# FOREIGN TAX CREDIT MAY NOT BE AVAILABLE FOR GAINS DERIVED OUTSIDE THE U.S.

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## INTRODUCTION

The U.S. applies a worldwide tax system imposed on residents and citizens alike. Therefore, U.S. citizens and persons treated as U.S. residents for U.S. tax purposes are subject to U.S. tax on income and gains derived from their investments outside the U.S.

Under U.S. tax law, a foreign tax credit is available for foreign-source income and gains that were taxed in the foreign jurisdiction. The general U.S. source rule provides that subject to certain exceptions, the source of capital gains from the sale of a personal property is determined based on the residency of the person selling the asset. Thus, for an individual who is treated as a U.S. person (for purposes of the source rule), gain from the sale of property outside the U.S. would be treated as U.S.-source gain.

This creates a problem whereby any tax paid outside the U.S. on such a sale will not be eligible for a foreign tax credit.<sup>2</sup> Fortunately, a tax treaty may provide relief by allowing re-sourcing of income or gains to the foreign country. In the absence of treaty relief, this problem may be alleviated if gains can be attributed to a foreign office maintained by the taxpayer outside the U.S.

# GENERAL SOURCE RULE FOR INCOME AND GAINS FROM A SALE OF PERSONAL PROPERTY

As mentioned above, income from the sale of personal property by a U.S. resident is generally U.S.-source income no matter where in the world the sale takes place.<sup>3</sup> For these purposes, "U.S. resident" is

- any individual who
  - is a U.S. citizen or a resident alien and does not have a tax home in a foreign country, or
  - o is a nonresident and has a tax home in the U.S.; and

<sup>&</sup>lt;sup>1</sup> Code §865(a)(1).

<sup>&</sup>lt;sup>2</sup> Code §§901, 904. See <u>"Foreign Tax Credits: General Principles and LB&I"</u> in this issue of *Insights*.

Code §865. This general rule does not apply to sales of: (i) inventory property; (ii) depreciable personal property; (iii) intangibles (e.g., patents, copyrights, trademarks) under certain circumstances, and goodwill; and (iv) stock of certain affiliated companies.

 any corporation, trust, or estate that is a U.S. person under the general rule for residence.<sup>4</sup>

For the purpose of determining an individual's "tax home" one must look to the individual's home for purpose of the travel expense deduction. The regulations provide that an individual's tax home is located where his or her regular or principal place of business is located.

However, if the individual has no regular or principal place of business then his or her tax home is located at the individual's regular place of abode (in a real and substantial sense). Under this rule, an individual will not be treated as having a tax home in a foreign country for any period for which his or her abode is within the U.S. Nevertheless, temporary presence in the U.S. does not necessarily mean that the individual's abode is in the U.S., and maintaining a dwelling in the U.S. (whether or not that dwelling is used by the individual's spouse and dependents) does not necessarily mean that the individual's abode is in the U.S.

Therefore, under certain circumstances, when an individual has more than one abode available (*i.e.*, one in the U.S. and one in a foreign country), claiming a foreign tax home may not be simple. This challenge not only extends to a U.S. citizens and residents but also to individuals who are otherwise treated as nonresidents. In these circumstances, case law provides that whether a taxpayer has a U.S. abode is determined by comparing the taxpayer's domestic ties (*i.e.*, familial, economic, and personal ties) to the U.S. with ties to the foreign country that is claimed as a tax home.<sup>9</sup>

In sum, when a U.S. citizen or resident maintains a home in the U.S. and has strong ties to the U.S., he or she may not be able to prove the existence of a tax home outside the U.S., even if that person spends a large amount of time outside the U.S. during the tax year. It must also be noted that showing that a U.S. citizen or resident's tax home is not in the U.S. is not sufficient grounds for the individual to be treated as a nonresident for purposes of the source rule unless a tax of 10% or more is imposed on the transaction by a foreign jurisdiction.<sup>10</sup>

## RE-SOURCING INCOME UNDER A TAX TREATY

As mentioned above, for U.S. citizens and residents, gains from sales of property outside the U.S. will be sourced to the U.S. Consequently, the foreign tax credit limitation will restrict taxpayers from claiming a credit for foreign taxes paid. This result undermines the allocation of taxing rights as agreed between the U.S. and its treaty partners. To avoid this undesirable effect, certain U.S. income tax treaties provide a re-sourcing rule, which allows an individual who is eligible for treaty benefits to treat

Code §865(g)(1)(A). The general rule for residence is found in Code §§7701(a) (30) and (31).

Code §865(g)(1)(A) defines "tax home" with reference to Code §911(d)(3).

<sup>&</sup>lt;sup>6</sup> Treas. Reg. §911-2(b).

<sup>&</sup>lt;sup>7</sup> Code §911(d)(3).

<sup>8</sup> Treas. Reg. §911-2(b).

<sup>&</sup>lt;sup>9</sup> See, e.g., Harrington v. C.I.R., 93 T.C. 297, 307-308 (1989).

<sup>&</sup>lt;sup>10</sup> Code §865(g)(2).

certain income and gains as arising from foreign sources.

For example, absent a re-sourcing rule, if a U.S. individual sold shares in a Canadian corporation holding Canadian real property, the U.S. would tax the transaction and treat it as U.S.-source income. At the same time, Canada would tax the gain because, under the U.S.-Canada Income Tax Treaty, gain attributable to real property may be taxed in the country where the real property is located.<sup>11</sup> Thus, if no treaty relief was available, double taxation would occur. However, Article XXIV (Elimination of Double Taxation) of the U.S.-Canada Treaty provides that gains that may be taxed in Canada under the U.S.-Canada Treaty will be deemed to arise in Canada. Paragraph 3(a) provides that:

Profits, income or gains (other than gains to which paragraph 5 of Article XIII (Gains) applies) of a resident of a Contracting State which may be taxed in the other Contracting State in accordance with the Convention (without regard to paragraph 2 of Article XXIX (Miscellaneous Rules)) shall be deemed to arise in that other State.<sup>12</sup>

Therefore, the gain from the transaction in the above example would be re-sourced for U.S. tax purposes and treated as foreign-source gain, creditable against the U.S. tax liability arising from the transaction. Note that in order to claim treaty benefits the taxpayer must file Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*.

However, not all countries have a treaty with the U.S., and not all treaties allow such re-sourcing in these circumstances. For example, under the U.S.-India Income Tax Treaty, the determination of the source of income for purposes of foreign tax credits is made under the domestic source rules of the two countries for all matters except for royalties and fees for included services.<sup>13</sup>

#### GAIN ATTRIBUTED TO A NON-U.S. OFFICE

Notwithstanding the general source rule mentioned above, if a U.S. citizen or resident maintains an office or other fixed place of business in a foreign country, income from a sale of personal property that is attributable to such office is sourced outside the U.S., provided that it is subject to a foreign tax of at least 10%.<sup>14</sup>

# Which Offices Can the Gain be Attributed to?

An office or other fixed place of business is generally defined as any fixed facility



Convention with Respect to Taxes on Income and Capital, U.S.-Can., art. xiii, para. 1 and 3, September 26, 1980. T.I.A.S. 11087; 1469 U.N.T.S. 189. Real property is defined to include stock of a domestic corporation of which value is derived principally from real property situated in that jurisdiction.

See also <u>Convention with Respect to Taxes on Income and Capital</u>, U.S.-Can., art. xiii, para. 5, and art. xxix, para. 2, with regard to expatriates.

See <u>Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income</u>, U.S.-Ind., art. 25, para. 3, September 12, 1989.

Code §865(e). Note that the same limitations applicable to the general rule, relating to inventory, depreciable property, intangibles, and stocks of affiliated company, apply here.

"Materiality will be satisfied if the non-U.S. office makes a significant contribution to the transaction by being an essential economic element in the realization of the gain." through which a taxpayer engages in a trade or business. This definition includes facilities that are not regularly thought of as "offices," such as stores or other sales outlets, factories, workshops, and mines.

The use of another person's office or fixed place of business, including that of a related person, is attributed to the taxpayer only if the taxpayer's trade or business is conducted in that office or fixed place of business and such activities are not "sporadic or infrequent." The office or fixed place of business of a dependent agent will be attributed to the taxpayer if one of the following requirements is met:

- The agent has the authority to negotiate and conclude contracts in the name
  of the taxpayer and regularly exercises that authority over a continuous period of time.
- The agent has a stock of merchandise belonging to the taxpayer from which the agent regularly fills orders on behalf of the taxpayer over a continuous period of time.

If the agent's authority to negotiate and conclude contracts is limited only to unusual cases or if such authority must be separately secured by the agent prior to each transaction, the above requirement will not be considered as met.

In contrast, an office or other fixed place of business of an independent agent is generally not treated as the taxpayer's office or fixed trade or business. The determination whether an agent is of independent nature depends on facts and circumstances.

# When is Gain Attributed to a Foreign Office?

For gain to be attributed to a non-U.S. office two conditions must be met:

- The office must constitute a "material factor" in realizing the gain.
- The office must regularly carry out, in the ordinary course of its trade or business, activities of the type from which such income or gain is derived.<sup>15</sup>

Materiality will be satisfied if the non-U.S. office makes a significant contribution to the transaction by being an essential economic element in the realization of the gain. For example, for an office to be treated as materially participating in the sale of stock, the office must actively solicit, negotiate, or perform certain other activities required to arrange the sale. An office will not be treated as materially participating merely because the office collects the gain from the sale, exercises general supervision over the activities or the persons directly responsible for the sale, performs clerical functions incident to the sale, or exercises final approval over the execution of the sale.

For the second requirement to be met, one must first determine that the office is engaged in a trade or business outside the U.S. and thereafter determine that the activity related to the transaction at issue takes place in the ordinary course of such trade or business.

"Trade or business" in not defined for purposes of the source rules. Thus, we refer

<sup>&</sup>lt;sup>5</sup> Code §864(c)(5)(B) and Treas. Reg. §1.864-6(b)(1).

Treas. Reg. §1.864-6(b)(1).

to the definition of a "U.S. trade or business" under Code §864. Under these rules, a non-U.S. person trading in securities through a resident broker or other independent agent is not considered to have a U.S. trade or business unless the taxpayer maintains an office or a fixed place of business in the U.S., through which the transactions were effected. This may be interpreted to mean that a U.S. person who sells stock through a foreign office or fixed place of business is engaged in a trade or business outside the U.S.

Thus, in order to have the foreign office attributed to the taxpayer, it may be advisable to conclude an agency agreement between the non-U.S. company whose office is deemed to be attributed and the taxpayer. Under such agreement, the non-U.S. company should be appointed as the taxpayer's agent and be granted the authority to negotiate and conclude contracts on behalf of the taxpayer on a regular basis and without the need for a prior authorization. Furthermore, the agent should be authorized to hold property as the taxpayer's agent, seek potential buyers, act as the principal point of contact in the negotiations to sell the property, sign the contract of sale, deliver the property to the buyer, and receive the proceeds from the sale as the taxpayer's agent.

# CONCLUSION

In sum, if a U.S. taxpayer owns foreign property, the sale may be treated as producing U.S.-source income or gains and the taxpayer may be denied a foreign tax credit. If a treaty is not be available to re-source such gains, the taxpayer may still find relief from double taxation if such gain is subject to non-U.S. tax of at least 10% and the taxpayer has an office outside the U.S. that is regularly engaged, as the taxpayer's dependant agent, in buying and selling property of the type in issue. If that office negotiates and concludes the contract for the sale of said property, the gains derived from the sale should be attributable to such non-U.S. office and be treated as foreign-source gains.

