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MEMORANDUM

To: Clients and Friends

From: Ruchelman P.L.L.C.

Re: U.S. Tax Planning and Compliance

Date: May 7, 2019

CONTENTS

INTRODUCTION[1]

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 the following:

- Effectively connected income[2]
- Allocation of expenses to that income[3]

Income tax treaties

- Arm's length transfer pricing rules[4]
- Permanent establishments under income tax treaties[5]
- Limitation on benefits provisions in income tax treaties that are designed to prevent "treaty shopping"[6]
- State tax apportionment

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1 This memorandum has been prepared for general informational purposes only. It is not intended to serve as legal advice or opinion and should not be relied upon as such. Readers are responsible for obtaining advice from their own legal counsel.

2 Section 864(c) of the Internal Revenue Code of 1986 as amended from time to time and currently in effect (the "Code").

3 Treas. Reg. §§1.861-8 through 1.861-17.

4 Code §482.

5 *E.g.*, Article 5 (Permanent Establishment) of the U.K.-U.S. Income Tax Treaty.

6 *E.g.*, Article 24 (Limitation on Benefits) of the Luxembourg-U.S. Income Tax Treaty.

- Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A.") withholding tax for transactions categorized as real property transfers[7]

- Fixed and determinable annual and periodical income ("F.D.A.P.")[8]

- Interest on items of portfolio debt.[9]

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 Internal Revenue Service ("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 if the following statements apply:

- The foreign investor itself, if it engages in a transaction directly in the U.S. that produces effectively connected taxable income or loss[10]

- The U.S. subsidiaries of the foreign investor, if they engage in transactions with affiliates controlled by the same investor[11]

- 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[12]

- General partners of partnerships that report effectively connected income as part of the distributable share of a foreign partner[13]

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[7] Code §1445.

[8] Code §§871, 881, 1441, and 1442.

[9] Code §§871(h)(2) and 881(c)(2).

[10] Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*, Section II.

[11] Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*.

[12] Form 8288-B, *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests*.

[13] Form 8804, *Annual Return for Partnership Withholding Tax*, *Section* 1446, Form 8804-C *Certificate of Partner-Level Items to Reduce,* §1446 Withholding, and Form 8805, *Foreign Partner's Information Statement of Section1446 Withholding Tax*.

- Payors of income, other than effectively connected income, deemed to be from U.S. sources[14]

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 (i) Federal income tax or alternative minimum tax, (ii) Federal branch profits tax on the dividend equivalent amount arising from taxable income; and (iii) state income tax. There also may be U.S. tax exposure imposed on the employees physically present in the U.S.

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 U.S. that is considerable, continuous, and regular.[15] 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, which 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.[16] 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.[17] 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.[18]

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.[19] With limited exceptions, a foreign corporation that is not engaged in

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14 Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*.

15 *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).

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

17 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.

18 *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.

19 *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);

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.[20] Two exceptions relate to dispositions of assets used in a trade or business in prior years and to deferred payment transactions.[21] In these instances, income is treated as effectively connected with a business conducted in an earlier year.[22] In addition, a foreign corporation can elect to treat real property income as connected with a U.S. trade or business.[23]

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.[24] Moreover, the gross income must be attributable to the conduct of a trade or business in the U.S. Only limited circumstance 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 banking, financing, or similar business by an investment company, and sales of inventory for use and consumption outside the U.S.[25]

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

For services income, the place where services are performed controls the source of the resulting service fee income.[26] 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.[27] Only the portion of the fee considered to be U.S.-

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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.

[20] Code §864(c)(1)(B).

[21] Code §§864(c)(6) and (7).

[22] Code §864(b).

[23] Code §882(d).

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

[25] Code §864(c).

[26] Code §861(a)(3).

[27] Treas. Reg. §1.954-4.

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 manufacture and sale of inventory property is allocated based on the location of production of the inventory. If the inventory is produced partly in and partly outside the U.S., the income is sourced in the U.S. to the extent allocated to the production in the U.S.[28] Thus, income derived from the sale of inventory property to a customer in a foreign jurisdiction is sourced wholly within the U.S. if the property is produced by the taxpayer entirely in the U.S., even if title passage occurred elsewhere. Similarly, income derived from the manufacture abroad of inventory property and the sale of that property in the U.S. is sourced in that country even if title passage occurs in the U.S.

The source of rental income is dependent on the place where the property is located.[29] For example, if rental real property is located within the U.S., the rental income is treated as an item of U.S.-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.[30] This will occur if income is derived from assets used or held for use in the conduct of a U.S. trade or business or the activities of the U.S. trade or business were a material factor in the realization of the income.[31]

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.[32] However, dividend-paying stock acquired and held to assure a constant source of supply for the trade or business of the U.S. branch is generally not an asset held for use in the conduct of a trade or businesses.[33] An asset is also viewed to be held for use in the conduct of a trade or business if it is acquired and held in the ordinary course of the trade or business conducted in the U.S..[34] 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 where a direct relationship exists between the asset and the trade or business.[35] This will exist if (i) the asset was acquired with funds of the business, (ii) the

28 Code §863(b).

29 Code §861(a)(4).

30 Code §864(c)(2).

31 Code §864(c)(2)(A)-(B).

32 Treas. Reg. §1.864-4(c)(2)(ii)(a).

33 Treas. Reg. §1.864-4(c)(2)(iii)(a).

34 Treas. Reg. §1.864-4(c)(ii)(b).

35 Treas. Reg. §1.864-4(c)(ii)(c).

income from the asset is retained or reinvested in the business, and (iii) U.S. personnel exercise significant management and control over the asset.

Before the enactment of the 2017 Tax Cuts and Jobs Act ("T.C.J.A."), the gain or loss of a foreign partner from a disposition of an interest in a partnership that conducts a trade or business through a fixed place of business in the U.S. was treated as gain or loss effectively connected with the U.S. trade or business.[36] However, the Tax Court, in Grecian Magnesite Mining, Industrial & Shipping Co. case[37] rejected the ruling position and held that a foreign corporation's gain on the sale of an interest in a partnership that was engaged in a U.S. trade or business was not U.S.-source income and wasn't effectively connected with a U.S. trade or business. The T.C.J.A. however, codified the position reached in the revenue ruling.[38] The partner's distributive share of the gain or loss from the sale of the partnership interest is treated as effectively connected gain or loss to the extent of a sale by the partnership of all its assets at their fair market value.[39]

If any portion of the gain on any disposition of an interest in a partnership is treated as effectively connected with the conduct of a U.S. trade or business, the buyer is required to deduct and withhold a tax equal to 10% of the amount realized on the disposition by the seller.[40] If the buyer fails to withhold the tax, the partnership is liable to deduct and withhold the tax and interest from subsequent distributions made to the buyer.[41] However, no withholding is required if the transferor furnishes an affidavit to the transferee stating, under penalty of perjury, that the transferor is not a foreign person. The statement must include the U.S. taxpayer identification number.[42] If the partnership holds any U.S. real property interests at the time of the sale or exchange of the partnership interest, the gain or loss treated as effectively connected income is reduced by the amount treated as effectively connected with the conduct of a U.S. trade or business because of the U.S. real property interests.[43] This is discussed below.

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 Treas. Reg. §§1.861-8 through 17. 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

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36 Revenue Ruling 91-32.

37 (2017) 149 T.C. No 3.

38 Code §864(c)(8)(A).

39 Code §864(c)(8)(B)(i).

40 Code §1446(f)(1).

41 Code §1446(f)(4).

42 Code §1446(f)(2)(A).

43 Code §864(c)(8)(C).

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 entirely nondeductible. 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.[44] The amount of interest expense allocable to effectively connected income of a foreign corporation is the sum of (i) the interest paid or accrued on liabilities booked in the U.S., as adjusted under a three-step process described below, and (ii) the directly allocated interest. Direct allocation of interest that can be directly allocated under the Reg. §1.861-10T rules is mandatory.[45] However, the I.R.S. has noted that certain U.S. income tax treaties provide for other interest allocation methods. If that type of treaty is applicable, the methods prescribed under the specific treaty may be used instead of the three-step method in Treas. Reg. §1.882-5.[46]

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 of debt

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44 Treas. Reg. §1.882-5.

45 *Id.*

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

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.[47] 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.[48] As a result, the excess is subject to the equivalent of a 30% 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.[49]

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

Income Taxes

Regular income tax is imposed on the net effectively connected income, after allowance of deductions.[50] The T.C.J.A. has reduced the corporate tax rate from 35% to a flat rate of 21% for tax years beginning after December 31, 2017. Further, the T.C.J.A. abolished the alternative minimum tax on corporations.

In addition to the regular income 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.[51] This tax is the functional equivalent of a dividend withholding tax imposed when a U.S. corporation pays a dividend to its foreign shareholder.

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

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

[48] Code §884(f)(1)(B); Treas. Reg. §1.884-4(a)(2).

[49] Treas. Reg. §1.884-4(a)(2)(iv).

[50] Code §§882 and 11.

[51] Code §884.

been retained in the U.S. and no equivalent of a dividend has been effectively distributed to foreign shareholders.

Several traps for the unwary exist with regard to 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.[52] This treatment equates to the 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.[53] 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 the 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 three-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 wholly-owned 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.[54] 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 are satisfied. Moreover, the foreign corporation must agree to terminate deferral of the branch profits tax in the event the shares of the U.S. transferee are sold or

[52] Treas. Reg. §1.884-2T(a)(1).

[53] Treas. Reg. §1.884-2T(a)(2).

[54] Treas. Reg. §1.884-2T(d)(1)-(4).

otherwise disposed of other than in an F-reorganization or a complete liquidation of the transferee, which is covered by Code §332.[55]

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.[56] Consequently, the branch profits tax on the dividend equivalent amount can be looked at as a trap for the unwary.

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. 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 visit actual or potential customers 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 following items:

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

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[55] Treas. Reg. §1.884-2T(d)(5).

[56] Code §316(a).

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

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 examiner can be prepared to question certain intercompany transactions under Code §482.[57] In either event, the preparation of the tax return for the affiliate must take these provisions into account.

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 Treas. 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.

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

The term reporting corporation is defined in Treas. Reg. §1.6038A-1(c). In general, it means either a domestic corporation that is 25% foreign-owned, a foreign corporation that is engaged in a trade or business in the U.S,, or a U.S. disregarded entity that is wholly owned by a foreign person.[58] 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.[59] 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

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

[58] Treas. Reg. §1.6038A-1(c)(1).

[59] Treas. Reg. §1.6038A-1(c)(2).

total value of all classes of stock of the reporting corporation.[60] These tests are applied on the basis of facts and circumstances and principles similar to Treas. Reg. §1.957-1(b)(2).

In determining whether a corporation is 25% foreign-owned, the rules of constructive ownership in Code §318 continue to be applied in modified form.[61] 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.[62]

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.[63] 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:[64]

- Sales and purchases of stock in trade (inventory)
- Sales and purchases of tangible property other than stock in trade
- Rents and royalties paid or received other than those relating to intangible property

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[60] Treas. Reg. §1.6038A-1(c)(3).

[61] Treas. Reg. §1.6038A-1(e)(1).

[62] Treas. Reg. §1.6038A-1(d).

[63] Treas. Reg. §1.6038A-1(e)(2).

[64] Treas. Reg. §§1.6038A-2(a)(2) and (b)(3).

- Sales, purchases, and amounts paid or 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 or borrowed, excluding open accounts arising from sales and purchases made and collected in full in the ordinary course of business

- Interest paid or received

- Premiums paid or received for insurance and reinsurance

- 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 domestic disregarded entity wholly owned by a foreign person is subject to a greater reporting requirement. In addition to reporting the above transactions, it is required to report any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented.[65] This requirement is intended to ensure that all transactions by the disregarded entity are reported on a U.S. tax form even if not considered to be an item of effectively connected income. The domestic disregarded entity is treated as a corporation rather than as disregarded entities for purposes of the reporting requirements. Therefore, the disregarded entity is required to attach Form 5472 to Form 1120 and mail it to the I.R.S. The option to electronically file the form is not available to a foreign owned U.S. disregarded entity.

A transaction is reportable even if monetary consideration is not required or is only part of the contemplated consideration.[66] 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.[67]

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[65] Treas. Reg. §1.482-1(i)(7).

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

[67] Treas. Reg. §1.6038A-2(b)(2).

Three principal exceptions are provided to the filing requirement.[68] 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.[69] 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. The reporting corporation is subject to a penalty of $25,000 (increased from $10,000 for tax years beginning after December 31, 2017) for failure to file, failure to filing late, or filing a substantially incomplete form.

Hybrid Arrangements Between a U.S. Corporation and Foreign Affiliates

Hybrid arrangements generally tend to exploit differences in the tax treatment of a transaction or entity under the laws of two or more tax jurisdictions to achieve double non-taxation, double deductions, or other tax benefits resulting from inconsistent treatment between the foreign law and U.S. law. For example, an entity may be a fiscally transparent entity for U.S. federal tax purposes but not so in the country in which it is resident or subject to tax (and *vice versa*) ("Hybrid Entity").[70] Similarly, an instrument may be treated as debt in one country but not in another, in which case a payment under the instrument may be a deductible interest expense in the payor's jurisdiction but an exempt dividend in the recipient's country.

Before T.C.J.A., there was no explicit disallowance of a deduction for an amount paid under a hybrid arrangement where the payor in the U.S. claimed a deduction and the recipient abroad did not pay tax on the receipt because, for example, the transaction was viewed to be an internal transaction within a single business entity. The T.C.J.A. introduced a provision that disallows a deduction for interest or royalty paid or accrued by a U.S. taxpayer to a related recipient that is not required to include the payment in income. For the deduction to be disallowed, the transaction must be either a hybrid transaction or by or to a Hybrid Entity.[71] A hybrid transaction is any transaction, agreement, or instrument involving one or more payments that are treated as interest or royalties for Federal income tax purposes when comparable treatment is not provided to the recipient for purposes of the tax law in its country of residence (or in a country where the recipient is subject to tax).[72] Under an exception, the expense is not disallowed if and to the extent the

[68] Treas. Reg. §1.6038A-2(f).

[69] Treas. Reg. §1.6038A-2(d).

[70] Code §267A(d).

[71] Code §267A(a).

[72] Code §267A(c).

recipient is a C.F.C. as to the U.S. and the payment is included as Subpart F income in the tax return of a U.S. Shareholder.[73]

Base Erosion and Anti-abuse Tax

The T.C.J.A. provided for a 100% deduction of the foreign sourced dividends received by a U.S. corporate shareholder if the shareholder owns at least 10% of the total voting power or the total value of shares of the foreign corporation ("D.R.D.").[74] Congress was concerned about attempts by affiliates of a multi-national corporation to erode the U.S. tax base by making deductible payments to related foreign corporations which would in turn declare dividends that would be exempt from U.S. tax as a result of the D.R.D. Therefore, in order to curb this base erosion practice, the T.C.J.A. implemented the base erosion anti-abuse tax ("B.E.A.T.").[75] The B.E.A.T. levied on a taxpayer only if it meets the following tests:

- The taxpayer must be a corporation that is not a regulated investment company, a real estate investment trust, or an S-corporation
- Its average annual gross receipts for the preceding three-year period are at least $500 million
- Its base erosion percentage for the tax year is at least 3% (2% for certain banks and registered securities dealers)[76]

In general terms, the base erosion percentage is computed by dividing the base erosion tax benefits by the sum of all allowable deductions subject to certain exceptions.[77]

The base erosion tax benefits are the payments made to foreign related parties with respect to which the payor is entitled to a tax deduction. Such payments include the acquisition costs of an asset that is subject to depreciation or amortization, as well as certain reinsurance payments.[78] However, any amount paid or accrued with respect to U.S.-source F.D.A.P. income is not treated as a base erosion tax benefits to the extent the payment is subject to full 30% U.S. withholding tax.[79]

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[73] Code §267A(b).

[74] Code §245A.

[75] Code §59A.

[76] Code §59A(e)(1).

[77] Code §59A(c)(4)(A).

[78] Code §59A(d).

[79] Code §59A(c)(2)(B).

The denominator of the base erosion percentage fraction is the sum of the taxpayer's total deductions allowable for the taxable year. Some deductions are not included in the denominator which, *inter alia*, include the following instances: [80]

- The net operating losses of the taxpayer
- The D.R.D. (mentioned above)
- The Code §250 deduction for global intangible low-taxed income and foreign-derived intangible income
- The U.S.-source F.D.A.P. payments to the extent they are subject to U.S. withholding tax

A related party for this purpose is defined to mean any 25% owner of the taxpayer by vote or value, related persons under Code §267(b) or §707(b)(1), or any person related under Code §482.[81]

In general terms, the B.E.A.T. is imposed when (i) the deductible payments to foreign related parties are greater than 3% of all deductible payments of the taxpayer, including payments to related parties and (ii) the taxpayer meets the $500 million average-gross-receipts threshold.

If the above conditions are satisfied, the corporate taxpayer is liable to pay the B.E.A.T. which is equal to the excess of 10% (5% for 2018; 12.5% after 2025) of the modified taxable income, or its regular tax liability reduced by some tax credits.[82]

The corporate taxpayer's modified taxable income is its taxable income increased by the amount of the taxpayer's base erosion tax benefits and base-erosion percentage of net operating loss deduction.[83]

<u>Limitation on Interest Expense Deductions</u>

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.[84] 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

80 Code §59A(c)(2)(B); Code §59A(c)(4)(B).

81 Code §59A(g).

82 Code §59A(b).

83 Code §59A(c).

84 Code §267(a)(3).

discount ("O.I.D.") on loans from related foreign persons.[85] Loans that do not provide for current payment of adequate interest are deemed to contain adequate O.I.D.

Before the enactment of the T.C.J.A., a corporation was denied the interest deduction for disqualified interest (*i.e.*, interest paid to a related person that is not subject to U.S. tax on receipt) to the extent of the corporation's excess interest expense (*i.e.*, the excess of net interest expense over the sum of 50% of the adjusted taxable income plus the excess limitation carryforward from the preceding three years). The limitation was applicable in any year that the U.S. corporation had a debt-to-equity ratio greater than 1.5 to 1. This is referred as the earning stripping rule.

The T.C.J.A. repealed the earnings stripping rules and replaced them with a limitation on the deduction of business interest.[86] Under this limitation, the deduction allowed for business interest for any tax year is limited to the sum of the following amounts:

- The taxpayer's business interest income for the tax year
- 30% of the taxpayer's adjusted taxable income for the tax year
- The taxpayer's floor plan financing interest[87] for the tax year

In other words, if the taxpayer did not earn any interest income or incur any floor plan financing interest, the new law limits the deduction for net interest expense to 30% of the adjusted taxable income. Further, the amount above is ignored if the taxpayer incurred losses for the tax year. Any disallowed business interest because of the business interest limitation can be carried forward indefinitely.[88]

<u>Foreign-Derived Intangible Income ('F.D.I.I.") – Servicing Foreign Markets</u>

The F.D.I.I. provisions impose a reduced corporate tax for hypothetical intangible income used in a U.S. business in servicing foreign markets. Under the F.D.I.I. rules, the hypothetical intangible income is reduced by a 37.5% deduction which results in an effective Federal corporate income tax rate of 13.125% for a U.S. corporation.[89]

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85 Code §163(e)(3).

86 Code §163(j)(1).

87 Floor plan financing interest is the interest incurred on the debt used to finance the acquisition of motor vehicles held for sale or lease and secured by the inventory so acquired.

88 Code §163(j)(2).

89 For tax years beginning after December 31, 2025, the effective tax rate will be 16.406%. Code §250(a)(3)(A).

A key concept under F.D.I.I. is the computation of a U.S. corporation's hypothetical intangible income, knows as deduction eligible income ("D.E.I."). The computation of D.E.I. begins with the gross income of the domestic corporation, from which the following income items are removed:

- Subpart F Income derived from C.F.C.'s and included in taxable income under Code §951(a)(1)
- Amounts of G.I.L.T.I. derived from C.F.C.'s and included in taxable income under Code §951A
- Financial services income of the corporation, typically limited to financial institutions
- Any dividend received from a C.F.C. in which the corporation is a U.S. Shareholder
- Domestic oil and gas extraction income of the corporation
- Foreign branch income[90]

Foreign branch income is defined as the business profits attributable to a qualified business unit ("Q.B.U.") in one or more foreign countries, unless the profits are categorized as passive income.[91] A Q.B.U., in turn, is any separate and clearly identified unit of a trade or business maintaining separate books and records.[92] In broad terms, a Q.B.U. is a formal branch or permanent establishment maintained in a foreign country by a U.S. corporation, provided the office is not merely a representative office having sales solicitation as its only function. The House Report to the 1986 Tax Reform Act provided the following relevant example:[93]

> For example, assume a corporation that manufactures and sells product X in the United States decides to establish an office in France. The French office maintains one salesperson whose only function is to solicit orders for product X, and the remaining sales functions continue to be conducted in the United States. On these facts, the activity of the French office would not be viewed as giving rise to a qualified business unit of the corporation.

D.E.I. is then reduced by a deemed 10% return on the corporation's qualified business asset investment ("Q.B.A.I.").[94] Q.B.A.I. is measured by reference to the U.S. corporation's average aggregate adjusted bases in depreciable tangible property used in the production of D.E.I. The average is computed by adding the Q.B.A.I. on the last day of each quarter during the year and multiplying the sum by 25%. As with G.I.L.T.I., a software engineering firm is not likely to have significant investment in Q.B.A.I., meaning that the reduction of D.E.I. by a deemed 10% return of Q.B.A.I. should be negligible. The result is then prorated

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[90] Code §250(b)(3)(A)(i)(VI).

[91] Code §904(d)(2)(J).

[92] Code §989(a).

[93] H.R. Rep. No. 99-426, at 472 (1985).

[94] Code §250(b)(2)(A).

in the ratio by which export-related D.E.I. (foreign derived deduction eligible income or "F.D.D.E.I.") bears to total D.E.I.

For purposes of the computation, F.D.D.E.I. is D.E.I. derived in connection with (i) property sold to a non-U.S. person and which is for non-U.S. use ("F.D.D.E.I. Sales") and (ii) services provided by the taxpayer to any person, or with respect to property, located outside the U.S. ("F.D.D.E.I. Services").[95] Non-U.S. use means use, consumption, or disposition which occurs outside the U.S.[96] The term "sold" includes any lease, license, exchange, or other disposition.[97]

If proposed regulations are adopted in their current version, F.D.D.E.I. Services will be divided into four groups:[98]

- **Transportation Services.** Transportation Services are services to transport a person or property using aircraft, railroad rolling stock, vessel, motor vehicle, or any similar mode of transportation. The services must be provided to a recipient or with respect to property located outside the U.S.

- **Property Services**. Property Services are services, other than transportation services, provided with respect to tangible property provided with respect to tangible property located outside the U.S. Substantially all of the service must be performed where the property is located and must result in physical manipulation of the property. Examples include assembly, maintenance, or repair. For this purpose, "substantially" means that more than 80% of the time providing the service is spent at or near the location of the property.

- **Proximate Services**. Proximate Services are services, other than property services or transportation services, provided to a recipient located outside the U.S., if substantially all of the service is performed in the physical presence of the recipient or the recipient's employees (in the case of a business recipient). For this purpose, "substantially" means that more than 80% of the time providing the service is spent in the physical presence of the recipient or its employees.

- **General Services**. General Services constitutes the default category. It encompasses all services not included in the other categories, provided to recipients located outside the U.S. General Services are divided into two broad categories. One consists of services directed at individual consumers located outside the U.S. who use the service for personal needs ("B2C"). The other consists of services directed at business recipients located outside the U.S.("B2B").

A service is provided to a business recipient outside the U.S. if (i) the business recipient is located outside the U.S. and (ii) the service provider obtains supporting documentation from the service recipient.[99] A business recipient is located outside the U.S. if, from the viewpoint of the customer, the service fee is an

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[95] Code §250(b)(4).

[96] Code §250(b)(5). Specific rules exist for non-U.S. related-party transactions.

[97] Code §250(b)(E).

[98] Prop. Treas. Reg. §1.250(b)-5(b).

[99] Prop. Treas. Reg. §1.250(b)-5(e)(1).

expense that is allocated to the recipient's operations outside the U.S. In other words, the service fee must relate to the customer's operations located outside the U.S. Operations are deemed located in any location where the service recipient maintains an office or other fixed place of business.[100] Supporting documentation includes a written statement by the service recipient, a binding contract specifying the locations of the operations of the business recipient that benefit from the service, documentation obtained during the course of the provision of the service, publicly available information establishing the location of the operations, any other type of documentation prescribed by the I.R.S. 101 Special rules exist for business receiving less than $10 million in gross receipts during a prior taxable year.

Income derived in connection with services provided to a related party that is not located in the U.S. is treated as F.D.D.E.I. only if the taxpayer establishes to the satisfaction of the I.R.S. that such service is not substantially similar to services provided by the related party to persons located within the U.S.[102] For this purpose, a subsidiary constitutes a related party with regard to a parent corporation if the parent corporation directly holds at least 50% of the stock, by vote or value, in the subsidiary.[103] This essentially constitutes an anti-abuse rule to fight against triangular transactions in which a U.S. service provider provides services to a non-U.S. related party that forwards the output of the services to a U.S. customer.

C.F.C. Rules – Subpart F and G.I.L.T.I.

A foreign corporation is considered to be a C.F.C. if shares representing more than 50% of the voting power or 50% of the value of the stock are owned directly, indirectly, or by attribution from others by five or fewer U.S. persons, and each of whom own shares representing at least 10% of the voting power or the value of the stock.[104]

The U.S. persons who meet the 10% ownership test are referred to as U.S. Shareholders. If a foreign corporation is a C.F.C., its U.S. Shareholders must report their respective share of Subpart F income on a yearly basis, to the extent of available earnings and profits ("E&P"), even if actual distributions are not received from the C.F.C.[105] This *pro rata* share constitutes the amount that would have been distributed with respect to the stock owned by the shareholder if the C.F.C. had actually distributed, on the last day during the taxable year in which it was a C.F.C., an amount equal to its Subpart F income as a dividend *pro rata* to all its shareholders.[106] The regulations further state that for purposes of determining the income inclusion amount, a person's proportionate interest in a foreign corporation is generally determined with

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100 Prop. Treas. Reg. §1.250(b)-5(e)(2)(ii).

101 Prop. Treas. Reg. §1.250(b)-5(e)(3).

102 Code §250(b)(5)(c)(ii).

103 Code §250(b)(5)(D).

104 Code §951(b).

105 Prior to the U.S. tax reform of 2017, all U.S. Shareholders also had to include their *pro rata* share of investments of earnings in U.S. property. Please see below for a discussion on this particular point.

106 Treas. Reg. §1.951-1(b)(1)(i).

reference to that person's interest in the income of the corporation.[107] Note that if the U.S. Shareholder is an individual or owns shares through an S-corporation, no foreign tax credit may be claimed for the corporate income taxes that are imposed on the C.F.C. when and as income is earned.

Pre-2018 Scope of C.F.C. Taxation – Subpart F Income

Under prior law, only the earnings from specified tainted income were subject to tax immediately under Subpart F. Tainted income includes, *inter alia*, foreign base company income,[108] which has three broad components: Foreign Personal Holding Company Income, and Foreign Base Company Services Income, and Foreign Base Company Services Income.[109] Other forms of Subpart F Income exists but are not generally relevant.

Foreign Personal Holding Company Income principally includes investment type income and gains.[110] Foreign Base Company Services Income is income derived by a C.F.C. in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which (i) are performed for or on behalf of any related person and (ii) are performed outside the country under the laws of which the controlled foreign corporation is created or organized.[111] As a result, income from services performed by a C.F.C. in its country of incorporation does not constitute Foreign Base Company Services Income. In applying the foregoing definition, the place where services are performed is a factual determination. Generally, services are considered performed where the persons performing the services for the C.F.C. are physically located during the performance of the services.[112] In addition, a person is related to the C.F.C. if (i) that person controls, or is controlled by, the foreign corporation, or (ii) that person is controlled by the same person or persons which control the foreign corporation.[113]

Expanded Scope of C.F.C. Taxation – G.I.L.T.I. Rules

Prior to 2018, income of a C.F.C. that did not cause its U.S. Shareholder to be taxed under Subpart F, generally could be deferred indefinitely by that U.S. Shareholder. Only a dividend distribution or an investment in "U.S. Property"[114] by the C.F.C. (*viz*., a loan to a parent company in the U.S.) would terminate deferral.

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[107] Treas. Reg. §1.958-1(c)(2).

[108] Code §954.

[109] Code §954.

[110] Code §954(c).

[111] Code §954(e).

[112] Treas. Reg. §1.954-4(c).

[113] Code §954(d)(3).

[114] Code §956.

The rules changed for 2018 in a way that significantly terminates the opportunity for complete deferral of tax when a U.S. person is a U.S. Shareholder of a C.F.C. Under the expanded rules, income that is not already taxed at the U.S. Shareholder level under the C.F.C. regime can be subject to tax when and as earned by the C.F.C. under the new global intangible low-taxed income regime ("G.I.L.T.I.").[115] Broadly speaking, under G.I.L.T.I., income of a C.F.C. that is not otherwise previously taxed under the C.F.C. regime is split into two pools. One is characterized as "Net C.F.C. Tested Income" and the other one as "Net Deemed Tangible Income Return," which is part of Net C.F.C. Tested Income. The excess of the former over the latter constitutes a U.S. Shareholder's G.I.L.T.I. inclusion amount. Please note that here again, a U.S. Shareholder is defined as a U.S. person holding 10% by vote or value in the C.F.C.

Net C.F.C. Tested Income is determined in several steps. First, for every C.F.C. with regard to which the shareholder is a U.S. shareholder, the U.S. Shareholder must determine its *pro rata* share of Tested Income or Tested Loss. For this purpose, Tested Income Is a C.F.C.'s modified gross income ("C.F.C. Modified Gross Income") decreased by the deductions (including foreign income taxes) properly allocable to such income.[116] C.F.C. Modified Gross Income begins with the total gross income of the C.F.C., which decreased by each of the following items:

- The C.F.C.'s income that is effectively connected with a U.S. trade or business and not exempt from tax in the U.S.
- The C.F.C.'s gross income taken into account to determine Subpart F income otherwise taxed to a U.S. Shareholder
- The C.F.C.'s income that would be considered to be Subpart F income except that it is subject to an effective rate of foreign income tax in excess of 90% of the U.S. Federal corporate income tax rate (21% x 90% = 18.9%)
- Dividends received from certain related persons[117]
- Foreign oil and gas extraction income
- Tested Loss is the amount by which deductions (including taxes) properly allocable to C.F.C. Modified Gross Income exceeds C.F.C. Modified Gross Income

Second, the U.S. Shareholder's *pro rata* share of tested income of each C.F.C. must be aggregated at the level of the C.F.C. (the "Aggregate Tested Income").Third, the U.S. Shareholder's pro rata share of tested losses of each C.F.C. must be aggregated (the "Aggregate Tested Losses"). Fourth, the Aggregate Tested Income must be decreased by the Aggregate Tested Losses.

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115 Code §951A.

116 Code §951A(c)(2).

117 This generally means that the dividend is received either (i) from a person in which the C.F.C. owns more than 50% by vote or value, or (ii) from a person that is owned directly or indirectly by more than 50% (by vote or value) by the same person(s) which directly or indirectly own more than 50% by vote or value in the C.F.C.

Net Deemed Tangible Income Return is the amount by which (i) a hypothetical 10% return on the aggregate adjusted bases of all tangible, depreciable assets used in the C.F.C.'s trade or business producing tested income exceeds (ii) certain interest expense ("Specified Interest Expense").[118] Specified Interest Expense is netted with tested interest income so that only net amount is considered to be Specified Interest Expense.[119]

For a C.F.C. that does not engage in production activity, the Net Deemed Tangible Income Return – which reduces Net C.F.C. Tested Income – will likely not be a material amount. As a result, most of a C.F.C.'s income that would not be included in the income of a U.S. Shareholder under the old C.F.C. rules, now will be included immediately under the G.I.L.T.I. rules.

Taxation of G.I.L.T.I.

A U.S. Shareholder of a C.F.C. having Net C.F.C. Tested Income will be subject to tax at ordinary income rates on its G.I.L.T.I. income. For an individual, the ordinary income tax rates are the graduated rates up to 37%. For a U.S. corporation that has not elected S-corporation status, a somewhat different rule applies. The corporation is entitled to a deduction equal to 50% of the G.I.L.T.I. amount. Because the corporate tax rate is 21%, the effect of the deduction is that the U.S. tax rate is effectively lowered to 10.5%.[120]

Note that an individual may elect to be treated as a corporation for purposes of computing tax on the undistributed G.I.L.T.I. amount.[121] However, when an actual dividend is paid by the C.F.C., the individual is considered to receive a taxable dividend from the C.F.C. The taxable amount is equal to the dividend declared by the corporation reduced by the G.I.L.T.I. tax previously paid, which typically should be 10.5% of the actual dividend. Consequently, if the G.I.L.T.I. inclusion and the dividend are each $100, the total tax for the shareholder is 28.4%, comprises of the original G.I.L.T.I. tax $10.50 plus the tax on the dividend, which is $17.90 (20% of $89).

A U.S. corporation that computes U.S. tax on a G.I.L.T.I. amount may claim a foreign tax credit for foreign income taxes paid or accrued by its C.F.C. The credit can reduce the net tax due on the G.I.L.T.I. inclusion amount. However, only 80% of the foreign income taxes allocable to Net C.F.C. Tested Income resulting in a G.I.L.T.I. inclusion may be claimed as a credit. In addition, a separate foreign tax credit limitation is applied for G.I.L.T.I. inclusions. Where the foreign income taxes for the year exceed the foreign tax credit limitation for G.I.L.T.I., no carryover or carryback is permitted. The effect of the two provisions is as follows:

- For a C.F.C. that has income categorized as Subpart F Income and tested income, a portion of the foreign taxes that could be claimed against Subpart F Income is moved to the G.I.L.T.I. basket, so that it is no longer available to shield U.S. tax imposed at the 21% rate

- Of the amount of the foreign tax that is placed in the G.I.L.T.I. basket, 20% is permanently non-creditable, immediately

118 Code §951A(b)(2).

119 Prop. Treas. Reg. §1.951A-1(c)(3)(iii).

120 For tax years beginning after December 31, 2025, the effective tax rate will be 13.125%. Code §250(a)(3)(B).

121 Code §962.

Of the balance, the foreign tax imposed at a rate in excess of 13.125% becomes permanently non-creditable

On the other hand, if a C.F.C. has tested income but no Subpart F Income, the cost of the lost credits is offset by the Foreign Source D.R.D. which eliminates U.S. Federal income tax entirely.

REAL PROPERTY TRANSACTIONS

The U.S. 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.[122] This characterization removes real estate transactions from the class of capital gains, which are generally exempt for foreign parties, and brings the normal income tax rules into play. As a result, the annual net gain or loss for foreign individuals is taxed at the graduated statutory tax rates of up to 37%,[123] at a minimum tax rate of 26% or 28%,[124] or at the favorable tax rates for long-term capital gains, currently 20%.[125]

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 planning mechanisms such as like-kind exchanges and corporate reorganizations, Code §897 limits the application of nonrecognition transactions when U.S. Real Property Interests ("U.S.R.P.I.'s") are involved.[126] Generally, they are permitted only when the U.S. tax on gain is fully protected, such as when one U.S.R.P.I. is exchanged for another. However, gain may be deferred if the transferee in a nonrecognition transaction is a foreign person, the transferred asset consists of shares of a domestic corporation that is a U.S. Real Property Holding Corporation ("U.S.R.P.H.C."), the transferee does not receive a step-up in basis, the shareholders of the U.S.R.P.H.C., the shareholders of the foreign entity remain substantially the same, and the shares of the foreign corporation are held for at least 12 months.[127]

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[122] Code §897(a)(1).

[123] Code §1.

[124] Code §55(b)(1)(A)(i).

[125] Code §1(h)(1)(D).

[126] Treas. Reg. §§1.897-6T.

[127] Notice 2006-46, 2006-1 C.B. 1044.

Withholding Obligation

The substantive tax rule under F.I.R.P.T.A. is augmented by a separate withholding tax provision.[128] The purchaser of a U.S.R.P.I. from a foreign person is obligated to withhold 15% 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.R.P.I. by a foreign corporation, the amount to be withheld is 21% of the appreciation over tax basis.[129]

Withholding Exemptions

Because the purchaser of the U.S.R.P.I. 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.[130] 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.[131] Lenders foreclosing on or repossessing a U.S.R.P.I. need not withhold in certain specially protected circumstances.[132] If they notify the I.R.S. of the foreclosure or repossession, their withholding obligation is 10% of the amount realized, or 10% 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.R.P.I.[133] 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 non-publicly traded partnership interest if a substantial part of the partnership's assets consist of U.S.R.P.I.'s interests and 90% or more of the value of the gross assets

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[128] Code §1445.

[129] Treas. Reg. §1.1445-5(d).

[130] Treas. Reg. §1.1445-2(d)(1).

[131] Treas. Reg. §1.1445-2(c)(2).

[132] Treas. Reg. §1.1445-2(d)(3).

[133] Treas. Reg. §1.1445-2(c)(1).

consist of U.S.R.P.I.'s plus cash or cash equivalents.[134] 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.[135] Except when the transferee has actual knowledge that such a statement is false, a withholding agent may rely on the statement. A non-foreign 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 I.R.S. upon request.[136] If the buyer is a foreign person, the certificate of non-foreign 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.[137] Partial 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 20 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.[138] In form, a withholding certificate is a letter from the 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 Treas. Reg. §§1445-3 and 1445-6 should be followed.

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134 Treas. Reg. §1.1445-11T.

135 Treas. Reg. §1.1445-2(b)(2).

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

137 Treas. Reg. §1.1445-2(d)(2).

138 Treas. Reg. §1.1445-2(d)(7).

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 45th day after receipt if it cannot respond in this 90-day period.

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.[139] 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.[140]

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 21% for a partner that is a foreign corporation and 37% for a partner that is a foreign individual or a foreign trust. 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 amounts of the installment payments are 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 invites 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.[141] The amount of the credit allocable to the foreign partner is treated as distributed to the partner on the earlier of (i) the day on which the tax was paid by the partnership or (ii) the last day of the partnership's tax year for which the tax was paid, thus reducing the partner's basis in the partnership.[142]

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[139] Code §1446.

[140] See Treas. Reg. §§1.1446-1 through 1.1446-7.

[141] Code §33.

[142] Code §1446(d)(2).

The installment payments are due by the 15th day of the fourth, sixth, ninth, and 12th months of the partnership's tax year.[143] Ordinarily, this is the 15th day of April, June, September, and December. Form 8813 is used to make the quarterly withholding payments.[144]

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.

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.

Interest on Portfolio Debt

An exception to the withholding tax exists for interest payments considered to arise from an item of portfolio indebtedness.[145] Such interest is totally exempt from U.S. withholding tax.

With limited exception, an item of portfolio indebtedness must be in registered format. This does not mean that the exemption applies only to publicly traded securities. Rather, an obligation is in registered form if it meets the following 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

- The right to the principal of, and stated interest on, the obligation may be transferred only through a book-entry system[146]

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

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143 Treas. Reg. §1.1446-3(d)(1)(ii).

144 Treas. Reg. §1.1446-3(d)(1)(i).

145 Code §§871(h) and 881(c).

146 Treas. Regs. §5f.103T-1(c).

that a promissory note that is "payable to the order of" is not an item of portfolio indebtedness even if the note contains terms that limit the ability to negotiate and transfer the promissory note. This position is generally viewed to be flawed.

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.[147] Thus, the amount of the interest may not be calculated by reference to the following items:

- 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
- 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.[148] 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.[149] Generally, a foreign corporation is a C.F.C. if shares 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.[150] Third, the exemption does not apply to interest paid to a "10% shareholder."[151]

The term "10% shareholder" is defined by the Code. If the borrower is a corporation, a 10% shareholder is any person who owns shares representing 10% 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.[152] attribution of ownership is as follows:

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[147] Code §871(h)(4)(A).

[148] Code §881(c)(3)(A).

[149] Code §881(c)(3)(C).

[150] Code §957(a)

[151] Code §§871(h)(3)(B) and 881(c)(3)(B).

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

- An individual is considered to own stock actually owned by his or her spouse, children, grandchildren, and parents.[153] However, stock attributed under this rule cannot be reattributed to other family members.[154] 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[155]

- A partnership or an estate is considered to own stock actually owned by its partners or beneficiaries[156]

- 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[157]

- A corporation is considered to own a *pro rata* portion of stock in other corporations that is actually owned by its shareholders.[158] 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.[159] However, stock attributed under this rule cannot be reattributed to or from corporations, partnerships, trusts, or estates[160]

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.

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[153] Code §318(a)(1).

[154] Code §318(a)(5)(B).

[155] Code §318(a)(2) as modified by Code §871(h)(3)(C).

[156] Code §318(a)(3)(A)

[157] Code §318(a)(3)(B).

[158] Code §318(a)(3)(C) as modified by Code §871(h)(3)(C).

[159] Code §318(a)(4).

[160] Code §871(h)(3)(C).

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.

It is not uncommon to encounter plans that have been designed to prevent application of the attribution rule through complex ownership arrangements designed to split-off capital investment from voting power. These types of plans are thought to work best when the split between ownership and voting power has economic substance in the circumstances.

Treaty Benefits

As previously mentioned, U.S. tax law imposes a 30% tax on items of F.D.A.P. of a foreign corporation or a nonresident, noncitizen individual.[161] 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 to what extent they reflect the general trends. For example, direct investment dividends are taxed at 5%[162] or in some cases are completely exempt,[163] portfolio investment dividends are taxed at 15%,[164] and interest and royalties[165] 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 U.S. 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:

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

- Subsidiaries of publicly traded companies qualify

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[161] Code §§1441 and 1442.

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

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

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

[165] 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.

- 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 a treaty exists with the resident country of the 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. Whether a business conducted outside the U.S. is substantial 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.

Purpose of W-9 / W-8BEN / W-8BEN-E

If a person makes a payment of U.S.-source interest, dividends, rents, royalties, commissions, non-employee compensation, and other forms of F.D.A.P., a Form W-9 (*Request for Taxpayer Identification Number and Certification*) or a Form W-8BEN (*Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding*) or a Form W-8BEN-E (*Certificate of Entities Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)*) must be obtained from the payee. These forms provide information from which the payor can determine whether the recipient is an individual U.S. citizen or resident or a foreign person, either a corporation or an individual. In the former instance, the receipt of Form W-9 officially provides the payor with a taxpayer identification number ("T.I.N.") of the recipient. If a valid W-9 is not received, a payment to an individual U.S. resident is subject to back-up withholding tax, imposed at the rate of 24% as of the date of this memorandum. Among other things, the Form W-8BEN or W-8BEN-E advises the payor that the payee 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 / W-8BEN-E, 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 back-up withholding tax.[166] However, this presumption can be overcome in several circumstances.

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[166] Treas. Reg. §1.1441-1(b)(3).

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: (i) the payor has actual knowledge of the payee's Employer Identification Number ("E.I.N."), a T.I.N. for entities and businesses, and the number begins with the digit 98, (ii) communications with the payee are mailed to an address in a foreign country, (iii) 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 (iv) the payment is made outside the U.S.[167]

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.[168]

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 (iv) income related to loans of any of the foregoing securities.[169]

For the grace period rules to apply, the payor must have in its possession information indicating that the person is a foreign person. The grace period begins for a newly opened account on the date amounts are first credited to an account.

Due diligence obligations are imposed on the withholding agent with regard to each Form W-8BEN / W-8BEN-E 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.

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, which has been discussed above. This is the form that is used by foreign individuals wishing to claim treaty benefits or an exception to 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

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[167] Treas. Reg. §1.1441-1(b)(3)(iii)(A).

[168] Treas. Reg. §1.1441-1(b)(3)(ii)(C).

[169] Treas. Reg. §1.1441-6(c)(2).

identification number if required, and a foreign tax identifying number. In addition, the form is used to make the following certifications to the payor of the income:

- The name of the individual that is the beneficial owner (or is authorized to sign for the individual that is the beneficial owner) of all the income to which the form relates
- The person named on the form as the beneficial owner is not a U.S. person
- The income to which this form relates is not effectively connected with the conduct of a trade or business in the U.S., is actually effectively connected but is not subject to tax under an applicable income tax treaty, or a share of a partnership's effectively connected income

If the person named as the beneficial owner is a resident of the treaty country listed on line 9 of the form within the meaning of the income tax treaty between the U.S. and that country, the form 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 limitation on benefits article as to the particular item of income.

A Form W-8BEN must contain the foreign individuals tax identification number issued by the country of residence and a date of birth to be valid. This requirement enables the I.R.S. to exchange necessary information under F.A.T.C.A.

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, Treas. 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.

Form W-8BEN-E

In 2010, Congress passed the Hiring Incentives to Restore Employment Act of 2010, P.L. 111-147 (the “H.I.R.E. Act”), which added chapter 4 of Subtitle A (”Chapter 4”) to the Code. The intent of F.A.T.C.A. is to export information reporting obligations on foreign financial institutions (“F.F.I.’s”) as defined. It is part of a larger scheme that forces F.F.I.’s to agree to several obligations designed to provide the U.S. with information on foreign accounts owned directly or indirectly, entirely or partly by U.S. individuals. A broader discussion of F.A.T.C.A. is beyond the scope of this article. However, the Form W-8BEN-E (*Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting* (Entities)) is used, *inter alia*, to identify[170] the following conditions:

- A foreign corporation is an F.F.I. or a non-financial foreign entity (“N.F.F.E.”)
- An F.F.I. is a participating F.F.I. that is registered with the I.R.S. and has undertaken an obligation to have systems in place and properly operating to report its U.S. ultimate beneficial owners and the income and asset flows allocable to those owners

170 It is also used to identify certain subclass of F.F.I. such as deemed compliant F.F.I.’s. However, the other purposes of the form are not relevant here.

- An N.F.F.E. is active or passive
- A passive N.F.F.E. has chosen to report on its substantial U.S. ultimate beneficial owners directly to the I.R.S. instead of reporting that information to U.S. domestic financial institutions and foreign financial institutions. If direct reporting has not been elected, the names of the substantial U.S. ultimate beneficial owners must be provided to U.S. payors and participating F.F.I.'s

The form is also used to provide information regarding ordinary withholding tax under Code §1441 and entitlement to the benefits of an income tax treaty. In comparison to the Form W-8BEN, the Form W-8BEN-E is eight pages long.

Form W-8IMY

The W-8IMY is the form that an intermediary submits to the payor of U.S.-source income or gain. An intermediary is any person that 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.[171]

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 or W-8BEN-E 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.

Like the Form W-8BEN-E, the Form W-8-IMY has been expanded to provide F.A.T.C.A. information. It, too, is eight pages in length.

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*)

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[171] 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.

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.

Form W-8EXP

The Form W-8EXP (*Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding and Reporting*) 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.

The form W-8EXP has been expanded to address limited F.A.T.C.A. concerns regarding government owned entities. The intent is to ensure that the entity identify the F.A.T.C.A. exemption on which it relies to eliminate F.A.T.C.A. obligations. It is now three pages in length.

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. Examples include the following:

- 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

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.