this, we mean the multinational group of corporations ("M.N.G.") that may act through its members as the supplier and the purchaser of goods, services, and related intangible property ("I.P."). The second is the country of residence of the supplier of these items. The third is the country of residence of the purchaser of these items. Where the M.N.G.'s parent company is resident in yet another country, that country is a stakeholder, too.

The M.N.G. has as a primary tax-related goal the minimization of taxes in each country where a group member that participates in the transaction is resident. As a backup goal, the M.N.G. prefers that more of the income should be taxed in the hands of the member that will incur the lowest tax rate, either because the headline rate of tax is lower in that country or the member benefits from certain attributes, such as a net operating loss carryover.

In the country where the group member supplying the goods, services, or I.P. is resident, the goal of the tax authorities is to ensure that the transfer price received as consideration for the item is consistent with the views on arm's length transfer pricing adopted in that country. A similar view is shared by the tax authorities in the country where the purchaser is resident. However, because so much of transfer pricing analysis involves an exercise in subjectively selecting objective data, there is no reason to believe that the tax authorities of the two jurisdictions will come to the same result, even though they apply the same transfer pricing guidelines (O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations) or comparable guidelines (Arm's Length Transfer Pricing Regulations issued by the I.R.S.). In principle, this risk can be mitigated through a bilateral transfer pricing agreement.

In the country where the M.N.G.'s parent is located, the goal is to ensure that the controlled foreign corporation ("C.F.C.") rules adopted by that country are not abused by the group members involved in the transaction and that if one group member or the other benefits from I.P. developed by the parent, an appropriate amount of income is reported by the parent and taxed by its country of residence.

It takes little imagination to see that the tax situation of the M.N.G. can quickly become a "pig's breakfast" if countries do not apply similar rules to the cross-border transaction in a similar fashion. The result may easily be a jingoistic approach to taxation by tax authorities and a save-tax-at-all costs approach by M.N.G. management. After all, as one jurisdiction or another will likely take an aggressive view on its right to a share of the global tax revenue, it is prudent to start negotiations from a very low base. Each stakeholder involved blames the others when tax exposure explodes and the overall effect is a *sub rosa* impediment to global trade.

In this environment, the Joint Committee on Taxation published Present Law and Selected Policy Issues in the U.S. Taxation of Cross-Border Income (JCX-51-15) (the "J.C.T. Report"), on March 16, 2015, in connection with a public hearing on March 17, 2015, titled "Building a Competitive U.S. International Tax System." The J.C.T. Report is broken into several sections. Part I describes general international principles of taxation and how they are applied in the U.S. tax system. Part II provides an overview of U.S. present law related to the taxation of cross-border income. Part III discusses selected issues that have been of particular interest to policymakers concerned with the U.S. international tax system: the competitiveness of the U.S. tax system, economic distortions arising from deferral, shifting of income and business operations away from the United States, the tax incentive for locating deductions in the United States, and inversions. This article, and the articles that follow, address the points raised in the report. The starting point is an overview of the way the U.S. taxes domestic income of foreign corporations; non-resident, non-citizen individuals; and foreign income of U.S. corporations, citizens, and residents.

GENERAL OVERVIEW OF PRINCIPLES OF INTERNATIONAL TAXATION

"A number of commonly accepted principles have developed to minimize the extent to which conflicts arise between countries as a result of extraterritorial or overlapping exercise of authority."

According to the J.C.T. Report, a number of commonly accepted principles have developed to minimize the extent to which conflicts arise between countries as a result of extraterritorial or overlapping exercise of authority. International law generally recognizes the right of each sovereign nation to prescribe rules to regulate conduct with a sufficient nexus to the sovereign nation. The nexus may be between conduct and the territory of the nation or it may be between a person (whether natural or juridical) and the status of that person in the view of the sovereign nation.

These two broad bases of jurisdiction (*i.e.*, territoriality and nationality of the person whose conduct is regulated) have been refined and, in varying combinations, form the basis for most systems of income taxation. The J.C.T. Report points out that the broadest assertion of taxing authority, exercised on the basis of a person's status as a national, resident, or domiciliary of a jurisdiction, reaches worldwide activities of such persons. A more limited exercise of authority occurs when taxation is imposed only to the extent that activities occur, or property is located, in the territory of the taxing jurisdiction. If a person conducts business or owns property in a jurisdiction, or if a transaction occurs in whole or in part in a jurisdiction, the resulting limited basis of taxation is a territorial application.

No matter which system is adopted, a jurisdiction's identification of its tax base depends upon establishing rules for determining whether the income falls within its authority to tax. According to the J.C.T. Report, those rules sometimes turn on residency and lead to another set of rules that determine how to identify which persons have sufficient contact with a jurisdiction to be considered resident. For individuals, the test may depend solely upon nationality, physical presence, or a combination of the two. For entities, residency may require a more complex consideration of the level of activities within a jurisdiction.

The J.C.T. Report points out that mechanisms to eliminate double taxation must exist to address situations in which the source and residency determinations of the respective jurisdictions result in a duplicative assertion of taxing authority, as well as to permit limited mutual administrative assistance between jurisdictions. Potential double taxation is usually mitigated by operation of bilateral tax treaties or by legislative measures permitting credit for taxes paid to another jurisdiction. A multilateral approach may also be used. An example is the Base Erosion and Profit Shifting project of the O.E.C.D. In addition, the E.U. has introduced proposals that deny tax benefits in arrangements in which companies might otherwise derive low-tax or zero-tax cross-border income.

PRINCIPLES OF INTERNATIONAL TAXATION APPLIED BY THE U.S.

The J.C.T. Report points out that U.S. law adopts a hybrid system when it comes to the scope of imposing its jurisdiction to tax. It imposes taxation on the worldwide income of all U.S. citizens, U.S. residents that are not citizens, and domestic corporations. Under this system, all income is taxed, whether derived in the United States or abroad. In comparison, the U.S. imposes a territorial-based system on non-resident, non-citizen individuals and foreign entities. This system taxes U.S.-source income or income effectively connected with a U.S. trade or business. When the foreign entity is a subsidiary of a U.S. person, limited deferral is provided for foreign income.

This hybrid approach results in significant differences in tax treatment when comparing the scope of taxation imposed on U.S. persons investing abroad with the U.S. taxation of foreign persons investing in the United States. A U.S.-based M.N.G. is taxed, either currently or on a deferred basis, on all global income, with the timing of the tax controlled by the identity and residence of the member generating the income. In comparison, non-U.S. persons are generally subject to U.S. tax only on U.S.-source income. For these persons, the source of income generally determines whether current tax liability exists. In addition, the character of the income plays a part in determining whether the income will be taxed at all and, if it is, the mechanism by which it is taxed (*viz.*, by withholding or direct filing and payment).

U.S. source rules are not applied consistently across the board. Accordingly, the character of income will control which source rule applies:

- Compensation for personal services is generally sourced where the services are performed;
- Dividends and interest are sourced based on the residence of the taxpayer making the payments;
- Rents and royalties for the use of property are generally sourced based on the place where the property is used;
- Income from the sale of inventory is sourced, in general, where risk of loss passes to the purchaser; and
- Gains are sourced at the place of residence of the person deriving the gain.

Many exceptions exist to these broad rules.

Once the source of gross income is determined, the J.C.T. Report comments on the rules for the allocation of deductible expenses between U.S.-source income and foreign-source income. These rules do not generally affect the timing of expense deductions for period expenses attributable to items of actual or potential foreign-source income of a U.S. domestic corporation. In broad terms, a domestic corporation is generally allowed a current deduction for expenses, such as interest and administrative expenses, that support income derived through foreign subsidiaries and on which U.S. tax is deferred.

The expense allocation rules apply to a domestic corporation principally for determining the corporation's foreign tax credit limitation. This limitation is computed by reference to the corporation's U.S. tax liability on its taxable foreign-source income in each of two principal limitation categories. These categories are commonly referred to as the "general basket" and the "passive basket." Consequently, the expense allocation rules may prevent domestic taxpayers from fully utilizing their foreign tax credits because the taxpayer's own deductible expenses may artificially inflate the effective foreign tax rate by reducing taxable income.

The J.C.T. Report highlights the fact that U.S. tax law includes rules intended to prevent reductions to the U.S. tax base through structural changes. These include excessive borrowing in the United States to drive down income through excess borrowing costs,[1] migration of the tax residence of domestic corporations from the United States to foreign jurisdictions through corporate inversion transactions, or aggressive intercompany pricing practices with respect to I.P.

PRESENT LAW PRINCIPLES COMMON TO INBOUND AND OUTBOUND TAXATION

The J.C.T. Report recognizes that certain concepts apply to both inbound and outbound investment. Such areas include arm's length transfer pricing rules, entity classification rules, rules for determining the source of income, and rules for determining whether a corporation is foreign or domestic.

Transfer Pricing

The J.C.T. Report acknowledges that a basic U.S. tax principle applicable in dividing profits from transactions between related taxpayers is that the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in similar transactions with unrelated parties. Consequently, the J.C.T. Report states that the transfer pricing rules of Code §482 and the accompanying Treasury regulations are intended to preserve the U.S. tax base by ensuring that taxpayers do not shift income properly attributable to the United States to a related foreign company through pricing that does not reflect an arm's length result. Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through transfer pricing.

The J.C.T. Report states that the arm's length standard is difficult to administer in situations in which unrelated-party market prices do not exist for transactions between related parties. However, taxpayers have applied arm's length transfer pricing rules

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[1] See Code §163(j).

for many decades, and their returns have been reviewed and accepted both with and without adjustments by the I.R.S.

When a foreign person with U.S. activities has transactions with related U.S. taxpayers, the amount of income attributable to U.S. activities is determined in part by the same transfer pricing rules of Code §482 that apply when U.S. persons with foreign activities transact with related foreign taxpayers.

Code §482 authorizes the I.R.S. to allocate income, deductions, credits, or allowances among related business entities, when necessary, to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations issued under that provision of U.S. tax law adopt the arm's length standard as the method for determining whether transaction values are appropriate. According to the J.C.T. Report, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated and dealing at arm's length.

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For income from I.P., Code §482 provides that the resulting income for the owner of the I.P. shall be commensurate with the income attributable to that intangible. This provision reflects a Congressional concern regarding the effectiveness of the arm's length standard with respect high-profit-potential intangibles. Acceptable measures of arm's length royalties for manufacturing I.P. include a fixed amount per unit, which does not reflect profit potential when the value of the I.P. increases over time.

Entity Classification

A business entity is generally eligible to choose how it is classified for Federal tax purposes under the "check-the-box" regulations. The J.C.T. Report explains that those regulations simplify the entity classification process for both taxpayers and the I.R.S. by making the entity classification of unincorporated entities explicitly elective in most instances. Eligibility of an entity, as well as the breadth of its choices, depends upon whether it is a "per se corporation" and the number of its beneficial owners.

For per se corporations, an election is not permitted. Generally, these are domestic entities formed under a State corporation statute. A number of specific types of foreign business entities are identified in the regulations as per se corporations. Typically, these entities are vehicles for a public offering of shares, such as P.L.C.'s in the U.K., S.A.'s in most French- and Spanish-speaking countries, and A.G.'s in German-speaking countries.

An eligible entity with two or more members may elect to be classified as a corporation or a partnership. If an eligible entity fails to make an election, default rules apply. A domestic entity with multiple members is treated as a partnership. A foreign entity with multiple members is treated as a partnership, if at least one member has unlimited liability, but is treated as a corporation if all members have limited liability.

The regulations also provide explicitly that a single-member unincorporated entity may elect either to be treated as a corporation or to be disregarded as not being separate from its owner for U.S. income tax purposes. A disregarded entity owned by an individual is treated in the same manner as a sole proprietorship. In the case of an entity owned by a corporation or partnership, the disregarded entity is treated in the same manner as a branch or division.

“The regulations extend elective classification to foreign, as well as domestic, entities.”

The J.C.T. Report explains that the regulations extend elective classification to foreign, as well as domestic, entities on the basis that the complexities and resources devoted to classification of domestic unincorporated business entities were mirrored in the foreign context. In actuality, the complexities were exacerbated in the international context, as the I.R.S. was making determinations in a world that did not contain the equivalent of a uniform statute such as the Uniform Partnership Act. As a result, a corporate law opinion based on the workings of foreign law was a prerequisite for the I.R.S. to issue a tax ruling. Also, the I.R.S. maintained the view at the time of the prior regulations that foreign laws were relevant only for purposes of explaining rights and obligations inherent in a foreign entity but not for tax treatment. The I.R.S. was not prepared to allow foreign tax treatment to control U.S. tax treatment. As a result, under the pre-1997 regulations and the check-the-box regulations, it is possible for an entity that operates across countries to elect into a hybrid status. “Hybrid entities” is a term that refers to entities treated as flow-through or disregarded entities for U.S. tax purposes, but as corporations for foreign tax purposes. Reverse hybrids also exist, typically where a partnership elects corporate status in the U.S. but retains tax transparent status abroad.

The existence of hybrid and reverse hybrid entities has various tax effects in the U.S. It can affect whether a taxpayer can use foreign tax credits attributable to deferred foreign-source income or income that is not taxable in the United States, as well as whether income of an offshore group is currently includible under Subpart F for the group’s U.S. shareholders. For individuals, the use of a hybrid entity allows foreign corporate income taxes imposed on the hybrid to offset U.S. tax on the income of the hybrid that flows through to those individuals who are members.

Source of Income Rules

The J.C.T. Report addresses the rules for determining the source of certain types of income. Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor, the status or nationality of the recipient, the location of the recipient’s activities that generate the income, and the location of the assets that generate the income. If a payor or recipient is an entity eligible to elect its classification for Federal tax purposes, its choice of whether to be recognized as legally separate from its owner in another jurisdiction can affect the determination of the source of the income and other tax attributes, if the hybrid entity is disregarded in one jurisdiction but recognized in the other. To the extent that the source of income is not specified by statute, the I.R.S. may promulgate regulations that explain the appropriate treatment. However, many items of income are not explicitly addressed by either the Code or Treasury regulations, sometimes resulting in non-taxation of the income. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.

Interest

Interest is derived from U.S. sources if it is paid by the United States government, any agency of the U.S. government, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a resident or a domestic corporation on a bond, note, or other interest-bearing obligation. Special rules apply to treat as foreign-source (i) certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or partnerships and (ii) certain other amounts paid by foreign branches of domestic financial institutions.

Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.

Dividends

Dividend income is sourced, generally, by reference to the payor's place of incorporation. Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source income. In very limited circumstances, dividends may be treated in part as U.S.-source income under a relic of pre-branch profits tax law.

Rents and Royalties

Rental income is sourced by reference to the location, or place of use, of the leased property. The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible.

Royalties are sourced in the place of use of (or the place of privilege to use) the property for which the royalties are paid. This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

Income from Sales of Personal Property

Subject to significant exceptions, income from the sale of personal property is sourced based on the residence of the seller. For this purpose, special definitions of the terms "U.S. resident" and "non-resident" are provided. A non-resident is defined as any person who is not a U.S. resident, a term that comprises any juridical entity that is a U.S. person and all U.S. citizens, as well as any individual who is a U.S. resident without a tax home in a foreign country or a non-resident alien with a tax home in the United States. As a result, a non-resident includes any foreign corporation.

Several special rules apply. For example, income from the sale of inventory property is generally sourced to the place of sale, as determined by the location where title to the property passes. However, if the sale is by a non-resident and is attributable to an office or other fixed place of business in the United States, it is treated as U.S.-source without regard to the place of sale, unless it is sold for use, disposition, or consumption outside the United States and a foreign office materially participates in the sale. Income from the sale of inventory property that a taxpayer produces in whole or in part in the United States and sells outside the United States, or that a taxpayer produces in whole or in part outside the United States and sells in the United States, is treated as partly U.S.-source and partly foreign-source.

In determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the I.R.S. applies the asset-use test and business activities test at the partnership level to determine whether there is a U.S. business and, if so, the extent to which the income derived is effectively connected with that U.S. business. Implicit in this statement of the J.C.T. Report is the understanding that the I.R.S. view is not widely respected, as it is contrary to various provisions of the tax law dealing with partnerships and to at least one case expressly on this point in which the I.R.S. made the argument and lost. Legislation has been proposed in the Administration's budget for the past several years that would revise the law. Under the I.R.S. view, to the extent that there is unrealized gain attributable to partnership assets effectively connected with a U.S. business, the foreign person's gain or loss from the sale or exchange of a partnership interest is effectively connected gain or loss to the extent of the partner's distributive share of such unrealized gain or loss. Similarly, to the extent that the partner's distributive share of unrealized gain is attributable to a permanent establishment of the partnership under an applicable treaty provision, it may be subject to U.S. tax under a treaty.

Gain on the sale of depreciable property is divided between U.S.-source and foreign-source pools of gain in the same ratio that the depreciation was previously deducted for U.S. tax purposes, or could have been deducted if not actually claimed. Payments received on sales of I.P. are sourced in the same manner as royalties, to the extent that the payments are contingent on the productivity, use, or disposition of the I.P.

Personal Services Income

Compensation for labor or personal services is generally sourced to the place of performance. Thus, compensation for labor or personal services performed in the United States is treated generally as U.S.-source income, subject to a limited exception for *de minimis* amounts. Compensation for services performed both within and without the United States is allocated between U.S.-source and foreign-source income.

Insurance Income

Underwriting income from issuing insurance or annuity contracts is treated generally as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of the United States.

Transportation Income

Generally, income from furnishing transportation that begins and ends in the United States is U.S.-source income. Typically, this rule is directed at cruises to nowhere and voyages from one city in the U.S. to another city where the route is in international water. Voyages that sail to a specific point outside the U.S. are not covered by this source rule, even if they do not end in a foreign country. Other income attributable to transportation beginning or ending in the United States is treated as 50% U.S.-source income, but it may be exempt under rules applicable to income from international shipping.

Income from Space or Ocean Activities or International Communications

In the case of a foreign person, generally no income from a space or ocean activity or from international communications is treated as U.S.-source income. With respect to the latter, an exception is provided if the foreign person maintains an office or other fixed place of business in the United States. In this case, the international communications income attributable to such fixed place of business is treated as U.S.-source income. For U.S. persons, all income from space or ocean activities and 50% of income from international communications are treated as U.S.-source income.

Amounts Received With Respect to Guarantees of Indebtedness

Amounts received, directly or indirectly, from a non-corporate resident or from a domestic corporation for the provision of a guarantee of indebtedness are income from U.S. sources. This includes payments made indirectly for the provision of a guarantee. For example, U.S.-source income under this rule includes a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through additional interest charged on the indebtedness. In this situation, the domestic subsidiary has paid the guarantee fee as an economic matter through higher interest costs, and the additional interest payments made by the subsidiary are treated as indirect payments of the guarantee fee and, therefore, are U.S.-sourced.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person, if the payments received are connected with income of such person that is effectively connected with the conduct of a U.S. trade or business. Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign source income if they are not from sources within the United States.

"A corporation is treated as domestic if it is incorporated under the laws of any State of the United States. All other corporations are treated as foreign."

Corporate Residence

The U.S. tax treatment of an M.N.G. depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of any State of the United States. All other corporations are treated as foreign. A corporation that has dual charters is treated as a U.S. corporation. Other substantive factors that might be thought to bear on a corporation's residence are not relevant. These factors include (i) the location of the corporation's management activities, employees, business assets, operations, or revenue sources; (ii) the exchange or exchanges on which the corporation's stock is traded; and (iii) the country or countries of residence of the corporation's owners.

Only domestic corporations are subject to U.S. tax on a worldwide basis. Foreign corporations are taxed only on income that has a sufficient connection with the United States.

To the extent that the U.S. tax rules impose a greater burden on a domestic multinational corporation than on a similarly situated foreign multinational corporation, the domestic multinational company may have an incentive to undertake a restructuring, merger, or acquisition that has the consequence of replacing the domestic parent company of the multinational group with a foreign parent company. This sort of transaction, in which a foreign corporation replaces a domestic corporation as the parent company of a multinational group, has been commonly referred to as an inversion. Subject to the Code's anti-inversion rules and other provisions (*e.g.*, those related to outbound transfers of stock and property, deductibility of related-party interest payments, and a foreign subsidiary's investment in U.S. property), an inversion transaction might be motivated by various tax considerations. These include the removal of a group's foreign operations from the U.S. taxing jurisdiction and the potential for reduction of U.S. tax on U.S.-source income through excessive payments of deductible interest or royalties from a U.S. subsidiary to the new foreign parent company.

Until 2004, U.S. tax law included no rules that specifically addressed inversion transactions, although the regulations issued under Code §367(a) contained gain recognition rules that were found by Congress to be ineffective in certain circumstances. Shareholder gain recognition is meaningless for a shareholder that is not a U.S. person or that is tax exempt. Even if a shareholder is a domestic person, gain recognition is irrelevant on a current basis if the share value is significantly below basis. Corporate gain recognition may be immaterial if the company can shield the tax through the use of certain tax attributes, such as net operating losses and credits. Consequently, until Code §7874 was enacted, a domestic corporation could be redomiciled in another country with limited U.S. tax consequences to the corporation or its shareholders.

Code §7874 adopts anti-inversion toll charge rules, which provide that during the ten-year period following the inversion transaction corporate-level gain recognized in connection with the inversion generally may not be offset by tax attributes such as net operating losses or foreign tax credits.

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These sanctions generally apply to a transaction in which, pursuant to a plan or a series of related transactions:

- A domestic corporation becomes a subsidiary of a foreign incorporated entity or otherwise transfers substantially all of its properties to a foreign incorporated entity;
- The former shareholders of the domestic corporation hold at least 60% but less than 80% of the foreign-incorporated entity, measured by vote or value, by reason of the stock they had held in the domestic corporation; and
- The foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50% ownership, does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group.

In addition, an excise tax is imposed under Code §4985 on certain stock compensation of executives.

If a transaction otherwise satisfies the requirements for applicability of the anti-inversion rules and the former shareholders of the domestic corporation end up holding 80% or more of the stock of the foreign-incorporated entity after the transaction, the anti-inversion rules deem the new top-tier foreign corporation to be a domestic corporation for all Federal tax purposes.

Similar rules apply if a foreign corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.

U.S. TAX RULES APPLICABLE TO NON-RESIDENT, NON-CITIZEN INDIVIDUALS AND FOREIGN CORPORATIONS

Non-resident, non-citizen individuals and foreign corporations are generally subject to U.S. tax only on U.S.-source income. Thus, the source and type of income received by a foreign person generally determines whether there is any U.S. income tax liability and the mechanism by which it is taxed. The U.S. tax rules for U.S. activities of foreign taxpayers apply differently to two broad types of income:

- U.S.-source income that is "fixed or determinable annual or periodical gains, profits, and income" ("F.D.A.P. income"), and
- Income that is effectively connected with the conduct of a trade or business within the United States ("E.C.I.").

F.D.A.P. income generally is subject to a 30% gross-basis withholding tax, while E.C.I. is generally subject to the same U.S. tax rules that apply to business income derived by U.S. persons. Deductions are permitted in determining the tax base, and the tax is imposed at the same rates applicable to U.S. persons filing similar returns – married persons filing separately or single individuals. F.D.A.P. income in the form of portfolio interest is exempt from withholding tax and other F.D.A.P. income is subject to a reduced rate of tax or an exemption under a bilateral income tax treaty.

Gross-Basis Taxation of U.S.-Source Income

Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30%, which is collected by withholding at the source of the payment. The items of F.D.A.P. income enumerated in Code §§871 and 881 are illustrative. The common characteristic is that taxes with respect to the income may be readily computed and collected at the source, in contrast to the administrative difficulty involved in determining the seller's basis and resulting gain from sales of property.

Types of F.D.A.P. Income

F.D.A.P. income encompasses a broad range of gross income but has limited application to gains on sales of property, including market discount on bonds and option premiums.

- Capital gains received by non-resident aliens present in the United States for fewer than 183 days are generally treated as foreign source and are thus not subject to U.S. tax, unless the gains are effectively connected with a U.S. trade or business. U.S.-source capital gains received by non-resident, non-citizen individuals present in the United States for 183 days or more are subject to gross-basis taxation. Typically, only students and persons who are not employed or have no fixed place of business are caught by this test, as those are typically the only non-resident, non-citizen individuals who would have U.S.-source gains. The reason is that residence controls the source of gains, and residence for this purpose is defined in Code §865(g). For a person who is not a tax resident of the U.S., as defined in Code §7701(b), the source of the gain is controlled by the place where a "tax home" is maintained by the individual. If a non-resident, non-citizen individual is present in the U.S. for at least 183 days, but has a tax home outside the U.S., any gain derived during the year is considered to be a foreign-source gain, absent unusual circumstances or a sale involving U.S. real property.
- U.S-source gains from the sale or exchange of intangibles are subject to tax if the amount of the sales proceeds is contingent upon productivity of the property sold and they are not effectively connected with a U.S. trade or business.

- Interest paid with respect to deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, are U.S.-source but are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient. Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income.

- Interest and original issue discount on certain short-term obligations having a maturity of not more than 183 days after the date of issuance are also exempt from U.S. withholding tax when paid to a foreign person.

- U.S.-source portfolio interest is specifically exempt from the 30% withholding tax. Portfolio interest is any interest that is paid on an obligation that is in registered form as to payments of interest and principle and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the recipient is not a U.S. person. Portfolio interest does not include interest received by a 10% shareholder determined after application of ownership attribution rules, contingent interest, interest received by a C.F.C. from a related person, and interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of a banking trade or business.

Imposition of Gross-Basis Tax and Reporting by U.S. Withholding Agents

The 30% tax on F.D.A.P. income is generally collected by means of withholding. Withholding on F.D.A.P. payments to foreign payees is required unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from or a reduced rate of withholding under an income tax treaty.

With respect to the income from which tax was withheld, the foreign recipient is not required to file a U.S. Federal income tax return if the recipient has no E.C.I. and the withholding is sufficient to satisfy the tax liability. Accordingly, although the 30% gross-basis tax is a withholding tax, it is also generally the final tax liability of the foreign recipient. Note, however, that if no tax return is filed, the period of limitations within which the I.R.S. can assert additional tax never begins to run.

A withholding agent that makes payments of U.S.-source amounts to a foreign person is required to report and remit any amounts of U.S. tax withheld. Two types of reports are required by March 15 of the following calendar year: (i) a summary of the total U.S.-source income paid and withholding tax withheld on foreign persons for the year, and (ii) a report to both the I.R.S. and the foreign person of the person's U.S.-source income that is subject to reporting.

The non-resident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions. To the extent that the withholding agent deducts and withholds an amount, the withheld tax is credited to the recipient of the income. If the agent withholds more than is required, the excess may be returned to the recipient upon filing of a timely U.S. tax return claiming a refund of excess tax.

Excise Tax on Foreign Reinsurance Premiums

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks. The excise tax is imposed on a gross basis at a rate of 1% on reinsurance and life insurance premiums, and 4% on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that otherwise are exempted under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to excise tax.

Many U.S. tax treaties provide an exemption from the excise tax, including those with Germany, Japan, Switzerland, and the U.K. Such treaties generally include an anti-conduit rule to prevent inappropriate claims of treaty benefits. The most common anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the underlying risks are not reinsured with a person not entitled to the benefits of a treaty.

Net-Basis Taxation of U.S.-Source Income

Income from a U.S. Business

Net-basis taxation is imposed on the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States. Any gross income derived by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in computing this tax.

U.S. Trade or Business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged.

Whether a foreign person is engaged in a U.S. trade or business is a factual question. Basic issues include whether the activity constitutes business rather than investing, whether sufficient activity is conducted in the United States – "considerable, continuous, and regular" – in connection with that business, and whether the relationship between the foreign person and the persons performing functions in the United States in respect of the business is sufficient to attribute those functions to the foreign person.

The trade or business rules differ from one activity to another. The term "trade or business within the United States" expressly includes the performance of personal services within the United States. This is subject to $3,000 and 90-day *de minimis* rules.

Detailed rules govern whether trading in stocks, securities, or commodities constitutes the conduct of a U.S. trade or business. A foreign person who trades in stocks, securities, or commodities in the United States through an independent agent is not generally treated as engaged in a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which trades are carried out. A foreign person who trades stocks, securities, or commodities for their own account rather than for customers generally is not considered to be engaged in a U.S. business, so long as the foreign person is not a dealer in stocks, securities, or commodities (*i.e.*, a person who sells to customers in the ordinary course of a trade or business). This should be compared with a long-term investor or short-term trader that sells into the market and has no customers.

For eligible foreign persons, U.S. bilateral income tax treaties restrict the application of net-basis U.S. taxation. Where a treaty is applicable, a U.S. permanent establishment must exist for the U.S. to impose tax on the business profits. The threshold level of activities that constitute a permanent establishment is generally higher than the threshold level of activities that constitute a U.S. trade or business.

The threshold for a permanent establishment includes the maintenance of a fixed place of business over a significant period of time. Among the specified inclusions are (i) places of management, (ii) branches, (iii) offices, (iv) factories, (v) workshops, and (vi) mine, oil or gas wells, and quarries.

Other activities are specifically excluded, such as one or more of the following: (i) use of facilities solely for the purpose of storage, display, or delivery of goods; (ii) maintenance of a stock of goods or merchandise, itself, if in the United States for the purpose of storage, display, or delivery; (iii) maintenance of a stock of goods or merchandise solely for the purpose of processing by another enterprise; (iv) maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise; and (v) maintenance of a fixed place of business solely for the purpose of carrying on an activity of a preparatory or auxiliary character.

Effectively Connected Income

Specific statutory rules govern whether income is E.C.I. In the case of U.S.-source capital gains and U.S.-source income of a type subject to gross-basis U.S. taxation, the factors taken into account include whether the income is derived from assets used, or held for use, in the conduct of the U.S. trade or business and whether the activities of such a trade or business were a material factor in the realization of the amount (the "asset use" and "business activities" tests). Under these tests, due regard is given to whether the income, gain, or asset was accounted for through the U.S. trade or business. All other U.S.-source income is treated as E.C.I.

Only limited categories of foreign-source income may be characterized as E.C.I., and only if the foreign person is engaged in a U.S. trade or business and maintains an office or other fixed place of business within the United States to which the income is attributable. The limited categories are as follows:

- Rents or royalties for the use of patents, copyrights, secret processes or formulas, goodwill, trade-marks, trade brands, franchises, or other like intangible properties;
- Interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; and
- Income derived from the sale or exchange outside the United States of inventory property held by the foreign person primarily for sale to customers in the ordinary course of its business.

Regarding the third category, a sale is not included if it is made for use, consumption, or disposition outside the United States and an office or other fixed place of business in a foreign country participated materially in the sale. Regarding the first and second categories, foreign-source dividends, interest, and royalties are not treated as E.C.I. if the items are paid by a foreign corporation in which more than 50% by vote is owned directly, indirectly, or constructively by the recipient of the income.

"If a U.S. office or fixed place of business exists, income, gain, deduction, or loss is considered attributable to the office only if the office is a material factor in the production of the income and it regularly carries on activities of the type from which the income is derived."

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. However, if the agent is not independent, the agent's place of business may be attributed to the foreign person if the agent has and regularly exercises the authority to negotiate and conclude contracts in the name of the foreign person or has a stock of merchandise from which orders are regularly filled on behalf of the foreign person.

If a U.S. office or fixed place of business exists, income, gain, deduction, or loss is considered attributable to the office only if the office is a material factor in the production of the income and it regularly carries on activities of the type from which the income is derived.

Special rules apply in determining the E.C.I. of an insurance company. The foreign-source insurance income of a foreign corporation is E.C.I. if it is attributable to its United States business.

Income, gain, deduction, or loss for a particular year generally is not treated as E.C.I. if the foreign person is not engaged in a U.S. trade or business in that year and the income is attributable to activities in that year. However, significant exceptions exist to this rule. If the income or gain is attributable to the sale or exchange of property, the performance of services, or any other transaction that occurred in a prior taxable year, the income or gain is taxable on a net basis in the year received if the income would have been E.C.I. in the earlier year. In addition, if any property ceases to be used or held for use in connection with the conduct of a U.S. trade or business and the property is disposed of within ten years after the cessation, the income or gain is taxable on a net basis as if the disposition occurred immediately before the property ceased to be used in connection with the U.S. trade or business.

Allowance of Deductions

Taxable E.C.I. is computed by taking into account deductions associated with gross E.C.I. For this purpose, the apportionment and allocation of deductions other than interest is addressed in detailed regulations. In some circumstances, deductions may be allocated on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. More specific guidelines are provided for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. Detailed regulations address the allocation and apportionment of interest deductions. In general, interest expense is allocated and apportioned based on the deployment of a foreign company's assets, rather than its income.

Special Rules

F.I.R.P.T.A.

The Foreign Investment in Real Property Tax Act of 1980 ("F.I.R.P.T.A.") generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("U.S.R.P.I.") as E.C.I. that is taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gains. In the case of a foreign corporation, the gain from the disposition of a U.S.R.P.I. may also be subject to the branch profits tax at a 30% rate or a reduced rate under an applicable income tax treaty. Branch profits tax is not applicable if the U.S.R.P.I. consists of shares of a U.S. Real Property Holding Corporation.

The purchaser of the U.S.R.P.I. is generally required to withhold U.S. tax from the payment. Withholding is generally imposed at the rate of 10% of the sales price. If a foreign person receives a distribution from a real estate investment trust ("R.E.I.T.") or regulated investment company ("R.I.C."), the withholding tax rate is 35% of the distribution to the extent attributable to a sale of a U.S.R.P.I. by the R.E.I.T. or R.I.C. If the withholding tax exceeds the actual net income tax due, a refund may be claimed through the filing of a U.S. tax return.

Branch Profits Tax

A domestic corporation owned by foreign persons is subject to U.S. income tax on its net income. The earnings of the domestic corporation are subject to a second tax at the shareholder level when dividends are paid. The second-level tax is imposed at a flat rate and collected by withholding. Unless the portfolio interest exemption, a treaty, or another exemption applies, interest payments made by a domestic corporation to foreign creditors are subject to U.S. withholding tax, as well. To approximate these second-level withholding taxes, the United States taxes a foreign corporation that is engaged in a U.S. trade or business through a U.S. branch on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest that are deducted by, the U.S. branch of the foreign corporation. These branch taxes may be reduced or eliminated under an applicable income tax treaty.

Under the branch profits rule, the United States imposes a tax of 30% on a foreign corporation's "dividend equivalent amount." The dividend equivalent amount is generally the earnings and profits of a U.S. branch of a foreign corporation attributable to its E.C.I. Limited categories of such income are excluded in calculating the dividend equivalent amount.

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity. The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings (i) are reinvested in trade or business assets in the United States or (ii) reduce U.S. trade or business liabilities. The second adjustment increases the dividend equivalent amount to the extent that prior reinvested earnings are considered remitted to the home office of the foreign corporation.

Generally, interest paid by a U.S. trade or business of a foreign corporation is treated as if paid by a domestic corporation and therefore subject to U.S. 30% withholding tax. Certain "excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to U.S. 30% withholding tax. For this purpose, excess interest is the excess of the interest expense of the foreign corporation apportioned to the U.S. trade or business over the amount of interest paid by the trade or business.

Earnings Stripping

U.S. corporations that are owned by foreign persons are limited in their ability to reduce their U.S. tax base through certain earnings stripping transactions involving interest payments. If the U.S. payor's debt-to-equity ratio exceeds 1.5 to 1, a deduction for disqualified interest paid or accrued by the payor in a taxable year is generally disallowed to the extent of the payor's excess interest expense. This rule is applied after the status of the debt as "true debt" for U.S. income tax purposes is determined. Disqualified interest includes (i) interest paid or accrued to related parties when no Federal income tax is imposed, (ii) interest paid to unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt") and withholding tax is not imposed, and (iii) interest paid to a R.E.I.T. by a taxable R.E.I.T. subsidiary.

Excess interest expense is the amount by which the payor's net interest expense (*i.e.*, the excess of interest paid or accrued over interest income) exceeds 50% of its adjusted taxable income. In broad terms, adjusted taxable income is equivalent to earnings before interest, taxes, depreciation, and amortization ("E.B.I.T.D.A."), with adjustments to eliminate net operating loss carryovers and domestic production activities under Code §199.

Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation can be carried forward three years.

U.S. TAX RULES APPLICABLE TO FOREIGN ACTIVITIES OF U.S. PERSONS (OUTBOUND)

In General

In broad terms, the U.S. does not impose an income tax on foreign corporations on income earned from foreign operations, whether or not some or all its shareholders are U.S. persons. Generally, income earned by a U.S.-based M.N.G. from foreign operations conducted by the group's foreign corporate members is subject to U.S. tax when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income is generally deferred until distributed to a U.S. shareholder or a U.S. shareholder recognizes gain on the sale of stock.

Having said that, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by its foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the C.F.C. rules known as "Subpart F" and the foreign fund rules known as "Passive Foreign Investment Company" or, more commonly, "P.F.I.C." rules. A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.

Anti-Deferral Regimes

Subpart F

"Subpart F, applicable to C.F.C.'s and their 'U.S. Shareholders,' is the main anti-deferral regime of relevance for a U.S.-based multinational corporate group."

Subpart F, applicable to C.F.C.'s and their "U.S. Shareholders," is the main anti-deferral regime of relevance for a U.S.-based multinational corporate group. A C.F.C. is generally defined as any foreign corporation whose U.S. Shareholders own (directly, indirectly, or constructively) more than 50% of the corporation's stock (measured by vote or value). For this purpose, a U.S. Shareholder is a U.S. person that owns stock representing at least 10% of the voting power of the foreign corporation. Under the Subpart F rules, the United States generally taxes U.S. Shareholders of a C.F.C. on their *pro rata* shares of certain income of the C.F.C. (referred to as "Subpart F Income"). Distributions are not necessary for tax to be imposed.

With exceptions described below, Subpart F Income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F Income consists of "Foreign Base Company Income," "Subpart F Insurance Income," and certain income relating to international boycotts and other violations of public policy. Foreign Base Company Income consists of "Foreign Personal Holding Company Income," which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including "Foreign Base Company Sales Income," "Foreign Base Company Services Income," and "Foreign Base Company Oil-Related Income." Insurance income subject to current inclusion under the Subpart F rules includes any income of a C.F.C. attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the C.F.C.'s country of organization." Subpart F Insurance Income also includes income attributable to an insurance contract in connection with risks located within the C.F.C.'s country of organization as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of risks in other countries.

Special rules apply under Subpart F with respect to "Related Person Insurance Income." For purposes of these rules, the U.S. ownership threshold for C.F.C. status is reduced to 25%. Any U.S. person who owns or is considered to own any stock in a C.F.C. is treated as a U.S. Shareholder for purposes of this 25% U.S. ownership threshold and exposed to current tax on the corporation's Related-Person Insurance Income. Related Person Insurance Income is defined for this purpose as any Subpart F Insurance Income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. Shareholder in the C.F.C. or a person related to such a shareholder.

Detailed exceptions are provided for certain C.F.C.'s maintaining active operations in the country of incorporation or the country of a qualified business unit ("Q.B.U.") of the C.F.C.

Investments in U.S. Property

The U.S. Shareholders of a C.F.C. are required to include currently in income for U.S. tax purposes their *pro rata* shares of the corporation's untaxed earnings invested in certain items of U.S. property. U.S. property generally includes (i) tangible property located in the United States, (ii) the stock of a U.S. corporation, (iii) an obligation of a U.S. person, and (iii) certain intangible assets, such as patents and copyrights, acquired or developed by the C.F.C. for use in the United States.

Specific exceptions apply, including (i) bank deposits, (ii) certain export property, and (iii) certain trade or business obligations. The inclusion rule for investment of earnings in U.S. property is intended to prevent taxpayers from avoiding U.S. tax on dividend repatriations by repatriating C.F.C. earnings through non-dividend payments, such as loans to U.S. persons or acquisition of plants leased to related and unrelated U.S. persons.

Subpart F Exceptions

A provision colloquially referred to as the "C.F.C. look-through" rule, which is applicable for taxable years beginning after 2005 and before 2015, excludes from Foreign Personal Holding Company Income the dividends, interest, rents, and royalties received or accrued by one C.F.C. from a related C.F.C. to the extent that they are attributable or properly allocable to non-Subpart F Income of the payor. Reflecting budget concerns in recent years, this provision has been repeatedly adopted for one or two years, each time taking effect retroactively on the first day of the year of enactment.

There is also an exclusion for certain income of a C.F.C. derived in the active conduct of banking or financing business ("Active Financing Income"). The exception from Subpart F for Active Financing Income now applies to taxable years of foreign corporations starting before January 1, 2015. Again, this exception has been enacted several times, each time for one or two years, often toward the end of a calendar year with retroactive effect.

Other exclusions from Foreign Personal Holding Company Income include (i) exceptions for dividends and interest received by a C.F.C. from a related corporation organized and operating in the same foreign country as the C.F.C. and (ii) exceptions for rents and royalties received by a C.F.C. from a related corporation for the use of property within the country in which the C.F.C. is organized. These exclusions do not apply to the extent that the payments reduce the Subpart F Income of the payor.

An exception from Foreign Base Company Income and Subpart F Insurance Income may apply for any item of income received by a C.F.C., if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90% of the maximum U.S. corporate income tax rate. At today's corporate rates, the effective foreign tax rate must exceed 31.5%.

Exclusion of Previously Taxed Earnings and Profits

A U.S. Shareholder of a C.F.C. may exclude actual distributions of earnings and profits from the C.F.C. that were previously included in its income under Subpart F. Any income inclusion under Code §956 resulting from an investment in U.S. property may cause a subsequent distribution to be excluded from income. The inclusion in income results in a previously taxed earnings account for the C.F.C., and dividends are allocated to those earnings before being allocated to undistributed earnings.

Basis Adjustments

In general, a U.S. Shareholder of a C.F.C. receives a basis increase with respect to its stock in the C.F.C. equal to the amount of the C.F.C.'s earnings that have been included in income and not distributed. When dividends are received and allocated to previously taxed earnings, the U.S. Shareholder reduces its basis in the shares of the C.F.C. This eliminates a double inclusion of income under Subpart F and gain from the sale of shares.

Rules Applicable to P.F.I.C.'s

A P.F.I.C. is generally defined as any foreign corporation if 75% or more of its gross income for the taxable year consists of passive income or 50% or more of its assets produce, or are held for the production of, passive income.

Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a P.F.I.C. These rules are not triggered by any specific ownership percentage in the P.F.I.C., and a 1% shareholder is treated the same as a 10% shareholder.

One set of rules applies to P.F.I.C.'s that are qualified electing funds, under which electing U.S. shareholders currently include in gross income their respective shares of the earnings of the P.F.I.C., with a separate election to defer payment of tax, subject to an interest charge.

A second set of rules applies to P.F.I.C.'s that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral. This is computed based on the holding period for the P.F.I.C. shares, rather than by reference to the years in which income is realized by the P.F.I.C.

A third set of rules applies to P.F.I.C. stock that is marketable. U.S. investors may elect to currently take into account as income or loss the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."

Coordination of Anti-Deferral Rules

Rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a P.F.I.C. with respect to a particular shareholder if the corporation is also a C.F.C. and the shareholder is a U.S. Shareholder.

Foreign Tax Credit

U.S. citizens, resident individuals, and domestic corporations are allowed to claim credit for foreign income taxes that are paid or accrued. In addition, a domestic corporation that owns at least 10% of the voting stock of a foreign corporation is allowed a deemed-paid credit for foreign income taxes paid by the foreign corporation. It applies to tax that is deemed to have been paid when the related income is distributed as a dividend, or that is otherwise included in the domestic corporation's income under the anti-deferral rules.

The foreign tax credit is generally limited to a taxpayer's U.S. tax liability on its foreign source taxable income, determined under U.S. tax accounting principles. This is known as the foreign tax credit limitation. It is intended to ensure that the credit mitigates double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed for each year by multiplying a taxpayer's total U.S. tax liability by the ratio of their foreign-source taxable income to total taxable income. For a given year, if the total amount of foreign income taxes paid and deemed paid exceeds the taxpayer's foreign tax credit limitation, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding ten years.

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each of two limitation categories. It does this by allocating and apportioning deductions between U.S.-source gross income and foreign-source gross income in each limitation category. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate. However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios. For interest expense, it is the ratio of the corporation's foreign or domestic assets to its worldwide assets. For research and experimental expenses, it is the ratio of sales or gross income. All members of an affiliated group of corporations are generally treated as a single corporation for purposes of determining the apportionment ratios.

The term "affiliated group" is determined, generally, by reference to the rules for determining whether corporations are eligible to file consolidated returns. These rules exclude foreign corporations from an affiliated group, except that beginning January 1, 2021, the interest expense of the members of the U.S.-affiliated group may be computed on a worldwide-group basis. As a result, interest expenses of foreign members of a U.S.-affiliated group are taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign-source income. An allocation to foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than the entire worldwide group. The new rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign-source income.

The foreign tax credit limitation is applied separately to passive basket income and general basket income. Passive basket income includes interest and dividend income. General basket income includes all other income. Having said that, a special rule applies to certain financial services entities. For these entities, passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is taxed at an effective rate that exceeds the highest rate for individuals and corporations.

When the U.S. taxpayer is a U.S. Shareholder of a C.F.C., dividends, Subpart F inclusions, interest, rents, and royalties from the C.F.C. are assigned to a category by reference to the category of income out of which the dividends or other payments were made. Dividends received by a 10% corporate shareholder of a foreign corporation that is not a C.F.C. are also categorized on a look-through basis.

Finally, a taxpayer's ability to claim a foreign tax credit may be limited by a matching rule under which the credit for foreign income taxes is not allowed prior to the time the foreign-source income is taxed in the U.S.