Tax Planning and Compliance for Foreign Businesses with U.S. Activity

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I. Introduction

The U.S. tax laws affecting foreign businesses with activity in the U.S. contain some of the more complex provisions of the Internal Revenue Code. Examples include:

- ❐ Effectively connected income,
- ❐ Allocation of expenses to that income,
- ❐ Arm's length transfer pricing rules,
- ❐ Permanent establishments under income tax treaties,
- ❐ Limitation on benefits provisions in income tax treaties that are designed to prevent "treaty shopping,"
- ❐ State tax apportionment,
- ❐ F.I.R.P.T.A. withholding tax for transactions categorized as real property transfers,
- ❐ Fixed and determinable annual and periodical income, and
- ❐ Interest on items of portfolio debt.

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One can imagine that it is no easy task to identify income that is subject to tax, to identify the tax regime applicable to the income, and to quantify gross income, net income, and income subject to withholding tax. Nonetheless, the I.R.S. has identified withholding tax obligations of U.S. payers as a Tier I audit issue.

Following closely with the technical obligations are the reporting obligations to ensure that the proper amounts of income, in some cases expense, and in all cases tax are reported on the income tax return filed by the foreign business. These reporting obligations can be imposed on –

- ❒ The foreign investor itself, if it engages in a transaction directly in the U.S. that produces effectively connected taxable income or loss;
- ❒ The U.S. subsidiaries of the foreign investor, if they engage in transactions with affiliates controlled by the same investor;
- ❒ A person who acquires real property from a foreign corporation, even when the acquisition would otherwise be free of tax under general concepts of domestic tax law;
- ❒ General partners of partnerships that report effectively connected income as part of the distributable share of a foreign partner; and
- ❒ Payors of income, other than effectively connected income, deemed to be from U.S. sources.

This paper explains when the technical provisions listed above are likely to be applicable to a specific fact pattern and addresses the reporting obligations in each of those circumstances.

II. Direct Operations

A foreign company that is engaged in a trade or business in the U.S. faces exposure to U.S. tax on several levels. It is subject to (a) Federal income tax or alternative minimum tax; (b) Federal branch profits tax on the dividend equivalent amount arising from taxable income; and (c) State income tax. There also may be U.S. tax exposure imposed on the employees physically present in the U.S.

A. Trade or Business

While it is easy to identify the tax exposure, it is not always easy to determine when the threshold has been crossed for the imposition of tax or how the tax will be computed. For a foreign corporation to be engaged in a trade or business in the U.S., it must engage in a course of activity within the United States that is considerable, continuous, and regular.[2] Whether the threshold has been crossed is a question of fact. The threshold of the I.R.S. is generally somewhat lower than that of the Courts. Courts look at activity in the U.S. exclusively. The I.R.S. contends that sporadic activity in the U.S. of a kind that comprises a business outside the U.S. comprises a trade or business in the U.S.

The activity may be carried on by the foreign corporation itself or by its agents.[3] Consequently, a foreign corporation that is a member of a partnership which is engaged in a U.S. trade or business is deemed to be engaged in the trade or business conducted by the partnership.[4] However, a foreign corporation is not engaged in a trade or business in the U.S. if it engages a subcontractor to provide services and that subcontractor acts in the course of its own business.[5]

The activity within the U.S. must be income-producing or capable of producing income or sales for it to comprise a U.S. trade or business.[6] With limited exceptions, a foreign corporation that is not engaged in a trade or business within the U.S. during a taxable year cannot have income, gain, or loss that is treated as effectively connected income.[7] Two exceptions relate to dispositions of assets used in a trade or business in prior years and to deferred payment

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2 InverWorld Inc. v. Commr., T.C. Memo 1996-301; InverWorld Inc. v. Commr., T.C. Memo 1997-226; Lewenhaupt v. Commr., 20 T.C. 151 (1953), affd. per curiam 221 F.2d 227 (9th Cir. 1955); and European Naval Stores Co., S.A. v. Commr., 11 T.C. 127 (1948).

3 Adda v. Commr., 10 T.C. 273 (1948), affd. per curiam 171 F.2d 457 (4th Cir. 1948), cert. denied 336 U.S. 952.

4 Code §875(1); Donroy, Ltd. v. U.S., 301 F.2d 200 (9th Cir. 1962); and Unger v. Commr., T. C. Memo. 1990-15, affd. 936 F.2d 1316 (D.C. Cir. 1991); Rev. Rul. 90-80, 1990-2 C.B. 170.

5 Miller v. Commr., T.C. Memo 1997-134, involving a U.S. subcontractor who performed some of the work on a project for a foreign related company. Compare InverWorld Inc. v. Commr., T.C. Memo. 1996-301, where virtually all of the activities that generated income were conducted in the U.S. by a related party acting as agent.

6 Linen Thread Co., Ltd. v. Commr., 4 T.C. 802 (1945), affd. 152 F.2d 625 (2d Cir. 1945); Lewenhaupt v. Commr., 20 T.C. 151 (1953), affd. per curiam 221 F.2d 227 (9th Cir. 1955); Spermacet Whaling & Shipping Co. v. Commr., 30 T.C. 618 (1958), affd. 281 F.2d 646 (6th Cir. 1960); Continental Trading, Inc. v. Commr., T.C. Memo. 1957-164, affd. 265 F.2d 40 (9th Cir. 1959), cert. denied 361 U.S. 827.

7 Code §864(c)(1)(B).

transactions.[8] In these instances, income is treated as effectively connected with a business conducted in an earlier year.[9] In addition, a foreign corporation can elect to treat real property income as connected with a U.S. trade or business.[10]

B. Effectively Connected Gross Income

To compute the taxable effectively connected income of a foreign corporation engaged in a U.S. trade or business, the first step is to identify the gross income that gives rise to effectively connected net income. Generally, effectively connected gross income must arise from U.S. sources as computed under the concepts of U.S. law.[11] Moreover, the gross income must be attributable to the conduct of a trade or business in the U.S. In only limited circumstances, will foreign source income be deemed to be effectively connected income and then only if a U.S. office exists and personnel assigned to that office materially participate in arranging the income. The limited circumstances involve foreign source rent or royalty income of a licensing company, dividends or interest derived in the active conduct of a banking, financing, or similar business by an investment company, and sales of inventory for use and consumption outside the U.S.[12]

In broad terms, the three most common forms of gross income for a foreign corporation engaged in a U.S. trade or business are services income, income from the sale of inventory, and rental income.

For services income, the place where services are performed controls the source of the resulting service fee income.[13] Fees for services performed in the U.S. are taxable; fees for services performed outside the U.S. are not taxable. The identity of the customer is irrelevant in determining the source of the income.

Where an organization provides services in return for a fee, many different people in many different locations may provide services. Where this occurs, all the service providers must be identified and the relative contributions of each must be evaluated.[14] Only the portion of the fee

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[8] Code §864(c)(6)&(7).

[9] Code §864(b).

[10] Code §882(d).

[11] See Code §861 for the general source rule of U.S. tax law.

[12] Code §864(c).

[13] Code §861(a)(3).

[14] Reg. §1.954-4.

considered to be U.S. source income will be treated as effectively connected income. No hard and fast guidelines exist to make the required determinations. The hours spent by all personnel involved can be tracked and values can be assigned. A ratio may then be developed which compares the aggregate value of all hours in the U.S. with the aggregate value of all hours for the project. The ratio, expressed as a percentage, can be applied to the total service fee to determine the percentage taxed in the U.S.

Income from the purchase and sale of inventory – not the manufacture and sale of inventory – (or property described in Code §1221(a)(1)) is generally sourced by reference to the place where title passes. Title passes at the place where risk of loss passes. In the U.S., risk of loss is determined under the Uniform Commercial Code and generally means the place where the seller has successfully fulfilled his obligation and merely awaits payment.[15] However, a sale of inventory through an office or fixed places of business may be sourced in the country where the office or fixed place of business is located. For foreign residents, if the sale is attributable to an office or fixed place of business in the U.S., the income is considered to be U.S. source income.[16] This rule applies to all sales of personal property by nonresidents, including inventory, except that a sale of inventory property for use, disposition, or consumption outside U.S. will be considered to generate foreign source income if a foreign office or fixed place of business materially participates in sale.

Where a foreign business manufactures property outside the U.S. and sells that property inside the U.S., only a portion of the income will be deemed to be U.S. source effectively connected income. That portion is determined under a formula.[17] Where an independent factory or production price can be established by regular sales to unrelated third parties under ex factory terms, the manufacturing profit is determined by reference to the ex factory price. That income is sourced at the location of the factory.[18] The balance of the income from manufacturing activities is sourced at the place where the sale occurs.

Alternatively, one may elect to apportion the income between U.S. and foreign sources. Under this method one-half of the taxpayer's gross income will be considered income attributable to production activity. Only the taxpayer’s production assets are taken into account. Assets of contract manufacturers are not relevant.[19] Production assets include only tangible and intangible

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15 Code §§865(b) and 861(a)(6).

16 Code §865(e)(2)(A).

17 Code §863(b)(2).

18 Reg. §1.863-3(b)(2).

19 Reg. §1.863-3(c)(1)(i)(A).

assets directly used by the taxpayer to produce inventory. If assets are not directly used to produce inventory, they are excluded. The remaining one-half of such gross income will be considered income attributable to sales activity.[20]

The source of rental income is dependent on the place where the property is located.[21] Thus, for example, if rental real property is located within the U.S., the rental income is treated as an item of domestic source income.

When a foreign corporation is engaged in a U.S. trade or business, items of passive income such as interest income and gains may be treated as effectively connected income if the passive income is attributable to the trade or business.[22] This will occur if income is derived from assets used or held for use in the conduct of a U.S. trade or business.[23] For financial institutions, investment companies, and licensing companies, it may occur where the activities of a U.S. business constituted material factors in the realization of the income.[24]

An asset is treated as held for use in the conduct of a trade or business if the asset is held for the principal purpose of promoting the present conduct of the trade or business in the U.S.[25] An example is dividend-paying stock acquired and held to assure a constant source of supply for the trade or business of the U.S. branch. An asset is also viewed to be held for use in the conduct of a trade or business it is acquired and held in the ordinary course of the trade or business conducted in the United States.[26] Here, the example is an interest-bearing account or note receivable issued by a customer of the branch's trade or business. Finally, an asset may be viewed to be held for use in the conduct of a trade or business a direct relationship exists between the asset and the trade or business.[27] This will exist if (1) the asset was acquired with funds of the business, (2) the income from the asset is retained or reinvested in the business, and (3) U.S. personnel exercise significant management and control over the asset.

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[20] Reg. §1.863-3(b)(1).

[21] Code §861(a)(4).

[22] Code §864(c)(2).

[23] Code §864(c)(2)(A).

[24] Code §864(c)(2)(B).

[25] Reg. §1.864-4(c)(2)(ii)(a).

[26] Reg. §1.864-4(c)(ii)(b).

[27] Reg. §1.864-4(c)(ii)(c).

C. Deductible Expenses

The expenses that may be taken into account in computing the net taxable income are the expenses incurred in the U.S. to generate effectively connected income and a portion of any expense incurred outside the U.S. to the extent related, directly or indirectly, to the generation of U.S. fee income. The computation is made under concepts which appear in Reg. §1.861-8 and related provisions. In making the computation, the accounts of the U.S. branch are likely the easiest to analyze. However, each expense of the foreign company no matter where incurred must be evaluated, account by account, to determine whether the expense is of a kind that is deductible in the U.S. If deductible in principle, each item must be analyzed to determine that the deduction does not exceed limitations of U.S. tax law. To illustrate, foreign law may contain liberal depreciation rules such as bonus depreciation, flexible depreciation, or accelerated depreciation. The depreciation computed under those methods must be adjusted to reflect U.S. depreciation rules.

Once expenses are identified as deductible for U.S. income tax purposes, they are generally placed into three pools. The first pool consists of expenses that relate entirely to U.S. source fee income. These expenses are deductible in full. The second pool consists of expenses that relate entirely to foreign source fee income. These expenses are not deductible. The final pool consists of expenses related in part to U.S. source fee income and in part to foreign source fee income. These must be apportioned under a reasonable method applied consistently from year to year and which makes sense in the circumstances.

In computing deductible expenses, the I.R.S. will attempt to ensure that expenses have actually been incurred, that they are of a kind that is deductible under U.S. concepts, that limitations of U.S. law are appropriately applied, and that expenses related to foreign operations which do not produce effectively connected income are not deducted on the U.S. tax return. If a deductible item is paid to a related party outside the U.S. An examiner will attempt to confirm that the expenditure does not exceed an arm’s length amount within the meaning of U.S. tax law.

It is not unusual for an examiner to contend that expenses incurred in the U.S. are related to foreign source income not taxed by the U.S. Those expenses are not deductible. An example would be advertising expenses incurred in connection with an overall marketing approach to a brand name owned by the foreign entity. The examiner may contend that the advertising promotes foreign as well as U.S. sales and therefore cannot be deducted in full even though incurred by the U.S. branch.

One particular item that poses computational problems for a U.S. branch of a foreign operating company is the deduction for interest expense. For foreign companies, interest expense is not computed under a straightforward method. Rather, a formula that appears in regulations must be used.[28] The amount of interest expense allocable to effectively connected income of a foreign corporation is the sum of (1) the interest paid or accrued on liabilities booked in the U.S., as adjusted under a three-step process described below, and (2) the directly allocated interest. Direct allocation of interest that can be directly allocated under the Reg. §1.861-10T rules is mandatory.[29] However, the IRS has noted that certain U.S. Income tax treaties provide for other interest allocation methods. Under this circumstance, the methods prescribed under the specific treaty may be used instead of the three-step method in Treas. Reg. §1.882-5.[30]

The first step of the formula is to determine the amount of assets owned by the foreign company that produce effectively connected income that is taxable in the U.S. Once that is determined, the portion of the assets that are deemed to have been acquired by the proceeds of debt must be identified. Under the premise that capital is fungible, the entity's worldwide debt-equity ratio is determined and that ratio is multiplied against assets that produce income taxable in the U.S. This is the hypothetical amount debt attributed to the U.S. branch. The amount treated as debt may have no resemblance to the debt reported on the U.S. balance sheet.

When the hypothetical debt is computed, the interest expense related to that debt must be identified. This is computed by reference to the actual effective rate of interest of the U.S. business (viz., book interest expense divided by average book liabilities). The rate is multiplied against the debt computed in the preceding steps. If the interest expense deduction for income tax purposes exceeds the actual interest expense reported on the books of the U.S. business, the excess is subject to 30% branch profits tax on excess interest expense.[31] The treatment of excess interest paid by a U.S. branch reverses unintended tax benefits that arise from the computation of deductible interest under the regulations. The excess is treated as if it were interest paid to the foreign corporation on a notional obligation of a wholly owned domestic corporation on the last day of the foreign corporation's tax year.[32] As a result, the excess is subject to the equivalent of a 30 percent withholding tax, absent an applicable exemption provided by domestic law or a reduction or elimination of tax for qualified treaty residents as provided by treaty. Any tax due is reported on the foreign corporation's U.S. income tax return for the year and is subject to the payment of estimated tax as provided in Code §6651.[33]

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28 Reg. §1.882-5.

29 Id.

30 Preamble to T.D. 9281, 2006-2 C.B. 517; see also Notice 2005-53, 2005-2 C.B. 263.

31 Code §884(f)(1)(B). Taiyo Hawaii Company, Ltd. v. Commr., 108 T.C. 590 (1997).

32 Code §884(f)(1)(B); Reg. § 1.884-4(a)(2).

33 Reg. §1.884-4(a)(2)(iv).

Other limitations on the deduction for interest expense are discussed below.

D. Income Taxes

Regular income tax is imposed on the net effectively connected income, after allowance of deductions.[34] The tax is imposed at various rates as follows: (i) 15% up to $50,000; (ii) 25% from $50,000 up to $75,000; (iii) 34% from $75,000 up to$10,000,000; and (iv) 35% thereafter. The benefit of the lower rates of tax is recaptured for companies having income over $100,000 and over $15 million. In addition, alternative minimum tax of 20% of alternative minimum taxable income is imposed if that tax is greater than the net income tax imposed at regular rates.[35]

In addition to the regular income tax or the alternative minimum tax, a foreign corporation that is engaged in a trade or business in the U.S. is subject to the 30% branch profits tax on the dividend equivalent amount.[36] This tax is the functional equivalent of a dividend withholding tax imposed when a U.S. corporation pays a dividend to its foreign shareholder.

E. Branch Profits Tax on Dividend Equivalent Amount

The dividend equivalent amount is the foreign corporation's effectively connected earnings and profits determined without reduction for dividends paid during the year. The earnings are reduced by reinvestment in a U.S. trade or business and are increased by reductions of investments that were used in prior years to shelter the dividend equivalent amount. By tracking U.S. asset investment and disinvestment, the branch profits tax broadly equates to a dividend withholding tax. If U.S. asset investment increases, profits have been retained in the U.S. and no equivalent of a dividend as been effectively distributed to foreign shareholders.

Several traps for the unwary exist with the branch profits tax on the dividend equivalent amount. Previously deferred branch profits tax on effectively connected earnings and profits may be triggered when the business of a U.S. branch is terminated or when the business is contributed to a U.S. corporation.

In principle, a foreign corporation is not subject to the branch profits tax for the taxable year in which it completely terminates all of its U.S. trade or business.[37] This treatment equates to the

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[34] Code §§882 and 11.

[35] Code §55.

[36] Code §884.

[37] Reg. §1.884-2T(a)(1).

treatment of a complete liquidation of a U.S. subsidiary by a foreign corporation. In that set of circumstances, a foreign corporation is not subject to dividend withholding tax when a liquidating dividend is received. Similarly, the non-previously taxed accumulated effectively connected earnings and profits as of the close of the taxable year of complete termination are extinguished for purposes of the branch profits tax.

However, this favorable treatment applies only when a complete termination of the business exists. If a complete termination does not exist, the branch profits tax may be imposed on the non-previously taxed accumulated effectively connected earnings and profits at such time as the net equity of the U.S. branch is reduced.

For there to be a complete termination, several tests must be met.[38] First, the foreign corporation must have no U.S. assets or its shareholders must adopt an irrevocable resolution to completely liquidate and dissolve the corporation and, before the close of the immediately succeeding taxable year, all assets in the U.S. must be distributed, used to pay creditors, or removed from the country. Second, for three years following the close of the year of complete termination, none of U.S. assets of the terminated business, or property attributable to the sale of the business or to the U.S. earnings in the year of complete termination can be used by the foreign corporation or by an affiliate in the conduct of a trade or business in the U.S. Third, the foreign corporation must not have any income that is, or is treated as, effectively connected with the conduct of a trade or business in the U.S. during the 3-year period. Finally, the foreign corporation must extend the period of limitations on the assessment of the branch profits tax for the year of complete termination for not less than six taxable years.

When a business carried on by a U.S. branch is incorporated, the transfer of assets to a U.S. corporation is not treated as a termination of a business. Rather, the incorporation is treated as a reduction of net equity. Consequently, deferred branch profits tax will be triggered because net assets will be reduced.

This treatment is subject to an exception. The foreign corporation and its U.S. subsidiary elect for the transferee to step into its shoes with regard to the non-previously taxed accumulated effectively connected earnings and profits.[39] This means that the U.S. corporation will be treated as if it has carryover earnings and profits. Moreover, dividend distributions to the foreign corporation from the earnings will qualify for treaty benefits only when the limitation on benefits provision of the treaty and its counterpart in the branch profits tax regulations. Moreover, the foreign corporation must agree to terminate deferral of the branch profits tax in the event the

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[38] Reg. §1.884-2T(a)(2).

[39] Reg. §1.884-2T(d)(1)-(4).

shares of the U.S. transferee are sold or otherwise disposed of other than in an F-reorganization or a complete liquidation of the transferee which is covered by Code §332.[40].

The final trap for the unwary relates to the benefit of net operating loss carryovers. The branch profits tax on dividend equivalent amounts is based on the annual earnings for a particular year. Consequently, it is not reduced by a loss carryover from earlier years. This parallels dividend treatment in the U.S. in that a distribution to shareholders will be treated as a dividend if paid from accumulated earnings and profits, or if none exist, current year earnings and profits.[41] Consequently, the branch profits tax on the dividend equivalent amount can be looked at as a trap for the unwary.

F. Permanent Establishment – A Treaty Concept

A full discussion of treaty benefits regarding withholding tax and the limitation on benefits provisions of U.S. income tax treaties appears below in Section VI.B. However, there is a concept in income tax treaties that is applicable to effectively connected income and for that reason is discussed here. It is the concept of a "permanent establishment."

Virtually all treaties raise the level of presence that must exist in a nation state before that state can impose tax on "business profits," the treaty term that is used to describe effectively connected income. Business profits derived by a resident of one of the countries (the resident state") can be taxed in the other country (the "host state") only if a permanent establishment exists in the host state. In broad terms, a permanent establishment is a fixed place of business through which business is conducted in whole or in part in the host state. It typically includes a place of management, a branch, an office, a factory, a workshop, and a mine, oil or gas well, quarry or other place of extraction of natural resources. Also included are agents, other than independent agents described below, that have and habitually exercise an authority to conclude contracts that are binding on the enterprise. Think in terms of salesmen employed by a U.S. subsidiary that visits actual or potential customers and for the purpose of soliciting sales of goods and discussing the terms of the sale.

Certain items are typically excluded from being a permanent establishment. These include:

❒ The use of facilities in the host state solely to store, display or deliver merchandise belonging to a corporation organized in the resident state.

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40 Reg. §1.884-2T(d)(5).

41 Code §316(a).

- The maintenance of a stock of goods in the host state belonging to an enterprise solely for the purpose of storage, display or delivery, or solely for the purpose of processing by another entity in the host state.

- The maintenance of a fixed place of business in the host state solely for the purpose of purchasing goods or merchandise, or for collecting information, or for other activities that have a preparatory or auxiliary character for the corporation organized in the resident state.

- The presence of an independent agent in the host state, provided that the agent is acting in the ordinary course of its business as an independent agent. To come within this exception, the agent must be both legally and economically independent and must be acting in the ordinary course of its business in carrying out activities on behalf of the enterprise. This provision is not infrequently abused by small or medium sized foreign companies that wish to avoid the compliance requirements of U.S. tax law that are applicable to intercompany transactions. Here, the arrangement entails the funding of an exclusive sales agency owned by the principal sales manager in the U.S., but entirely funded by the foreign supplier.

III. Transactions Between U.S. Subsidiary and Foreign Affiliate

U.S. tax law imposes several distinct obligations on U.S. companies that are owned substantially by foreign persons or that are controlled by foreign persons. In some instances, the obligations may limit or defer deductions. In other instances, the obligation mandates reporting so that an I.R.S. examiner can be prepared to question certain intercompany transactions under Code §482.[42] In either event, the preparation of the tax return for the affiliate must take these provisions into account.

A. Reporting Transactions

When a U.S. company that has substantial foreign ownership enters into a transaction with a foreign affiliate, an obligation exists to report the amount of the transaction to the I.R.S. The obligation is imposed by reason of Code §6038. The stated reason is to allow the I.R.S. to determine the true taxable income of the 25% foreign-owned corporation under U.S. law. Reporting is made on Form 5472.

The reporting obligation is set forth in Reg. §1.6038A-2. Each reporting corporation is required to make a separate annual information return on Form 5472 with respect to each related party with which it engaged in a reportable transaction during the taxable year. The information must be furnished even if the particular item does not affect the amount of any tax that may be due.

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[42] A full discussion of Code §482 is beyond the scope of this paper.

Key terms that are defined in the regulations are "reporting corporation" "related party" and "reportable transaction".

The term "reporting corporation" is defined in Reg. §1.6038A-1(c). In general, it means either a domestic corporation that is 25% foreign-owned or a foreign corporation that is engaged in a trade or business in the U.S.[43] After November 4, 1990, a foreign corporation engaged in a trade or business within the United States at any time during a taxable year is a reporting corporation.[44]

For a corporation to be 25% foreign-owned, it must have at least one direct or indirect 25% foreign shareholder at some point during the taxable year.[45] The ownership threshold is met if a foreign person owns at least 25% of either (i) the total voting power of all classes of voting stock of the reporting corporation or (ii) the total value of all classes of stock of the reporting corporation.[46] These tests are applied on the basis of facts and circumstances and principles similar to Reg. §1.957-1(b)(2). These principles are designed to prevent a foreign corporation from avoiding the status of a controlled foreign corporation ("C.F.C.") by adopting a capital structure in which the class of shares retaining voting power is separated from the class of shares with value.[47] As a result, attempts to separate voting power from value will be closely examined to determine if a separation in form is also a separation in fact.

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43 Reg. §1.6038A-1(c)(1).

44 Code §6038C.

45 Reg. §1.6038A-1(c)(2).

46 Reg. §1.6038A-1(c)(3).

47 The 1986 Tax Reform Act introduced a test based on value to the then existing test based solely on voting power for purposes of determining whether a foreign corporation is a C.F.C. This put an end to many schemes that allocated shares with voting power to foreign persons and shares with value to U.S. persons. In the period since the enactment of the 1986 Tax Reform Act, §1.957-1(b)(2) has been applied to circumstances where a foreign corporation is owned in small part by one foreign entity and in equal and principal shares by a U.S. person and by a foreign person that, itself, is not owned in substantial part by a U.S. person. If the first mentioned foreign entity informally agrees to vote its shares with the U.S. person, the U.S. person is deemed to possess the requisite voting power even though it may not possess shares having the requisite value. As a result, the foreign corporation may be deemed to be a C.F.C.

In determining whether a corporation is 25% foreign-owned, the rules of constructive ownership in Code §318 continue to be applied in modified form.[48] The modifications appear in Code §6038(c)(5), which relates to the reporting of certain information by U.S. persons that control foreign corporations on Form 5471. The threshold for attribution to a shareholder from a corporation is reduced to 10% from 50%. (The ownership threshold has not been reduced for attribution from a shareholder to a corporation.) Also, the rules attributing ownership to a corporation, partnership or trust from a shareholder, partner or beneficiary will not be applied if the effect is to cause a U.S. person to be deemed to own shares actually owned by a non-U.S. person.

If no single foreign person owns or is considered to own through attribution the required 25% of the voting power or value of the corporation, the corporation is not a reporting corporation even if foreign persons own 25% or more of the voting power or value of the corporation.

The term "related party" includes a 25% foreign shareholder of the reporting corporation, determined after application of the attribution rules. It also includes a person who is related, within the meaning of Code §267(b) or §707(b), to the reporting corporation or to a 25% foreign shareholder. Finally, it includes a person that is related to the reporting corporation within the meaning of Code §482., i.e., under common control with the related person.[49]

In determining whether a reporting corporation has engaged in a transaction with a related person, all transactions of the partnership may be attributed to a partner that is a reporting corporation on a pro rata basis, determined by reference to relative partnership interests.[50] The rule applies if the reporting corporation directly or indirectly owns a capital or profits interest which by itself, or when added to the partnership interests owned by related parties, comprises 25% or more of the total interests in the partnership. The effect of this rule is to cause the reporting corporation to treat the partnership transactions as its own for purposes of the reporting, records maintenance, monetary penalty, agent for service of process, and production of records rules of the regulations.

A reportable transaction is any transaction with a foreign related person involving any of the following items:[51]

❒ Sales and purchases of stock in trade (inventory);

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48 Reg. §1.6038A-1(e)(1).

49 Reg. §1.6038A-1(d).

50 Reg. §1.6038A-1(e)(2).

51 Reg. §1.6038A-2(a)(2) and (b)(3).

- ❒ Sales and purchases of tangible property other than stock in trade;
- ❒ Rents and royalties paid and received other than those relating to intangible property;
- ❒ Sales, purchases, and amounts paid and received as consideration for the use of intangible property, including copyrights, designs, formulas, inventions, models, patents, processes, trademarks, and similar rights;
- ❒ Consideration paid or received for technical, managerial, engineering, construction, scientific, or similar services;
- ❒ Commissions paid or received;
- ❒ Amounts loaned and borrowed, excluding open accounts arising from sales and purchases made and collected in full in the ordinary course of business;
- ❒ Interest paid and received;
- ❒ Premiums paid and received for insurance and reinsurance; and
- ❒ Any other transaction not specifically mentioned above to the extent that such amounts are taken into account for the determination and computation of the taxable income of the reporting company.

A transaction is reportable even if monetary consideration is not required or is only part of the contemplated consideration.[52] Thus, for example, the provision of managerial services by a foreign related party for a start-up or troubled operation in the U.S. is a reportable transaction even if the services are provided without a fee. This, of course, is difficult for outside accountants to track.

The Form 5472 requires the reporting corporation to identify itself by providing its name, address, and U.S. taxpayer identification number. Similar information is provided for each 25% foreign shareholder, again determined after attribution rules are applied. Finally, information must be provided with regard to each related party, whether foreign or domestic, with which the reporting corporation has engaged in a reportable transaction.[53]

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[52] Reg. §1.6038A-2(a)(2) and (b)(4).

[53] Reg. §1.6038A-2(b)(2).

Three principal exceptions are provided to the filing requirement.[54] First, no reporting is required if a reporting corporation has no transactions during the year with any related parties. This exception does not relieve the reporting corporation of its obligations to maintain records or to serve as agent of process for a foreign related party. Second, if the reporting corporation is a foreign corporation for which all reportable transactions are with one or more related domestic corporations that are not members of the same affiliated group, the foreign corporation is excused from listing those transactions. Finally, no reporting is required with regard to a reportable transaction with a related corporation if a U.S. person controls the reporting corporation and files Form 5471 that fully describes the reportable transaction.

The Form 5472 is to be filed with the reporting corporation's income tax return.[55] If the income tax return is not timely filed, the Form 5472 is to be filed separately by the due date of the income tax return, as properly extended. A duplicate copy of the return is to be filed with the I.R.S. Center, Philadelphia, PA 19255.

B. Limitation on Interest Expense Deductions

U.S. tax law contains several limitations on the deduction of interest expense.

The simplest limitation applies to accrued but unpaid interest. A U.S. company is not entitled to a current interest expense deduction for accrued but unpaid interest owed to a related foreign entity unless an amount attributable to such item is currently includible in the income of the related foreign entity.[56] This provision is designed to recognize the U.S. tax benefit only when the offshore creditor is clearly subject to tax in its jurisdiction of residence. A similar limitation denies an interest expense deduction for original issue discount ("O.I.D.") on loans from related foreign persons.[57] Loans that do not provide for current payment of adequate interest are deemed to contain adequate O.I.D.

The limitations become more complex with the application of the earnings stripping rules.[58] Under the earnings stripping limitation, no deduction is allowed for disqualified interest (i.e., interest paid to a related person that is not subject to U.S. tax on receipt). The interest expense deduction is capped under the earnings stripping rules so that a U.S. borrower cannot claim a tax

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54 Reg. §1.6038A-2(f).

55 Reg. §1.6038A-2(d).

56 Code§267(a)(3).

57 Code §163(e)(3).

58 Code § 163(j).

benefit for excess interest expense. Disqualified interest may be carried forward and deducted in a subsequent year if sufficient excess limitation exists in the subsequent year.

The scope of the earnings stripping provision is broad. It contains no grandfather provision. Thus, interest on all related-party loans is covered. The earnings stripping rules could apply to defer the benefit of the interest expense deduction even if the interest is paid to unrelated holders of debt issued by a domestic corporation if two conditions are met. The first is that no U.S. withholding tax is imposed on the gross amount of the interest paid. The second is that the loan from the unrelated party is "guaranteed" by a related foreign person. For purposes of the limitation, a guarantee is any arrangement in which a person directly or indirectly assures, on a conditional or unconditional basis, the payment of another's obligation. Thus, any form of credit support received from a foreign parent in connection with a borrowing may result in the application of the earnings stripping rules to a particular borrowing.

The limitation applies if a corporation has "excess interest expense" and, at the end of its year or at other designated times, has a debt-equity ratio of greater than 1.5:1. The excess interest expense is not currently deductible.

Excess interest expense is the excess of “net interest expense” over the sum of 50% of adjusted taxable income plus excess limitation carryforward from the preceding three years. Net interest expense is the excess of interest expense over interest income. This computation is made by taking into account all interest income and interest expense of the corporation. The identity of the creditor is irrelevant. Adjusted taxable income means taxable income computed by adding back net interest expense, NOL carryovers, depreciation, amortization, and depletion. Excess limitation means the excess of 50% of adjusted taxable income over net interest expense in any particular year.

IV. Real Property Transactions

A. In General

The United States taxes a foreign party's disposition of U.S. real estate or shares in a U.S. Real Property Holding Company under a statutory provision known as the Foreign Investment in Real Property Tax Act (“F.I.R.P.T.A.”). F.I.R.P.T.A. mandates that income from the disposition of U.S. real property interests must be treated as income that is effectively connected with a U.S. trade or business.[59] This characterization removes real estate transactions from the class of capital gains that is generally exempt for foreign parties, and brings the normal income tax rules into play. As a result, the annual net gain or loss is taxed at the graduated statutory tax rates or at

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[59] Code §897(a)(1).

a minimum tax rate of 26% or 28%, or the favorable tax rates for long-term capital gains, currently 15%.

A major departure from the Code's normal tax provisions for foreign parties is in the nonrecognition override provisions under F.I.R.P.T.A. To ensure that the taxing provisions are not avoided by simple mechanisms such as like-kind exchanges and corporate reorganizations, Code §897 limits the application of nonrecognition transactions when USRPIs are involved. Generally, they are permitted only when the U.S. tax on gain is fully protected, such as when one USRPI is exchanged for another.

B. Withholding Obligation

The substantive tax rule under F.I.R.P.T.A. is augmented by a separate withholding tax provision.[60]

The purchaser of a U.S. real property interest from a foreign person is obligated to withhold 10% of the amount realized, i.e., the amount of cash and the value of other property given plus the amount of debt that is relieved. If the taxable event is in the form of a distribution of a U.S. real property interest by a foreign corporation, the amount to be withheld is increased to 35% of the appreciation over tax basis.[61]

C. Withholding Exemptions

Because the purchaser of the U.S. real property interest is personally liable for any unpaid F.I.R.P.T.A. withholding tax, an incentive exists to withhold unless a transaction is specifically exempted by the statute and regulations. Currently, there are seven situations in which withholding is not required. The transferee need not withhold if he or she is buying a property to use as a residence and the amount paid is $300,000 or less.[62] This provision is designed to relieve ordinary home buyers from the burden of withholding. The exemption applies not to the type of property but to the purpose for which it is bought. Investors must withhold even if they are buying a residential property. This provision does not excuse the seller from tax on the gain; it merely exempts the purchaser from having to withhold.

Withholding is not required from a transfer of any publicly traded class of corporate interests or any publicly traded partnership interest or trust interest.[63] Lenders foreclosing on or repossessing

[60] Code §1445.

[61] Reg. §1.1445-5(d).

[62] Reg. §1.1445-2(d)(1).

[63] Reg. §1.1445-2(c)(2).

a U.S. real property interest need not withhold in certain specially protected circumstances.[64] If they notify the Service of the foreclosure or repossession, their withholding obligation is 10% of the amount realized, or 10 percent of the excess of the amount realized over the debt, whichever is less. Thus, they must withhold only on amounts that will be paid over to the debtor.

Withholding is not required if the transferred property is not a U.S. real property interest.[65] The transferee withholding agent independently determines the status of an interest that is not an interest in a corporation or public partnership. If the transfer involves an interest in a corporation, withholding is negated by a statement from the corporation that it has not been a U.S. real property holding corporation within the five years ending on the date of the transfer. A transferee may normally rely on these statements unless it knows them to be false or is notified of that fact by an agent.

Withholding is required on a transfer of a nonpublicly traded partnership interest if a substantial part of the partnership's assets are real estate of the partnership consist of U.S. real property interests, and 90% or more of the value of the gross assets consist of U.S. real property interests plus cash or cash equivalents.[66] Otherwise, a partnership interest is not currently subject to withholding at all.

Withholding is not required if a transferor provides the transferee with a "certificate of non-foreign status" signed under penalty of perjury.[67] Except when the transferee has actual knowledge that such a statement is false, a withholding agent may rely on the statement. A nonforeign affidavit is not sent to the I.R.S. Instead, it is retained in the transferee's records. It must be kept for five years, and must be made available to the Service upon request.[68] If the buyer is a foreign person, the certificate of nonforeign status obtained when the property was purchased should be retained until the property is sold. A foreign seller asking for a withholding certificate from the I.R.S. must include documentation that all withholding on its purchase of the property was accounted for, and this certificate is that documentation.

A transferor may give the transferee a notice that a nonrecognition provision applies to excuse withholding if the entire gain will be covered by the nonrecognition provision.[69] Partial

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64 Reg. §1.1445-2(d)(3).

65 Reg. §1.1445-2(c)(1).

66 Reg. §1.1445-11T.

67 Reg. §1.1445-2(b)(2).

68 Reg. §§1.1445-2(b)(1) and 1.1445-2(b)(3).

69 Reg. §1.1445-2(d)(2).

nonrecognition requires a withholding certificate from the I.R.S. The validity of the affidavit is conditioned on the transferee's mailing a copy to the I.R.S., with a cover letter identifying the transferee, within twenty days after the transfer date.

All other claims of exemption from, or reduction of, F.I.R.P.T.A. withholding are made to the I.R.S. through the mechanism of a withholding certificate application. When a withholding agent receives a withholding certificate application, it is absolutely protected from liability for any unpaid tax, provided the amount specified in the withholding certificate is withheld and the payment requirements are met.[70] In form, a withholding certificate is a letter I.R.S. to the applicant stating that statutory authority exists to excuse withholding, in whole or in part, and that it may be relied on by the withholding agent.

Because of the absolute protection, withholding certificates may be of interest in situations that do not strictly require them, such as when a nonrecognition provision is claimed. The I.R.S. prefers not to issue certificates when an exemption can be claimed and supported without one, but will issue withholding certificates for a number of reasons.

Revenue Procedure 2000-35, 2000-2 C.B. 211, governs the kinds of certificates that will be issued and the information that must be supplied to get one. The two most common are based on the transferor's tax liability being less than the required amount of withholding tax, as when a net operating loss applies, and on the transferor's agreement to pay tax in a blanket withholding situation where a number of dispositions are planned over a short period. Other categories include installment withholding and secured agreements.

A special form, Form 8288-B, is used for applications in the three most common categories—nonrecognition transfers, maximum tax, and installment sales. For applications that Form 8288-B does not cover, the procedures set forth in Revenue Procedure 2000-35 and Reg. §§1445-3 and 1445-6 should be followed.

A withholding certificate application must be signed under penalty of perjury. A representative can sign it but must submit a power of attorney specifically authorizing the signing. The application must be filed with the Philadelphia Service Center not later than the date of the transaction. Common practice is for the purchaser to establish an escrow account and to deposit the full amount of statutory withholding in the account until such time as the certificate is issued.

In general, the I.R.S. response time is currently 45 days or less for applications in the three categories of certificate for which Form 8288-B is prescribed. The I.R.S. policy is to reply to any application within 90 days of receiving an application. It will advise the applicant by the forty-fifth day after receipt if it cannot respond in this ninety-day period.

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[70] Reg. §1.1445-2(d)(7).

V. Partnership Withholding Tax

Where a foreign person operates in the U.S. through a partnership or an entity treated as a partnership for U.S. income tax purposes such as an L.L.C., the general partners of the partnership have an obligation to withhold U.S. income tax on the distributive share of effectively connected income allocated to the foreign partner.[71] The general partners of the partnership – including the officers of a corporate general partner – are jointly and severally liable as withholding agents for the partnership.[72]

The amount of the withholding tax is the highest U.S. tax rate to which a foreign partner may be subject. At present, that rate will be 35% for a partner that is a foreign corporation or a foreign individual. Although labeled a withholding tax, the tax is more aptly thought of as an estimated tax payment. The reason is that the liability arises from the quarterly determination of income at the partnership level. The amount of the installment payments is determined by applying the estimated tax principles for annualizing income.

The fact that no distribution is made to the foreign partner is not material in abating or reducing the imposition of the withholding tax obligation. As a result, the tax results in difficult problems for partnerships having phantom income.

After the year ends, the foreign partner is required to file a tax return for the year. On that return the partner's final tax liability is computed. A credit may be claimed by the partner for the withholding tax collected by the partnership.[73] The amount of the credit allocable to the foreign partner is treated as distributed to the partner on the earlier of (1) the day on which the tax was paid by the partnership, or (2) the last day of the partnership's tax year for which the tax was paid, thus reducing the partner's basis in the partnership.[74]

The installment payments are due by the 15th day of the fourth, sixth, ninth and 12th months of the partnership's tax year.[75] Ordinarily, this is the 15th day of April, June, September, and December. Form 8813 is used to make the quarterly withholding payments.[76]

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[71] Code §1446.

[72] *See* Reg. §§1.1446-1 through 1.1446-7.

[73] Code §33.

[74] Code §1446(d)(2).

[75] Reg. §1.1446-3(d)(1)(ii).

[76] Reg. §1.1446-3(d)(1)(i).

The partnership reports the aggregate withholding tax liability for effectively connected taxable income for the tax year on Form 8804. At that time, catch-up payments should be made. The withholding tax for each foreign partner is reported on a separate Form 8805.

VI. Withholding Tax on Noneffectively Connected Income

When a U.S. person makes a payment of income to a foreign person, the payor must determine whether the income is subject to withholding tax in the U.S. and if so at what rate. For example, if a payment is made to an individual and no Taxpayer Identification Number is provided, the withholding agent must determine whether the proper withholding tax rate is 28% under the back-up withholding tax rules or 30% under the foreign person withholding tax rules. If the latter could apply, the withholding agent may have to determine whether the tax rate is reduced by an applicable income tax treaty or by the Code for items such as interest on items of portfolio indebtedness.

A. Interest on Portfolio Debt

An exception to the withholding tax for interest payments considered to arise from an item of portfolio indebtedness.[77] Such interest is totally exempt from U.S. withholding tax.

An item of portfolio indebtedness may be in two formats – (i) registered and (ii) unregistered, but targeted for foreign holders. Each is discussed in turn.

An obligation is in registered form if it meets certain requirements:

❒ The obligation must be registered as to both principal and interest and any transfer of the obligation may be accomplished only through the surrender of the old instrument and its re-issuance to the new holder or

❒ The right to the principal of, and stated interest on, the obligation may be transferred only through a book-entry system.[78]

In general, a book-entry system is a paperless record of ownership of an obligation where the transfer of ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued. A negotiable instrument would not be in registered form. The position of the I.R.S. is that a promissory note that is "payable to the order of" is not

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77 Code §§871(h) and 881(c).

78 Temp. Regs. §5f.103-1(c).

an item of portfolio indebtedness even if the note contains terms that limit the ability to negotiate and transfer the promissory note.

If a debt instrument is not in registered form, several conditions must be met to separate the borrowing from the U.S. so that it meets the rules for foreign targeted securities. These may be summarized as follows:

- ❒ There must be arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issuance) only to a person who is not a U.S. person;
- ❒ The interest on the obligation must be payable only outside the U.S.; and
- ❒ A statement must be shown on the face of the obligation that any U.S. person that holds the obligation will be subject to limitations under the U.S. income tax laws.[79]

To qualify as portfolio interest, the interest on the indebtedness may not be contingent on the business performance of the borrower or a related party.[80] Thus, the amount of the interest may not be calculated by reference to:

- ❒ Any receipts, sales or other cash flow of the borrower or a related person;
- ❒ Any income or profits of the of the borrower or a related person;
- ❒ Any change in value of any property of the borrower or a related person; or
- ❒ Any dividends, partnership distributions, or similar payments made by the borrower or a related person.

There are a few classes of creditors who cannot benefit from the exclusion. First, portfolio interest does not include interest received by a foreign bank in connection with the extension of credit in the ordinary course of its banking business.[81] Second, interest received by a “controlled foreign corporation” (referred to as a “C.F.C.”) that is related to the U.S. issuer does not qualify for the portfolio interest exemption.[82] Generally, a foreign corporation is a C.F.C. if shares

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79 Code §871(h)(2)(A) citing Code §163(f)(2)(B).

80 Code § 871(h)(4)(A).

81 Code §881(c)(3)(A).

82 Code §881(c)(3)(C).

representing more than 50% of the voting power or value, are owned by one or more U.S. persons, each of whom owns shares representing at least 10% of the voting power of the foreign corporation.[83] Third, the exemption does not apply to interest paid to a "10% shareholder."[84]

The term "10% shareholder" is defined by the Internal Revenue Code. If the borrower is a corporation, a 10% shareholder is any person who owns shares representing10% or more of the total combined voting power of all classes of stock entitled to vote. If the borrower is a partnership, a 10% shareholder is any person who owns 10% or more of the capital or profits interest in the partnership.

A 10% shareholder need not own shares directly in the borrower. Stock ownership is determined after application of attribution rules under which stock owned by one person is attributed to another person.[85] Under the attribution rules:

❒ An individual is considered to own stock actually owned by his or her spouse, children, grandchildren and parents.[86] However, stock attributed under this rule cannot be reattributed to other family members.[87] Thus, for example, stock owned by an individual cannot be reattributed to a sister in two stages, i.e., from the individual to the parent and then from the parent to the sister.

❒ An individual is considered to own his proportional share of stock actually owned by a partnership of which he is a partner, an estate or a trust of which he is a beneficiary, and a corporation of which he is a shareholder.[88]

❒ A partnership or an estate is considered to own stock actually owned by its partners or beneficiaries.[89]

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83 Code §957(a).

84 Code §§871(h)(3)(B) and 881(c)(3)(B).

85 Code §871(h)(3)(C). This provision refers to the general attribution rules of the Code which appear in §318 with certain modification.

86 Code §318(a)(1).

87 Code §318(a)(5)(B).

88 Code §318(a)(2) as modified by Code §871(h)(3)(C).

89 Code §318(a)(3)(A).

- ❐ A trust is considered to own the stock actually owned by its beneficiaries other than remote contingent beneficiaries whose interest in the trust is valued at 5% or less.[90]

- ❐ A corporation is considered to own a pro rata portion of stock in other corporations that is actually owned by its shareholders.[91] The portion is based on the ownership percentage maintained in the corporation that will be considered the owner under these rules.

- ❐ The holder of an option is considered to own the underlying shares.[92] However, stock attributed under this rule cannot be reattributed to or from corporations, partnerships, trusts, or estates.[93]

Except as provided above and in the following sentences of this paragraph, stock attributed from one person to another generally is considered to be actually owned by that individual and may be reattributed to other persons. Notwithstanding anything previously stated, stock attributed to a corporation, partnership, estate, or trust from its shareholders, partners, or beneficiaries cannot be reattributed to other shareholders, partners, or beneficiaries. Thus, stock cannot be attributed in two stages from one shareholder to a second shareholder, i.e., first from one shareholder to the corporation and second from the corporation to a second shareholder.

Similar attribution rules are to be applied if the borrower is a partnership or an L.L.C. In such case, however, the ownership standard is measured on a flow-through basis to the partners or members.

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90 Code §318(a)(3)(B).

91 Code §318(a)(3)(C) as modified by Code §871(h)(3)(C).

92 Code §318(a)(4).

93 Code §871(h)(3)(C).

B. Treaty Benefits

As previously mentioned, U.S. tax law imposes a 30% tax on items of fixed and determinable annual and periodic income of a foreign corporation or a nonresident, noncitizen individual.[94] However, the rate of withholding tax may be reduced or eliminated by an income tax treaty obligation of the U.S. Reflecting the fact that an income tax treaty is a contract between two nation states in which the nation states allocate the first right to impose tax to one and ensure that the other provides a form of relief so that income is not taxed twice, each income tax treaty is a unique document. While trends exist among all treaties, each one is unique and must be checked to determine whether and the extent to which they reflect the general trends. For example, direct investment dividends are taxed at 5%[95] or in some cases are completely exempt,[96] portfolio investment dividends are taxed at 15%,[97] and interest and royalties[98] are exempt from withholding tax.

The benefits provided by income tax treaties contain a safeguard intended to prevent inappropriate claims of treaty tax benefits. The provision is known as the limitation on benefits article of a treaty and with limited exception all treaties of the U.S. contain this type of provision. The provision reflects the policy of the U.S. Treasury Department that a treaty's benefits should be limited to qualified investors. The policy ensures that a reduction in U.S. withholding tax should be used only as a means of avoiding actual double taxation. With the exception of dividends that are exempt under a participation provision of foreign law, the United States will not reduce its withholding tax under a treaty if the treaty partner does not impose tax on the receipt of the income. The second goal is that only foreign entities with a strong connection to a treaty partner should benefit from U.S. treaty benefits. This goal is embodied in the limitations on benefits provisions that are part of the U.S. tax treaty negotiating policy.

Several broad themes exist under which a foreign corporation may qualify for treaty benefits. These may be summarized as follows, although it is emphasized that each treaty must be checked in advance because the limitation on benefits provision varies from treaty to treaty:

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94 Code §§1441 and 1442.

95 *See, e.g.*, Paragraph (2)(a) of Article 10 (Dividends) of the U.K.-U.S. Income Tax Treaty.

96 *See, e.g.*, Paragraph (3) of Article 10 (Dividends) of the U.K.-U.S. Income Tax Treaty.

97 See, *e.g.*, Paragraph (2)(b) of Article 10 (Dividends) of the U.K.-U.S. Income Tax Treaty.

98 See, *e.g.*, Paragraph (1) of Article 11 (Interest) and Paragraph (1) of Article 12 (Royalties) of the U.K.-U.S. Income Tax Treaty.

- ❒ Publicly traded companies qualify. Specific tests must be met regarding annual turnover of shares.

- ❒ Subsidiaries of publicly traded companies qualify.

- ❒ Companies that are primarily owned by resident individuals in that country or owned by U.S. residents or citizens (or a combination thereof) qualify if base erosion is absent. Base erosion means that the corporation is a conduit to residents of third countries so that the tax base in the treaty jurisdiction is eroded by deductible payments to persons not subject to tax in that country or the U.S. This provision is more limited in the case of countries that in the past were gateways to other countries, such as Cyprus, Barbados and The Netherlands, where U.S. ownership is generally not sufficient by itself or in conjunction with local ownership.

- ❒ In the context of treaties with European countries, a company owned by a defined class of third country persons (E.U. or N.A.F.T.A.) qualify if treaty exists with resident country of owners and benefits are identical in both treaties.

If a company does not qualify for general treaty benefits, it may, nonetheless qualify with regard to specific streams of income related to an active trade or business carried on in the country of residence that is viewed to be substantial in relation to the U.S. That substance is determined either under a facts and circumstances basis or in some circumstances under a safe harbor in which the foreign business is roughly 10% of the size of the U.S. business when viewed in terms of income, assets, and payrolls.

In some circumstances, the competent authority of the U.S. will rule that treaty benefits are allowed based on facts and circumstances even if none of the tests are met. This reflects a view that if there is no harm, there is no foul and typically applies if a resident in a treaty jurisdiction forms a company in a second jurisdiction to make an investment and the relevant treaty benefits in the second jurisdiction are not more favorable than the benefits in the treaty with the country of residence of the investor.

C. Purpose of W-9 and W-8BEN

If a person makes a payment of U.S. source interest, dividends, rents, royalties, commissions, non-employee compensation, and other forms of fixed or determinable annual or periodical income, a Form W-9 (Request for Taxpayer Identification Number and Certification) or a Form W-8BEN must be obtained from the payee. These forms provide information from which the payor can determine whether the recipient is an individual U.S. resident or a foreign person. If the former, the receipt of Form W-9 officially provides the payor with a taxpayer identification number (“T.I.N.”) of the recipient. If a valid is not received, a payment to an individual U.S. resident is subject to 28% back-up withholding. Among other things, the Form W-8BEN advises the payor that the individual is exempt from back-up withholding, is otherwise subject to 30%

withholding for payments to foreign persons, and may qualify for a reduced withholding tax rate under a treaty. The forms are retained by the withholding agent and not forwarded to the I.R.S.

If the payor receives neither a Form W-9 nor a Form W-8BEN, it must make a determination whether back-up or foreign person withholding tax is due. In making that determination, the payee is generally presumed to be a domestic person who is subject to 28% back-up withholding tax.[99] However, this presumption can be overcome in several circumstances.

The first circumstance is that the payment is made to a corporation or other entity exempt from domestic back-up withholding and all of the following facts exist: (1) the payor has actual knowledge of the payee's Employer Identification Number, a T.I.N. for entities and businesses, and the number begins with the digit "98;" (2) communications with the payee are mailed to an address in a foreign country; (3) the name of the payee indicates that it is on the list of foreign entities that are not eligible to check the box for partnership treatment; and (4) the payment is made outside the U.S. [100]

The second circumstance is that the payment is generally subject to foreign person withholding tax and is made outside the U.S. to an offshore account. An offshore account is one that is maintained at an office or branch of a U.S. or foreign financial institution located outside the U.S. Payment is considered to be made outside the U.S. if the payee completes the acts necessary to effect the payment outside the U.S.[101]

The final circumstance relates to payments on publicly traded securities. Under so-called "grace period rules," a payor may treat the payee as a foreign person for up to 90 days even if a valid Form W-8 is not held. The grace period rules apply only to (i) dividends and interest from shares of stock and debt obligations that are actively traded, (ii) dividends from a redeemable security issued by a mutual fund, (iii) dividends interest or royalties from units of beneficial interest in a unit investment trust publicly offered and registered with the S.E.C., and income related to loans of any of the foregoing securities.[102]

For the grace period rules to apply, the payor must have in its possession information indicating that the person is a foreign person. The information may be in the form of an address for the payee in a foreign country, or it may be a facsimile copy or a nonqualified electronic transmission of the information required to be stated in a Form W-8BEN has been received, or it

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[99] Reg. §1.1441-1(b)(3).

[100] Reg. §1.1441-1(b)(3)(iii)(A).

[101] Reg. §1.1441-1(b)(3)(ii)(C).

[102] Reg. §1.1441-6(c)(2).

may be a Form W-8BEN that may no longer be relied upon for a reason other than the lapse of time. The grace period begins for a newly opened account on the date amounts are first credited to an account. The grace period cannot extend beyond the close of the calendar year. It closes automatically when the amount in the account is reduced to 28% or less of all amounts credited to the account during the grace period. In general, information other than a valid Form W-8BEN or Form W-8IMY received by the payor during the grace period cannot be relied upon to reduce foreign person withholding tax. There is one exception. If the Form W-8BEN in the possession of the payor is complete and valid but for the fact that it was faxed, the payor may rely on the faxed Form W-8BEN to reduce foreign person withholding tax.

Due diligence obligations are imposed on the withholding agent with regard to each Form W-8BEN received. The withholding agent is responsible for ensuring that all information relating to the type of income covered by the form is complete and appears to be accurate. In that regard, the withholding agent may rely on the information and certifications provided on the form unless actual knowledge or reason to believe otherwise exists. Such knowledge or reason to believe could take the form of information in the possession of the agent that contradicts information provided on the form.

The due diligence standard is relaxed for withholding agents acting in connection with publicly traded securities of a kind mentioned above. For these withholding agents, reason to believe that the Form W-8BEN is erroneous is limited to several circumstances. First, a withholding agent has reason to suspect the veracity of the Form W-8BEN if records in its possession indicate that the permanent address of the recipient is in the U.S. Where such records exist, the recipient must be treated as a U.S. resident unless other information in the possession of the agent supports the claim of nonresidence and that other information is less than three years old. If such other information does not exist, the recipient must be contacted and must provide documentation supporting the statements in the Form W-8BEN.

Second, a withholding agent has reason to suspect the veracity of the Form W-8BEN if the address to which payment is directed is a post office box, an in-care-of address, or a U.S. address. Third, if a Form W-8BEN requests a reduction of foreign person withholding pursuant to the terms of an income tax treaty, a withholding agent has reason to suspect the veracity of the Form W-8BEN if the address to which payment is directed is not in the country with which the treaty exists. Fourth, the mailing address on the form is in the U.S., or the beneficial owner notifies you of a new address for mailing or residential purposes and the new address in the U.S., or is a post office box, or is an in-care-of address, or is not in the country with regard to which an income tax treaty benefit is claimed. In each of these circumstances, the withholding agent must obtain a certificate of residence or other documentary evidence issued by a foreign government that contains the individual’s name, address, and photograph to support the veracity of the Form W-8BEN. For persons other than individuals, the withholding agent may rely on other evidence to ascertain that the recipient is not a U.S. person, such as articles of incorporation or extracts or a deed of formation.

Finally, a withholding agent has reason to suspect the veracity of the Form W-8 if the form is internally inconsistent regarding the recipient's status such as a corporation, partnership, trust, estate, or individual.

D. Form W-8 BEN

The I.R.S. has published a series of Forms that must be used by persons wishing to reduce or eliminate withholding tax on payments received from U.S. persons.

The first form is the W-8BEN ("Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding"), which has been discussed above. This is the form that is used by foreign persons wishing to claim treaty benefits or an exception to the 28% back-up withholding tax for domestic individuals who fail to submit valid social security numbers to certain payors. The form requires full identification of the recipient, including a permanent address other than a post office box, the U.S. taxpayer identification number if required, and a foreign tax identifying number. In addition, if tax treaty benefits are claimed, the recipient – who is the beneficial owner – must certify that:

- ❐ He or she is a resident of a country that has an income tax treaty in effect with the U.S. and he or she must provide the name of that country;
- ❐ The U.S. taxpayer identification number is valid;
- ❐ If the recipient is not an individual, it meets the limitation on benefits provision of the applicable income tax treaty;
- ❐ If the recipient is not an individual and claims treaty benefits for dividends paid by a foreign corporation or interest paid by a U.S. trade or business which is subject to tax by virtue of the branch profits tax provisions of U.S. domestic law and the applicable treaty came into effect prior to January 1, 1987, that the recipient is a qualified resident of a treaty jurisdiction within the meaning of the branch profits tax provisions;
- ❐ If the recipient is related to the payor, the recipient will file form 8833 ("Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)").

In addition, the recipient must specify the article of the income tax treaty which provides the tax benefit, the rate of withholding tax, and the reason why the recipient meets the limitations on benefits article as to the particular item of income.

The Form W-8BEN is used by the beneficial owner of the income. The term "beneficial owner" is defined by reference to the anti-conduit regulations, Reg. §1.881-3. Thus, an "intermediate entity" treated as a "conduit" in a "financing transaction" cannot provide the "financed entity" with a Form W-8BEN as to income it receives.

Where the recipient is fiscally transparent, such as a hybrid entity or a trust, the form W-8 BEN must be obtained by the entity from the beneficiaries (if a trust), or the grantor (if a grantor trust), or its members (if a hybrid entity and certain other tests are met). Those forms are attached to a W-8IMY ("Certificate of Foreign Intermediary, Foreign Partnership, or Certain U.S. Branches for United States Tax Withholding").

E. Form W-8IMY

The second form released is the W-8IMY ("Certificate of Foreign Intermediary, Foreign Partnership, or Certain U.S. Branches for United States Tax Withholding"). This is the form that an intermediary submits to the payor of U.S. source income or gain. An intermediary is any person what acts as a custodian, broker, nominee, trustee, executor, or other type of agent for another person, even if the other person in that intermediary is the beneficial owner of the amount paid. Intermediaries may be either qualified intermediaries or nonqualified intermediaries. An intermediary is a qualified intermediary if it is one of a designated group of intermediaries and has entered into an arrangement with the I.R.S. to withhold and pay-over taxes applicable to payments to members and to provide the I.R.S. with sufficient information to support the appropriate withholding tax rates. The designated group consists of foreign financial institutions or foreign clearing houses, foreign branches of U.S. financial institutions or clearing organizations, foreign corporations for purposes of presenting claims of treaty benefits on behalf of its shareholders, and other persons accepted by the I.R.S. pursuant to Rev. Proc. 2000-12.[103]

The form is also used by foreign partnerships. The partnership may be a withholding foreign partnership or a nonwithholding foreign partnership. The former has entered into a withholding agreement with the I.R.S. in which it agrees to assume primary withholding responsibility for all payments that are made to it for its partners. A withholding foreign partnership is not itself subject to withholding and indicates such status on the Form W-8IMY. If the foreign partnership is a nonwithholding foreign partnership, it must provide Forms W-8BEN of all its partners to the payor of income to the foreign partnership. The payor can use the information to determine the appropriate amount of withholding tax that must be collected on behalf of the beneficial owners. In the context of tiered foreign partnerships, the higher tier foreign partnership is obligated to provide a Form W-8-IMY to the lower tier foreign partnership. The latter includes the form and attached certificates and documentation with its submission to the I.R.S. Note that if some of the beneficial owners claim treaty benefits and others do not, or if the rate of withholding tax differs among beneficial owners, a spread sheet must be attached to the Form W-8IMY that shows the income allocated to each beneficial owner.

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[103] Rev. Proc. 2000-12, 2000-1 C.B. 387, as supplemented by Announcement 2000-50, 2000-1 C.B. 998, as modified by Rev. Proc. 2003-64, 2003-32 I.R.B. 306.

F. Form W-8ECI

The I.R.S. also released Form W-8ECI ("Certificate of Foreign Person's Claim for Exemption from Withholding on Income Effectively Connected with the Conduct of a Trade or Business in the United States") and Form W-8EXP ("Certificate of Foreign Government or other Organization for United States Tax Withholding").

The W-8ECI replaces Form 4224. It specifically requests that each item of income that is expected to be received and that will be effectively connected with the conduct of a trade or business in the U.S. must be identified. The principal users of this form will be foreign entities that own real property in the U.S. and receive rental income and U.S. branches of foreign financial institutions that receive interest income and the like from business conducted in the U.S. by the branch.

G. Form W-8EXP

The Form W-8EXP is used by governments, international organizations, and central banks of issue not wholly owned by a foreign government. It requires the governmental entity to check a box which specifies the factual reason why the entity is legally entitled to the exemption of U.S. domestic law. The form is designed to ensure that the limitations imposed by Code §892 on the exemption provided to foreign governments are complied with. Under that provision, income of foreign governments derived from commercial activities, or income received by foreign governments from controlled commercial entities, and income received by a controlled commercial entity wholly owned by a foreign government do not qualify for exemption.

VII. State Taxes

A full discussion of the application of state taxes to a foreign entity engaged in business in the U.S. is beyond the scope of this paper. Nonetheless, certain items have been problematic on a recurring basis. They are:

❒ Worldwide income of a foreign entity may have to be apportioned for state income tax purposes. Beyond the fact that this represents "the tail (state tax considerations) wagging the dog (the groupwide tax director located outside the U.S.)," the tax base is not determined by reference to the effectively connected income rules that apply under Federal law.

❒ Items that are deductible for Federal tax purposes may not be deducted for state tax purposes. A typical example relates to royalty expense paid to a related party outside the U.S. State tax law may treat the royalty payment to a foreign licensee in a way that is similar to a royalty payment to an affiliate in Delaware.

❒ Income tax treaties of the U.S. do not apply to the various states, except for certain nondiscrimination provisions. Thus, a foreign entity that does not have a permanent establishment in the U.S., and for that reason is exempt from U.S. Federal tax on effectively connected income, may nonetheless be subject to state tax if the foreign entity is conducting business in a particular state.

VIII. Conclusion

As U.S. tax provisions applicable to foreign investment in the U.S. become more and more complex, the burdens on tax return preparers have grown concomitantly. The forms that are prepared after the close of the year do not reflect the judgments that must be made throughout the year in classifying income and expenses. This paper has attempted to bridge the gap between compliance and planning for the tax return preparer facing a daunting task.

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