



Triaging the Cross-Border Transaction

A Primer and Beyond

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Triaging* the Cross-Border Transaction

A Primer and Beyond, A Caveat / Key

- This document is intended to “visit” almost all (but probably not quite all) of the key concepts and issues a tax/business legal practitioner might need to (should) evaluate in the process of advising a client contemplating a cross-border business or investment transaction, where the U.S. is on one side of that transaction.
- That being said, in most cases, this work certainly does not explore everything (and on some topics explores very little) one would need to know about the various concepts and issues before putting their e&o insurance on the line.
- Use this document as a quick refresher or primer to assist in the triaging of your client’s particular situation, and as a springboard into the further research, investigation, and application of your own experience and judgment. Seek help when you need it.
- That is a longwinded way of saying that this is intended for educational (and recreational) use of those individuals at least somewhat skilled in some areas of U.S. tax law. It is not intended to be, and cannot be used, as legal advice concerning any particular person’s situation. It is further likely to be dangerous in the hands of the non-tax practitioner...so if that is you, and you are crazy enough to do so...read on with caution.
- Unless otherwise indicated, numerical references (351, 367, etc) are to the U.S. Internal Revenue Code; numerical references with a period in them – e.g. 1.861-8T – are to U.S. Treasury Regulations
- **SP/CG**
*Triage - The assigning of priority order to projects on the basis of where funds and other resources can be best used, are most needed, or are most likely to achieve success.
<http://www.merriam-webster.com/dictionary/triag>

Background

The Small, Lucrative, but (Tax) Dangerous World

- Globalization
 - Fairly simple to engage in international commerce
 - Fairly common for all business/tax lawyers to be consulted sometimes, maybe even often
 - All clients are not multinational enterprises with in-house tax departments or access to Wall Street law firms, Big Four, etc.
- Increased U.S Scrutiny of cross-border investments
 - “Foreign” is “bad” and is the whipping boy
 - FBAR enforcement
 - Hiring Incentives to Restore Employment Act (“HIRE Act”)
 - New withholding
 - Also Included many provisions of proposed “Foreign Account Tax Compliance Act of 2009 (“FATCA”)
 - Patient Protection and Affordable Care Act (“Health Care Act”)
 - Pending Legislation
 - Sen. Levin
 - Obama “Greenbook” proposals re check the box
 - Ramped up IRS international enforcement team
- Reporting traps galore for the unwary

Purpose

A Guide to Triaging the Cross-Border Transaction

- A refresher / primer on:
 - U.S. foreign income tax principles
 - Both inbound and outbound
 - Treaties and their effect
- Checklists for:
 - Areas where domestic “instincts” don’t apply
 - e.g. gain on transfer of property to fund corporation 367/351
 - e.g. “pass-through” treatment of “C” corporations 951
 - Key principles necessary to triage client needs
 - Rapidly changing cross-border U.S. tax law areas
- Focus on income taxes
 - But some estate/gift taxation discussion by necessity

A Guide to Triaging the Cross-Border Transaction (continued)

- Other areas deserve equal (if not more) attention in evaluating the cross-border transaction, but are not discussed here. They include:
 - Immigration law
 - Work visas
 - Local taxes
 - GST
 - HST
 - VAT
 - Ad Valorem
 - Cross-border commercial payment systems, mechanics
 - Local business registration requirements
 - Import/export regulations and restrictions
 - Cultural education
- Assess your client's ability to deal with these issues – if they can't and you can't get help

Purpose

A Guide to Triaging the Cross-Border Transaction (continued)

- For outbound cases, quality in-country expertise is a must
- All the domestic business planning issues apply
 - Choice of entity (with a twist)
 - Shareholder / partner agreements
 - Employment agreements
 - Vendor contracts

In General

- Cross-border taxation involves the interface (and clash) between tax systems of sovereign nations
 - Every nation wants its fair share
 - Similar to multi-state “nexus” issues (without the troublesome U.S. constitution to consider)
- Who is taxable where?
 - From U.S. perspective
 - Subject to U.S. tax on worldwide income?
 - or
 - Subject to tax on “U.S. sourced” income ?
 - From other country perspective
 - Maybe the same, maybe not
 - Residence may or may not matter; citizenship may not matter
 - Risk of double taxation is constant economic threat

In General (continued)

- How is income taxed ?
 - Gross or net basis ?
 - Rates vary from nation to nation
 - Deductions, exemptions, credits, etc. vary from nation to nation
 - Sourcing of income and allocation and apportionment of expenses are problematic
- Cross-border transaction involves AT LEAST two, maybe three (or more) bodies of law
 - Inbound taxing nation's tax laws
 - Outbound taxing nation's tax laws
 - Tax treaty (if any) between the two nations
- Rules (and penalties) apply to small, medium, and big businesses alike
 - Cost of compliance, accounting, planning (much) greater than purely domestic transaction
 - No "little guy" exceptions to penalties (except maybe lack of sophistication)
 - Many penalties in U.S. foreign reporting are not based on tax due – \$10,000 and up... and it's getting worse

Beginning Point – Who is the Client? Is there a treaty?

- The starting point of analysis – who is the client?
 - U.S. taxes “U.S. persons” on worldwide income
 - U.S. taxes “foreign persons” generally only on U.S. sourced income
- Due diligence is a must
 - Evaluate place of organization
 - Evaluate citizenship
 - Evaluate residence
 - Evaluate “home” per client’s intent
 - Where is individual’s family?
 - Evaluate individual person’s travel patterns (how often in the U.S.)
- Next – is there a treaty?
 - Discussion separately below
 - But treaty overrides many statutory rules

Who is a U.S. Person? 7701(a)(30)

- U.S. Citizens 7701(b)(1)(B)
- Green card holders (lawful permanent resident) 7701(b)(1)(A)(i)
- Residents for income tax purposes 7701(b)(1)(A)(ii)
 - “Substantial presence” test
 - Generally, 31 current days, plus 183 days in current and prior 2 years
 - Different weights given to days in prior two years (1/3, 1/6th rule)
 - Commuter rule for routinely commuting Mexican/Canadian taxpayers – days in U.S. don’t count
- Domestic corporation / partnership
 - Based on organization – U.S. state
 - Compare other trading partners: e.g. taxation of entity driven by “place of management”
- Trust where U.S. court has primary supervision over administration of trust, or U.S. persons (trustee) has authority to control all substantial decisions of trust - 7701(a)(30)(E)

Who is a Foreign Person?

- Anyone who is not a U.S. person
 - Non-U.S. citizen
 - Non-green card holder
 - Does not satisfy “substantial presence test”
 - AND, does not make special first year resident election 7701(b)(1)(A)(iii)
 - Trust with no U.S. court supervision or U.S. trustee
- Foreign corporation / partnership (organized outside the U.S.)
- Foreign Estate
 - Facts and circumstances - 7701(a)(31)
- Foreign Government

What income is taxed? How is income taxed?

- What income?
 - U.S. person taxed on worldwide (universe wide) income wherever sourced
 - Does not matter where U.S. citizen lives
 - Citizenship rule is unusual, unique
- How?
 - Net taxable income
 - Progressive rates 1, 11
 - Double taxation avoidance:
 - Foreign tax credit (or deduction)
 - Earned foreign income exclusion; housing allowance

What income is taxed?

- U.S.-sourced income that is:
 - “ECI” - income “effectively connected” with U.S. “trade or business” 871(b)(1) (individuals); 882 (corporations)
 - “FDAP” - “fixed, determinable, annual, or periodic gains, profits, and income” 871(a)(1)/881(a)(1)
 - Interest, dividends, rents, royalties, wages, salary
 - Other items enumerated under IRC or rulings, cases
 - ECI can include effectively connected FDAP items
- Certain foreign-sourced income that is ECI
 - If foreign person has office or other fixed place of business
 - THEN, rents, royalties, dividends, interest, and income from sale of goods which is “attributable” to that office are ECI 864(c)
- Gain on sale of U.S. real property – 897

What income is NOT taxed?

- Not all U.S.-sourced income falls within ECI or FDAP rules
 - Thus, just because US-sourced, might not be taxed
- Examples
 - Capital gain from other than from real estate
 - BUT, if foreign person present =>183 days in single calendar year U.S-source capital gains are taxed in certain circumstances 871(a)(2) (compare substantial presence rule)
 - Payments for sale of inventory (if otherwise no ECI)
 - Statutory exemptions – e.g. portfolio interest
 - Treaty exemptions

How is income taxed?

- Rates of Taxation:
 - ECI (including FDAP that is ECI) is taxed at regular graduated rates
 - “Net” taxable income is taxed
- FDAP income (not treated as ECI) is taxed at flat statutory rate 30%
 - Typically enforced through withholding at source
 - Rate usually reduced for certain types of FDAP under applicable income tax treaty

Is the Foreign Person Susceptible to U.S. Taxation?

- Are they engaged in U.S. trade or business?
 - Will they be in-country or at home ?
 - If yes, do they earn income that is effectively connected with that U.S. trade or business?
 - If yes, what is the source of their income?
 - U.S. source - may be taxed as ECI or non-ECI
 - Foreign source income
 - Never taxed if non-ECI
 - Sometimes taxed if treated as ECI
- If not engaged in U.S. trade or business
 - Usually only taxed on U.S.-sourced FDAP
 - Special presence rule may cause some capital gain to be taxed
 - Special cases: Real estate gain always taxed (FIRPTA - see below)

In General

- Next important place of inquiry - sourcing of income (U.S. or non-U.S.?)
- For U.S. persons (“USP” hereafter), sourcing has one primary function:
 - Determine the ability to use foreign tax credits
 - i.e. what is net foreign source taxable income relative to worldwide net taxable income
- For foreign persons (“FP” hereafter), sourcing has different primary function:
 - Determines (usually) whether income is taxable in U.S. at all
 - Sometimes, foreign sourced income of FP taxable in the U.S.
- Allocation and apportionment of deductions goes hand in hand

Sourcing of Income

Specific Rules

- Personal Property
- Inventory
- Intangibles
- Interest
- Dividends
- Royalties
- Personal Services
- Rent
- Strange Stuff

Specific Rules: Personal Property

- Sale of personal property (including stock)
 - Different residency requirement for 865: “tax home”
 - U.S. resident is
 - U.S. citizen or resident without tax home outside U.S.
 - Nonresident alien with a tax home in U.S.
 - If sold by U.S. resident, sourced to U.S.
 - Exception: office or fixed place of business outside of U.S. to which sale is attributable—foreign source gain if
 - (1) no other exceptions of 865 applies,
and
 - (2) gain is subject to foreign income tax of at least 10%

Specific Rules: Personal Property (continued)

- Sale of personal property
 - If sold by nonresident, sourced outside of U.S.
 - Exception: office or fixed place of business in U.S. to which sale of personal property is attributed, sale will be sourced to U.S. (865(e)(2)(A))
 - This overrides all other exceptions of 865
 - For example, products manufactured overseas and sold in the U.S. are not eligible for the allocation of gain typically allowed under 863(b)
 - Foreign producers in U.S. may wish to consider avoiding creation of U.S. office and deal instead with independent distributors
 - If nonresident is U.S. citizen or resident alien, only foreign source if income tax equal to at least 10% of the gain is paid to foreign country

Specific Rules: Inventory

- Sale of inventory
 - Sourced to where title passes 861(a)(6) and 862(a)(6)
 - Look to UCC delivery terms, as well as contract between the parties
 - Inventory manufactured by taxpayer within U.S. and sold without, or vice versa 863:
 - Gross income from sale apportioned, generally 50/50, between the two countries
- ECI exception- 864(c)(4)
 - If ECI, this foreign source income will be U.S. source
 - Exception to exception: sole or exchanged for use, consumption or disposition outside U.S. and foreign country office of taxpayer materially participated in sale- 864(c)(4)(B)(iii)

Specific Rules: Intangibles

- Generally the same as personal property residence sourcing rule of 865(a)
 - Exception:
 - if consideration contingent on productivity, use, or disposition of the intangible (865(d)), sourced under royalty rule (place of use of intellectual property giving rise to the royalty)

Specific Rules: Interest

- Generally, residence rules of 861(a)(1) and 862(a)(1) apply: sourced to residence or situs of payor
 - Exception: If nonresident individual or corporation meets the 80% foreign business requirements, interest will be foreign source 861(a)(1)(A) and 861(c)(1)
 - 80% of all gross income for such person from all sources for the testing period is active foreign business income
 - “active foreign business income”- derived from sources outside of U.S., and attributable to active conduct of trade or business in a foreign country
 - “testing period”- three year period ending with the close of the taxable year of the nonresident preceding the payment
 - Exception: foreign branch of U.S. bank- interest on deposits will be foreign source
 - U.S. Branch: interest paid by a U.S. branch of a foreign corporation is treated as if paid by a domestic corporation, meaning it will generally be sourced to U.S. 884(f)(1)

Specific Rules: Interest (continued)

- Partnerships: generally sourced to where partnership is doing business
 - o Exception: foreign partnership that pays interest from active U.S. trade or business or from income that is ECI—interest will be U.S. source
- Portfolio interest exemption
 - o Interest on bank deposits
 - o Interest on registered and bearer bonds
 - BUT, HIRE Act removes exemption for bearer bonds issued after March 18, 2012
- ECI Exception- 864(c)(4)
 - o If ECI, this foreign source income will be U.S. source

Specific Rules: Dividends

- Sourced to residence of corporation paying the dividend 861(a)(2) and 862(a)(2)
 - Exception: 25% rule: “Second tax of old”
 - If 25% or more of foreign corporation’s income is ECI in the three years preceding declaration of dividend, then the dividend will be proportionately U.S.-sourced.
 - However, this rule has been largely replaced by the branch profits tax
 - Exception: Domestic corporation with 80% or more active foreign source income
 - ECI Exception: 864(c)(4)
 - If ECI, this foreign source income will be U.S. source

Specific Rules: Personal Services

- Sourced in accordance with where service provider is physically located when services are performed 861(a)(3) and 862(a)(3)
 - Allocation done on time basis when services performed within and without U.S. (1.861-4(b))
- Exception: treated as foreign source if nonresident:
 - Works for employer not ETBUS,
 - Is present in U.S. for 90 days or less (typically extended by tax treaty), and
 - Does not receive more than \$3,000 as compensation for services (typically increased by tax treaty)
- Exception for temporary presence in U.S.

Specific Rules: Royalties

- Sourced where use of intangible property giving rise to royalty occurs 861(a)(4) and 862(a)(4)
 - “Intangibles”-
 - Patents
 - Copyrights
 - Trade secrets
 - Know how
 - Customer lists
 - Goodwill
 - Trademarks
 - Trade brands
 - Etc (197, 936(h)(3)(B))
 - ECI Exception- 864(c)(4)
 - If ECI, this foreign source income will be U.S. source

Specific Rules: Rent

- Sourced to location of use of property rented 861(a)(4) and 862(a)(4)
 - Apportion payments based on time, mileage, etc. if property used outside of U.S.
- ECI exception- 864(c)(4)
 - If ECI, this foreign source income will be U.S. source
- Rents from real property
 - Withholding required
 - Usually no treaty reduction
 - No expenses allowed
 - Triple net leases? Withhold on gross amount
 - Consider electing to treat as ECI

Specific Rules: Strange Stuff

- Where no clear statutory or regulatory rule, see case law, rulings
- Life settlement investment proceeds
 - Facts: Foreign investor in life settlement (life policy acquired in purposeful violation transfer for value rules)
 - Until 2009, many had wondered about (or ignored) character and sourcing of death proceeds
- Revenue Ruling 2009-14 holdings:
 - Receipt of death benefit is U.S. sourced FDAP
 - Withholding applies (30% unless treaty reduction)
 - OR
 - Could be ECI if FP investor is ETBUS
 - Sale of policy by investor is capital transaction – no income or withholding

Synopsis

- Sourcing of income only part of the equation
- Once source of income determined, must properly apportion/allocate expenses
- Net taxable income determination important for:
 - Foreign tax credit determination for USPs
 - Amount of net taxable income subject to tax in U.S. for FPs (in cases where net taxable income is calculated - ECI)
 - 482 principles apply to some extent -- arms length pricing should prevail
 - Advance pricing agreements not available though
- No “little guy” exception

Specific Rules: General 1.861-8

- Allocation of specific expenses to items or “classes” of income
 - Business profit, interest, dividend, etc.
- Apportionment of expenses allocable to more than one class of income – facts and circumstances
- Ratable allocation of expenses that cannot “definitely be allocated to some item or class of income”
 - e.g. for individual, standard deduction
 - Generally on pro rata basis
- Must allocate and apportion to “classes” of income and then to “statutory groupings”
 - General and passive categories of income

Specific Rules: Laundry List

- Interest 1.861-9T through -13T
- R&D expense 1.861-17
- Stewardship and controlled service 1.861-8(e)(4)
- Legal and accounting fees and expense 1.861-8(e)(5)
- State income taxes 1.861-8(e)(6)
- Losses on property sale 1.861-8(e)(7)
- Etc.

Specific Rules: Interest

- Complex allocation of interest rules
- Assumption is:
 - That taxpayer can elect to use debt or equity financing for related entities or activities

“The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid.”

- Taxpayer should not be able to shift income/deductions by crafty placement of debt

Specific Rules: Interest

- Different rules for different types of taxpayers:
 - Individuals, estates, trusts – use regulations under 163 (tracing)
 - Partnerships – 1.861-9T(e) – allocate distributable share of interest not directly apportioned to partnership activity
 - Corporations – Ratably based on worldwide assets 1.861-9T(g)
 - Special rules for “affiliated” groups allowing worldwide allocation among group but election used until 2021
 - Special rules for nonrecourse debt – specifically allocated to income produced by that property

Anti-Earnings Stripping with Debt – 163(j): Synopsis

- Applies to corporations
- Limits the deductibility of certain interest paid by corporations to certain related parties 267, 707
- Effect is to disallow the “stripping” of earnings from the U.S. through interest payments to foreign related parties
 - Can apply even in cases of interest paid to non-related parties where foreign related corporation guarantees debt

Anti-Earnings Stripping with Debt – 163(j): Specific Rules

- 163(j) applies if
 - Corporation has excess interest expense and
 - Debt to equity capitalization ratio exceeds 1.5 to 1
- “Excess interest expense” is interest expense that exceeds 50% of corporation’s adjusted taxable income
- Interest that is disallowed is “disqualified interest”
 - Defined as interest paid to related party that is not taxed in the U.S.
 - Will thus affect interest that is not subject to withholding tax due to treaty reduction
- Interest paid to non-related party can be “disqualified interest” if debt is guaranteed by person not subject to U.S. tax.

ETBUS: Generally

- When is a FP “engaged in carrying on trade or business in the U.S.? (“ETBUS”)?”
 - No code or regulatory definition – facts and circumstances test – fodder for the courtroom
- Quantity of activities:
 - Regular, continuous, and substantive profit-oriented activities occurring in the U.S.
- Quality of activities:
 - Major functions of business must occur, not merely clerical activities

ETBUS: Generally (continued)

- Common situations in which alien individuals may be engaged in U.S. trade or business:
 - Employees
 - Self-employed personal service providers
 - Investors

ETBUS: Employees

- Employees
 - Safe harbor (three-prong test):
 - Services not performed for USP or FP that is ETBUS or for foreign office of U.S. business,
 - Individual present in U.S. less than 90 days, and
 - Total compensation received for services is less than \$3,000
 - If employee meets safe harbor test, compensation received in connection with such activities will be foreign source
 - Potential treaty exemption: dependent personal services
 - Must be tax resident of treaty country
 - Must not be resident of U.S.
 - Must be present less than 183 days in U.S.
 - Employer may not be a USP
 - No deduction of employee's salary by a permanent establishment in the U.S.

ETBUS: Self-employed personal service providers

- Income from performance of personal services by FP within the U.S. at any time during the tax year will be ECI
 - What is “personal service?”
 - Probably means that the service is contracted to be performed by a particular individual
 - What are “services performed in the United States?”
 - Generally requires a physical connection with U.S.
 - Tech support performed overseas for customer in U.S. is not a personal service performed in U.S.
 - Safe harbor
 - Services not performed for USP or FP that is ETBUS or for foreign office of U.S. business,
 - Individual present in U.S. less than 90 days, and
 - Total compensation received for services is less than \$3,000
 - Compensation received under same circumstances as safe-harbor will be foreign source
 - Potential treaty exemption
 - “Business Profits”
 - No U.S. taxation if compensation not attributable to a U.S. permanent establishment

ETBUS: Investors

- A taxpayer trading for his own account is not engaging in a U.S. trade or business (even if done in U.S.)
 - However, must be mindful of definition of “securities”
 - Notes, bonds, debentures, and other evidences of indebtedness
 - Purchasing a loan is ok,
 - But, making a loan is not trading in “securities” and may cause FP to have a U.S. trade or business if loan is made in U.S. or if made by USP as agent for FP
- FP may avoid ECI on securities, commodities, and derivatives trading executed by an agent or broker in some circumstances:
 - Trading through independent agent/broker is not U.S. trade or business if taxpayer does not have a U.S. office through which trades are made or effected.
 - “Independent agent/broker”: general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity

Deemed ETBUS

- In some circumstances, a FP is deemed to be ETBUS:
 - FIRPTA rules 897
 - Payments deferred into non-ETBUS year 864(c)(6)
 - Sale of ETBUS assets in later year
 - 10 year look back under 864(c)(7)
 - Consider real property ECI election under 871(d)

ETBUS: Partnerships

- Partners will be engaged in U.S. trade or business if the partnership is engaged in U.S. trade or business
 - A foreign partner's distributive share of the partnership's effectively connective income is subject to the graduated ECI tax in the partner's hands
- If the partner is acting as agent of partnership and is conducting business in the United States, it can pull the partnership into U.S. for ECI purposes
- Gain from the sale of a partnership interest held by a foreign partner will be ECI in amount equal to lesser of gain or loss or partner's distributive share of gain or loss that partnership would realize if it sold all assets used in its U.S. trade or business

ETBUS: Trusts & Estates

- FP will be treated as engaged in any U.S. trade or business that a trust or estate of which it is a beneficiary is engaged in
- So FP trust that is ETBUS earning ECI will be taxed in U.S. as follows:
 - Income taxable to beneficiary if distributed
 - Income taxable to trust if not distributed
- Similar rule concerning FDAP earned by trust/estate that is FP
- Be aware of throwback rules regarding undistributed net income, on DNI not currently distributed

Effectively Connected Income (“ECI”)

- If the FP is ETBUS, do they have ECI?
 - Compensation for personal services
 - Gross ECI includes compensation allocable to time working in U.S., unless safe harbor or treaty exception applies
 - Capital-intensive business
 - Asset use test; Material factor test
 - Other U.S. source income
 - Generally, U.S. source income, gain, or loss, that is not FDAP income will automatically be ECI
 - Income and gain on sales of inventory and other property held for sale to customers in ordinary course of business
 - Will not be U.S. sourced if nonresident has U.S. office, item is sold for use, disposition, or consumption outside the U.S., and an office or fixed place of business of the taxpayer in a foreign country materially participates in sale
 - Gains on sales of property used in U.S. trade or business to extent gain is ordinary income
 - Foreign-source income that is ECI under 864(c)

ECI: FDAP income

- U.S.-sourced FDAP income is ECI if it meets one of two tests:
 - Asset Use Test:
 - FDAP income derived from assets used or held for use in conduct of U.S. trade or business is ECI
 - Business Activities/Material Factor Test:
 - If activities of a U.S. trade or business are a material factor in realization of income, gain, or loss, then FDAP is ECI

ECI: Foreign source income

- Foreign source income of FP is usually not effectively connected with a U.S. trade or business
- There are some exceptions where income, although sourced outside of the U.S. under sourcing rules, is earned by or attributable to business activities occurring in U.S.
- Examples:
 - Rents, royalties, dividends, interest, and income on sales of goods

ECl: Foreign source income (continued)

- Requirements for foreign source income to be ECl:
 - Taxpayer must have U.S. office or other fixed place of business in U.S.
 - Use of another's office
 - Subsidiary use of parent's office (or vice versa)
 - Activities of agent
 - Income must be attributable to such office
 - Material factor
 - Dependent employees

ECI: Foreign source income (continued)

- Foreign Source Rents and Royalties
 - From foreign sources if received for use of intangible property outside U.S.
 - ECI if:
 - Derived in active conduct of U.S. trade or business, and
 - Attributable to taxpayer's U.S. office
 - Exceptions
 - Lessees of tangible property
 - Foreign source gain on sale of intangibles
 - Income received by foreign corporation of which taxpayer owns greater than 50% of the voting stock

ECI: Foreign source income (continued)

- Foreign Source Dividends and Interest
 - Dividends are foreign source if distributing corporation is foreign
 - Interest is from foreign sources if it accrues on an obligation of a foreign corporation or nonresident alien
 - ECI if:
 - Derived in active conduct of a banking, financing, or similar business in the U.S., or
 - Is a foreign corporation whose principal business is trading in stocks and securities for its own account, and
 - Taxpayer has a U.S. office, and
 - Income is attributable to that office
 - Exceptions:
 - Does not apply to gain or loss from stocks or securities held, sold, or exchanged in connection with incidental investment activities of taxpayer
 - Does not apply to foreign source gains on sales of stock and debt obligations, even if dividends and interest on the same securities are ECI
 - Does not apply to income received from foreign corporation and taxpayer actually or constructively owns 50% or more of voting stock

ECI: Foreign source income (continued)

- Foreign Source Sales in the Ordinary Course of Business
 - Sale of personal property is ECI if property held for sale to customers and sale is made through taxpayer's U.S. office
 - Exception: not ECI if property sold for use, consumption, or disposition outside of U.S. and taxpayer's foreign office materially participates in the sale

Reporting of ECI

- Graduated rates applied to net taxable income similar to USP
- Requires income tax return to be filed
 - 1040NR
 - 1120F
 - 1065 (no such thing as 1065NR)
- Deduction issues:
 - Expenses “connected with” ECI are deductible (see Allocation and Apportionment of Expenses above)
 - Certain other expenses allowed (casualty losses, charitable contributions, certain exemptions)
 - No standard deduction for individuals
 - No deductions allowed if return not timely filed
 - May not be enforceable in all cases if a treaty is in place

Branch Taxes – Corporations – 884

- Basic operation:
 - Imposes an additional tax on a corporation operating through a branch
 - Intended to mimic the effect that would occur if the branch were a separate local corporation
- Applicable to corporations only
- U.S. and some other countries have a branch tax
 - U.S. basic branch tax rate – 30% of “dividend equivalent amount” – usually reduced by treaty
 - Dividend equivalent amount roughly equals current year ECI less increase in “U.S. net equity” plus decrease in “U.S. net equity”

FDAP: Synopsis

- Fixed and Determinable Annual or Periodic Payments (“FDAP”)
 - Generally, “passive” types of income
 - Usually collected through withholding
 - But treated favorably under treaties to encourage investment
 - Gains on sale of property are generally not FDAP

FDAP: Specific Rules

- Types
 - Interest, dividends, royalties, rents, salaries, wages, alimony, gambling winnings
 - To be taxed to FP must be U.S. source
- Collection - source withholding on gross basis by payor
 - 30% statutory rate
 - Many times reduced by treaty – (see below)
- But FDAP sometimes treated as ECI

U.S. Withholding Rules: General Principles 1441 to 1464

- Withholding at source is used for collecting U.S. tax on certain income paid to FP
 - Burden on payor
 - To determine whether U.S. or foreign
 - To determine whether payment is a withholding type payment
 - Failure to withhold ? Responsible person penalty
 - ECI is not generally subject to withholding EXCEPT in case of partnerships
- Rate Often reduced by treaty for specific types of payments
- New withholding rules

U.S. Withholding Rules: General Principles 1441 to 1464 (before HIRE act)

- Types subject to withholding:
 - U.S. source FDAP
 - 30% unless payor receives appropriate [W-8] from beneficial owner
 - U.S. source services income
 - Usually no withholding on payment to foreign corporation because ECI
 - Payments to foreign independent contractor is FDAP (1441)
 - Payments to foreign employees are subject to employee withholding (3401)
 - Partner's share of partnership ECI income (see below)
 - Disposition of USRPI

U.S. Withholding Rules: Reporting

- U.S. payor reports income and withholding on Form 1042 and 1042-S
 - Remit tax withheld to IRS
- Foreign Payee
 - No return required if appropriate tax withheld
 - But, Consider FIRPTA (below) – return maybe required even though withholding.
 - Otherwise, file Form 1040NR/Form 1120F to claim refund or pay additional tax

U.S. Withholding Rules: New 1471 to 1474, Synopsis “Super Withholding”

- HIRE Act instituted new, and controversial, withholding regime
 - Most significant change wrought on international financial system by U.S. tax law in years – watch the fallout
- 30% withholding on expanded FDAP payments made to foreign financial institution accounts unless
 - Certain information disclosure / reporting agreement entered into by institution
 - or
 - Confirmation of no U.S. customers

Foreign Persons

U.S. Withholding Rules: New 1471 to 1474, Synopsis “Super Withholding” (continued)

- 30% withholding applies to expanded FDAP type payments made to foreign non-financial entity unless entity
 - Confirms no substantial U.S. owner
or
 - Provides information regarding all U.S. owners
- Expanded FDAP - Gross proceeds of sale of property that would create FDAP are subject to reporting under these new rules
- Trumps treaty withholding rate reductions; vastly expands withholding

U.S. Withholding Rules: Partnership Rules, 1446

- Partnership that has FP as partner
 - If it has ECI,
 - Must withhold at highest applicable marginal rate under 1, 11 for income allocated to FP partner
- Partnership rules reflect unusual and unique situation where ECI is subject to withholding (typically not)
- Withheld amounts treated as distributed to such partner

Avoiding Double Taxation: Foreign Tax Credits, In General

- Purpose of foreign tax credit (“FTC”)
 - Mitigates double taxation arising in international tax regime
 - Divides worldwide tax liability between U.S. and foreign country
- 3-pronged philosophy of the FTC system
 - The U.S. will not use the FTC to subsidize a foreign tax system
 - The U.S. will oppose distortions of economic activity to increase the credit
 - The U.S. applies its own rules and definitions to FTC concepts

Avoiding Double Taxation: Foreign Tax Credits, Planning Goals

- Objectives of FTC Planning:
 - Avoid excess credit positions
 - Utilize tax attributes optimally
 - Access foreign taxes efficiently
 - ...resulting in increased cash flow, earnings, shareholder value
- Methods:
 - Timing of income recognition
 - Sourcing of income and deductions
 - Controlling basket allocations
 - Managing effective tax rate

Avoiding Double Taxation: Foreign Tax Credits, Detailed Rules

- A credit against “tax” - 1.901-2
 - Compulsory payment pursuant to authority of foreign country
 - Excludes penalties, fines, interest, customs duties
 - Determined under U.S. law, not law of taxing jurisdiction
 - No economic benefit received
 - “Soak up” taxes
 - Separate levies- Tier 1 audit issue; payments of foreign levies in connection with certain structured passive investment arrangements
 - Determined to be noncompulsory, and therefore noncreditable.
- Must be tax on “income”
 - Tax must be an income tax in the U.S. sense
 - Likely to reach net gain
 - Realization, gross receipts, net income requirements of 1.901-2(b)
 - Alternative: “in lieu of income”- Section 903
 - operates as a tax imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed

Avoiding Double Taxation: Foreign Tax Credits, Detailed Rules (continued)

- Must be paid or accrued to a foreign country or possession of the U.S.
 - “any foreign state...and any political subdivision of any foreign state”
 - Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands, and American Samoa
 - Prove that it was paid: Forms 1116 and 1118, foreign tax receipt or return; careful of foreign tax redeterminations
 - Paid by taxpayer: who is the technical taxpayer? The person who has legal liability for the tax.

Avoiding Double Taxation: Foreign Tax Credits, Eligibility

- Who may claim?
 - U.S. Citizen
 - Resident Alien
 - Domestic Corporation
 - Does not include 897(i) corporations
 - Partnerships and Partners
 - No tax credit for partnership
 - Credit passes through to partners
 - Estates, Trusts, Beneficiaries
 - Less clear as to amount that can be claimed
 - But, generally treated as individual, and credited at trust or beneficiary level (if distributed)

Avoiding Double Taxation: Foreign Tax Credits, Direct Credit

- Direct credit
 - Available to taxpayer who is legally obligated to pay, and pays, the foreign taxes
 - Credit available under 901 and 903
 - Credit available to branch, [including partnership or disregarded entity, but not to 100% owned subsidiary]
 - Applies to all USPs (corporations, individuals)

Avoiding Double Taxation: Foreign Tax Credits, Indirect Credit

- Indirect credit
 - Foreign income taxes paid or accrued by 10% owned foreign subsidiary are deemed paid by U.S. parent
 - Parent and sub must be C corporations
 - Earnings subject to the foreign tax must be recognized by parent as a dividend
 - Dividend “grossed up” by credit (Code Section 78)
 - 902: credit to domestic parent corporation for taxes paid by foreign subsidiary
 - 960/962: credit to U.S. shareholder for taxes paid by CFC
 - 1248: credit against deemed dividend on sale of foreign corporation stock
 - 367: credit against deemed dividend included in income
 - 1292: distributions from passive foreign investment company to domestic shareholder owning 10% or more of stock
 - 1293: Inclusion by taxpayer income from of passive foreign investment company that is a qualified electing fund

Avoiding Double Taxation: Foreign Tax Credits, Limitations

- Limitations
 - Section 904 “Basket Rules”
 - Limits taxpayer ability to claim foreign tax credit to the proportion of tax against which credit is taken which taxpayer’s foreign source taxable income within a particular basket bears to his total taxable income for such year.
 - Passive vs. general (tax years after 2006)
 - Interest, rents, royalties, etc. are “passive”
 - Everything else is “general”
 - Special rules
 - High tax
 - Active rents/royalties
 - Export interest
 - Look-through
 - Capital gains
 - Changes in ownership: Section 383
 - Limits use of tax credits following change in ownership

U.S. Persons

Avoiding Double Taxation: Foreign Tax Credits, Impact of Income Tax Treaties

- May allow for direct or indirect credit independent from 901
- May specify particular foreign taxes that qualify for foreign tax credits
- May specify sourcing rules for certain foreign income
- Competent authority option

Avoiding Double Taxation: Dividend Received, Deduction 243

- U.S. corporations generally entitled to dividend received deduction for dividends from domestic corporation
 - 70% deduction for corporation owned <20%
 - 80% deduction for corporation owned =>20%
 - 100% deduction for affiliated (consolidated)
- Foreign corporation dividend qualifies to extent of earnings and profits accumulated while corporation was a domestic corporation.

Anti-Deferral: Controlled Foreign Corporations

- Primary mechanisms to avoid (perceived) abusive deferral of income of foreign corporations
- Key notions
 - U.S. Shareholders,
of
 - Foreign corporations controlled by such U.S. shareholders that earn
 - Subpart F incomeor
 - Make investment in U.S. property
 - Will be taxed on the corporation's income on a current basis to extent of corporation's earnings and profits

Anti-Deferral: Controlled Foreign Corporations, Definition

- A CFC is a foreign corporation of which more than 50% of the value or voting power of its stock is owned by one or more “U.S. Shareholders” 957
 - A U.S. Shareholder is any USP owning more than 10% of the voting power of a foreign corporation- 951(b)
 - Not a value test
- Regardless of combined voting power held by USPs, if they are not “U.S. Shareholders,” 50% threshold will not be met
 - Example: 11 shareholders, all USPs, each own 9.09% of a foreign company.
 - None are U.S. Shareholders, so the corporation is not a CFC
 - Family/entity attribution rules apply to determine share ownership 958
- Even if not a CFC, see discussion of Passive Foreign Investment Companies

Anti-Deferral: Controlled Foreign Corporations

- U.S. Shareholders of CFCs must include certain types of income of the CFC in their own income
 - Inclusion is a deemed dividend whether or not actually distributed, limited to current year E&P
 - No tax on subsequent actual distribution of such income to shareholder.
- Income subject to inclusion includes:
 - Subpart F income
 - Withdrawals of previously excluded subpart F income invested in less developed countries
 - Withdrawals of previously excluded subpart F income from foreign base company shipping operations
 - Earnings invested in U.S. property (Section. 956)

Anti-Deferral: Subpart F, Subpart F Income

- What is “Subpart F” income?
 - Foreign base company income (954)
 - Insurance income (953)
 - Income from bribes, kickbacks, or other such payments (162(c))
 - Blacklisted countries (901(j))

Anti-Deferral: Subpart F, Common Types of Subpart F Income

- Most common type of Subpart F income is foreign base company income
 - Foreign personal holding company income (954(c))
 - Foreign base company sales income (954(d))
 - Foreign base company services income (954(e))
 - Foreign base company oil related income (954(g))
 - Foreign base company shipping income no longer included after 2004 (previously 954(f))

Anti-Deferral: Subpart F, Foreign Base Company Income

- Most common type of foreign base company income is foreign personal holding company income
 - Dividends, interest, royalties, rents, and annuities—income typically earned from passive investments
 - Gains on sales of assets that produce the income listed above
 - Foreign currency gains
 - Income equivalent to interest
 - Income from notional principal contracts
 - Payments in lieu of dividends
 - Amounts received under personal services contracts

U.S. Persons

Anti-Deferral: Subpart F, Exceptions from Foreign Personal Holding Company Income

- Exceptions from foreign personal holding company income
 - Rents and royalties derived in active business from unrelated person
 - Same country exception
 - Dividends and interest- related company organized in same jurisdiction as CFC and has substantial part of its assets used in trade or business located in such country
 - Rents and royalties from received from related corporation for use of property located in CFC country
 - Does not apply to the extent such income reduces the payor's Subpart F income
 - Dividends, interest, rents and royalties received from a related CFC to the extent such income is not Subpart F or effectively connected income of such CFC.
 - "Related": CFC that controls or is controlled by the other CFC, or controlled by common owner. "Control" is ownership of more than 50% of stock by vote or value.

Anti-Deferral: Subpart F, Foreign Base Company Sales Income

- Foreign Base Company Sales Income: 3 Requirements
 - Related party sale and/or purchase
 - Property is manufactured, produced, grown, or extracted outside of the CFC's country of organization
 - Does not include products manufactured by CFC
 - Possible to use contract manufacturers whose manufacturing will be attributed to CFC
 - Property is sold for use, consumption, or disposition outside of the CFC's country of organization
- Exceptions
 - Property manufactured by CFC or in CFC's country
 - High tax exception: taxed at an effective rate greater than 90% of U.S. tax rate

Anti-Deferral: Subpart F, Foreign Base Company Service Income

- Foreign Base Company Service Income
 - Income from performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services, where such services
 - Are performed by or for a related party of the CFC,
and
 - Are performed outside of the CFC's country of organization
 - Purpose is to prevent a company from shifting profits of a CFC through the use of cross-border payments to related parties
 - Substantial assistance - if more than 50% of cost of service rendered by related person, then probably FBCSI

Anti-Deferral: Subpart F, Investment in U.S. Property 956

- Amounts invested by a CFC in U.S. Property will be included in U.S. Shareholder's income 956
 - Tangible property located in United States
 - Stock of a domestic corporation
 - An obligation of a United States person
 - Any right to use in the US
 - A patent or copyright
 - An invention, model, or design
 - A secret formula or process
 - Any other similar property right

Anti-Deferral: Subpart F, De Minimis Rules

- General exceptions to inclusion of FBCI
 - De minimis rule: FBCI and gross insurance income equals less than the lesser of
 - 5% of total gross income, or
 - \$1,000,000
 - High tax
 - Not included if taxpayer pays tax rate on such income greater than 90% of effective U.S. rate.
- Watch out for full inclusion:
 - If FBCI and insurance income equal more than 70% of the CFC's total gross income, all of CFC's gross income shall be included, and treated as FBCI or insurance income (as appropriate)

Anti-Deferral: Subpart F, Inclusion Amount

- Steps in calculating Subpart F income inclusion amount
 - 1. Determine initial gross Subpart F income
 - 2. Apply de minimis and full inclusion rules
 - 3. Allocate and apportion expenses
 - 4. Exclude income subject to high tax exception 954(b)(4)
 - 5. Limit to current E&P 952(c)(1)(A)
 - Recapture earlier Subpart F income not included due to E&P limitation
- Future distributions from inclusion are NOT taxable (similar to S corporation)

CFC – Earnings and Profits: Synopsis

- Earning and profits key concept in measuring Subpart F inclusion amount
- Must be calculated using U.S. tax principles
- Must contemporaneously account for earnings and profits
 - Hard to recreate the wheel

CFC - Section 1248 – Sale of Stock Effects: Synopsis

- Recharacterizes capital gain recognized upon sale of foreign corporation as dividend income to the extent of accumulated E&P
 - Dividend income may not be bad in current environment
 - Assuming “qualified dividends” for individual
 - Corporation could possibly use deemed paid credit
 - Will get worse as tax rates rise in any event
- Purpose is to avoid permanent U.S. loss of taxation over of E&P accumulated while foreign corporation was CFC
- To whom does it apply?
 - U.S. Shareholders (CFC definition)
 - Who owned stock in foreign corporation anytime during prior 5 year period if corporation was CFC during any portion of that time

CFC - Section 1248 – Sale of Stock Effects: Specific Rules

- When is it applicable?
 - Gain-recognition transactions involving CFC shares
 - Actual or deemed sales
 - Taxable redemptions or liquidations
 - Sales of interests in partnerships that own CFCs
 - Certain non-recognition transactions that become gain recognition transactions under 1248
 - 1248(f): distribution of CFC stock by domestic corporation that is 10% or more owner
 - 1248(i): indirect transfers of stock of company that is a 10% corporate shareholder of a CFC

Anti-Deferral: Passive Foreign Investment Companies, Synopsis 1291 - 1298

- Passive foreign investment companies (PFIC) rules are additional anti-deferral mechanism
- Applies to ANY U.S. shareholder
 - CFC-type determinations of ownership do not matter
- PFIC are generally entities that has substantial amount of passive type income
 - Caution: Operating entity can conceivably turn into a PFIC over time through retention of earnings
- PFIC rules seek to discourage (and punish) retention of PFIC earnings not distributed currently
- Certain elections can be made to avoid application of PFIC inclusion rules
- See new and expanded reporting requirements under HIRE Act

Anti-Deferral: Passive Foreign Investment Companies, Specific Rules - General

- PFIC is foreign entity that:
 - =>75% of income is “passive income
or
 - Passive assets constitute => 50% of total assets
- Result (bad):
 - “Excess distributions” are treated as being received in current year as ordinary income
 - Interest charge applied “as if” payments were received during the shareholder’s entire holding period
 - Gain on sale treated as ordinary income

- To avoid PFIC rules
 - Qualifying Electing Fund (“QEF”) election which causes current income inclusion to USPs
 - Character is retained (ordinary/capital)
 - QEF must have applied since 1/1/1987
 - Mark to market election for all assets annually
 - Deemed gain passed through to all U.S. shareholders
 - QEF election requires cooperation of investee entity – sometimes difficult to come by

U.S. Persons

Anti-Deferral: Accumulated Earnings Tax 531-537, Personal Holding Company 541-547

- Accumulated earnings tax can apply to foreign corporation
 - BUT, certain adjustments apply
 - CFC inclusion amounts deducted
 - Capital gains exempt via treaty
 - Generally only applies to extent income is from U.S. sources or ECI.
- Personal holding company rules inapplicable to foreign corporations

Overall Foreign Loss Recapture 904(f)

- “Net losses” from foreign sources affect planning in two ways
 - Future foreign source income may be recharacterized as U.S. source (hurts foreign tax credit limitation)
 - Gains realized (even in non-recognition transaction) may be recognized

General Considerations

- Considerations in choice of entity
 - Foreign entity characteristics
 - Liability issues
 - Foreign tax component
 - U.S. tax component of using foreign entity
 - Treaty provisions
 - Foreign currency
 - U.S. and foreign transfer pricing and policy

Options

- Options:
 - “Tax-opaque”
 - Corporation
 - “Tax-transparent”
 - Partnership
 - Disregarded entity
 - Hybrid
 - Reverse hybrid
 - Branch or permanent establishment

Foreign Entities

- Per se corporations 301.7701-2(b)(8)
- Foreign eligible entities: an entity that is not a per se corporation
 - Check the box rules for foreign eligible entities:
 - 2 or more members: can elect to be classified as a partnership or as an association (taxed as a corporation)
 - 1 member: can elect to be classified as a disregarded entity or an association (taxed as a corporation)
 - Default classification of foreign eligible entities
 - Corporation
 - 2 or more members, all of which have limited liability
 - 1 member, who has limited liability
 - Partnership
 - 2 or more members, at least one of which has unlimited liability
 - Disregarded entity
 - 1 member, who has unlimited liability

Hybrids

- Hybrid Entities
 - Transparent for U.S. tax purposes, taxed as a corporation (or other tax-opaque entity) in the foreign jurisdiction
- Reverse Hybrid Entities:
 - Taxed as corporation for U.S. tax purposes, transparent in foreign taxing jurisdiction

Advantages of Hybrid

- Losses, deductions, and foreign tax credits flow to the U.S. tax return
- In the case of branches, cash can move between foreign entities and reinvested overseas rather than repatriated and taxed in U.S.
- Also for branches, foreign taxes can be reduced through deductible payments made by high tax entities to low tax entities
- Subpart F foreign base company sales income issues mitigated
 - Subject to 954(d)(2)
- For hybrids that are partnerships, flexibility of partnership allocations of tax items

Advantages of Hybrid (continued)

- 367 rules do not apply, thus making outbound transfers of property, including intangible property, tax-free
- Distributions of property to partner are generally tax-free (except to the extent of 731(a)(1))
- Liquidations are generally tax-free (again, subject to 731(a)(1))
- Easy and generally more tax-efficient to convert into a corporation, than from corporation to tax-transparent entity
 - But be wary of 367 issues
 - Branch loss recapture rule if partnership incurred losses that flowed through to U.S. return
 - Deemed contribution of assets

Disadvantages of Hybrid

- Inability to control flow of income to U.S. return
- Foreign losses flow through to entity's U.S. return
 - Impair ability to claim foreign tax credits
- Dual consolidated losses 1503
- Overall foreign loss rules 904(f)
- Currency issues 987
- Limitation on partnership losses 704(d)
- Subpart F branch rule 954(d)(2)
- Other typical loss limitation rules applies – 465, 469

Funding the Entity 367: Synopsis

- 367 is key provision dealing with transfers of appreciated property from the U.S. to foreign entity
 - Concern is that appreciation will be lost to the U.S. tax system
 - Trumps principles of 332 (controlled sub liquidation), 351 (tax-free formation); 354, 355, 368 (tax-free reorgs)
 - Must be consulted anytime engaging in what property transfer/restructure/recapitalization involving foreign entities
- Old law
 - Had excise taxes, and such
 - Also applied to partnership

Funding the Entity 367: Specific Rules

- General Rule: If USP transfers property to a foreign corporation in connection with exchange described in 332 , 351 , 354, 356, or 361 such corporation shall not, for purposes of determining recognized gain, be considered to be a corporation
 - If not a “corporation” then normal non-recognition does not apply
 - Loss is NOT recognized
- Trade or Business Property Exception to General Rule:
 - Property to be used in active trade or business outside the U.S.
 - Sounds good so far BUT limited because:
- Exception to Trade or Business Exception:
 - Inventory, AR’s, installment receivables, foreign currency
 - Intangible property
 - Leased property where transferor is lessor
 - Also, property subject to depreciation recapture

Funding the Entity 367: Specific Rules (continued)

- Stock Exception to General Rule
 - Transfer of stock in foreign corporation a “party to exchange” will not cause gain recognition, BUT only if
 - Transferor enters into “gain recognition agreement” with U.S. 1.367(a)-8T
 - Provides for deferral of gain until certain triggering events occur
- Branch Exception to Property Exception
 - Branch with previous losses
 - Must recognize gain to extent of previous uncovered losses attributable to branch
 - Thus no exception for trade or business property to that extent
 - Thus be cautious upon incorporating branch
- Special Rule for Intangibles
 - Deemed to receive annual royalty payments “commensurate with the income” attributable to the intangible property

367 - Funding the Entity: What About Partnerships?

- No specific rules regarding contributions of property to foreign partnership
 - Prior to 1997, 35% excise tax applied
- But, reporting required Form 8865
 - Generally requires reporting for controlled partnerships by 10% U.S. shareholders
 - Effectively a mini-Form 1065
 - But reports contributions, changes in ownership

Investment In U.S. Real Estate 897: Synopsis / General Principle

- Real estate interests are treated “jealously” by source countries
 - Strong tendency for source country to claim tax on income/gain from real estate
 - US particularly treats real estate interests that way since enactment of Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”)
- In US, the sale of real estate owned by FPs directly, through partnerships, and the sale of interests in certain domestic corporations and partnerships holding real estate, are all treated as the FP’s ECI who is ETBUS.
- The tax is collected by withholding by buyer
 - A buyer must be aware of who they are dealing with
 - Liability for tax if not withheld

Investment In U.S. Real Estate 897: What is Real Estate?

- “Real estate property interest” includes
 - Land, improvements, leaseholds, options,
 - Personal property used in association, therewith
 - Oil and gas interests and other mineral interests
 - Located in U.S. or Virgin Islands
 - Equity in domestic corporations and partnerships owning real estate property interest

Investment In U.S. Real Estate 897: Specific Rules – USRPI

- Gain or loss of FP from disposition of “US real property interest” (“USRPI”) is treated as ECI as if FP was ETBUS
- USRPI means:
 - Direct ownership of real estate
 - Indirect ownership through partnerships, trusts, estates
 - Ownership of a “US real property holding corporation” (“USRPHC”)
 - Ownership does not include straight debt interest (no equity kicker)
 - USRPHC does not include foreign corporation
 - Ownership of certain partnerships, trusts, estates holding U.S. real property (“USRPPE”)

Investment In U.S. Real Estate 897: Specific Rules – USRPHC

- USRPHC is a U.S. corporation where real property =>50% of its total “qualified” assets during “look back period”
 - Qualified assets include only U.S. and non-U.S. real estate and other trade or business assets
 - Non trade or business assets don’t get counted in denominator
 - Look through rule applies in case of controlled corporations (>50% of value of stock)
 - Excludes publicly traded corporation where FP never owned >5% of stock during “look back period”
- Look back period” with regard to a FP is shorter of
 - Period of 6/18/80 ownership
 - 5 years

Investment In U.S. Real Estate 897: USRPPE

- USRPPE is partnership ,trust or estate where
 - $\geq 50\%$ of assets are USRPI, AND
 - $\geq 90\%$ of assets are USRPI and cash or cash equivalents
 - No “look back period” in case of USRPPE – date of transaction controls
- Foreign corporation holding USRPI can elect to be treated domestic corporation 897(i)
 - All income essentially becomes ECI (see rules regarding FDAP rental income)
 - Gain on sale of stock is treated as if domestic corporation

Investment In U.S. Real Estate: REITS and RICs

- REITs and RICs
 - Distributions to FP attributable to real estate disposition will be treated as it were ECI attributable to FP's ETBUS

Unless either

 - Publicly traded and FP did not own >5% of stock within 1 year preceding distribution

or

 - Domestically controlled entity
 - <50% owned by FPs during "testing period"
 - Testing period is generally 5 years (but shorter in some circumstances)

Investment In U.S. Real Estate: Collection of Tax by Withholding - 1445

- Generally, transferee (buyer) of USRPI must withhold at 10% of gross proceeds unless:
 - Transferor confirms in statement that it is not a FP
 - 897(i) election allows foreign corporation to claim it is domestic corporation
 - In the case of stock sale, corporation confirms in statement that it is not a USRPHC
 - Personal residence sale \leq \$300,000
- Domestic partnerships, estates, trusts:
 - If they dispose of real estate, THEN
 - Partnership, trustee, representative, must withhold 35% of amount of gain allocable to FP
 - Doesn't matter if distribution made
- Other rules regarding transactions such as:
 - Distributions of property by USRPHC to FP shareholders
 - 10% withholding applies
 - Compare USRPPE – no withholding at present on distributions from USRPPE's
 - Distributions by REITs, RICS

Foreign Persons

Investment In U.S. Real Estate: Exceptions to Collection of Tax by Withholding - 1445

- Transferee will use property as personal residence with cost <\$300,000
- Domestic corporation or partnership publicly traded (but see >5% rule)
- Transferor confirms they are not an FP
- Corporation or partnership confirms it is not a USRPHC or USRPPE

Synopsis

- Engaging in cross-border transactions can and likely will involve use of foreign currency
- Each business unit must have a “functional” currency (the day-to-day currency used to denominate its transactions)
 - All other currencies are treated as personal property
 - Exchange of “nonfunctional currency” for “functional” currency is thus a sale or exchange – all normal rules of basis, recognition, gain, loss apply [1001 etc.]
- Gains or losses from “exchange” of foreign currency can thus arise
 - Must be measured
 - Must be sourced
- Almost no one is excluded
 - Very small exclusion from 988 for “personal transactions” where gain recognized does not exceed >\$200

General Rules

- Foreign currency exchange (“FX”) gain or loss resulting from “988 transaction” shall be recognized
 - FX gain - any gain resulting from exchange rate change from date of “booking” to date of payment
 - FX loss - any loss resulting from exchange rate change from date of “booking” to date of payment
- “988 transaction”/“booking” means
 - Either of these types of transactions:
 - Loan or borrowing of money (booking is date of borrowing/loan)
 - or
 - Accruing an expense or income prior to the time payment is made (booking is date of accrual);
 - Where the transaction is denominated in “nonfunctional currency”

General Rules

- “Functional currency” means the currency
 - Of the economic environment in which a “qualified business unit’s” (“QBU’s”) activities are conducted
 - and*
 - Which is used in keeping the QBU’s books and records.
- QBU means any separate and clearly identified unit of a taxpayer’s business which maintains separate books and records
 - Does not have to be separate entity
 - Can be branch, permanent establishment, corporation, partnership, etc.

Synopsis

- Overview:
 - Seeks to ensure that pricing for goods and services transferred between related parties is “arms length”
 - U.S. has rules; other countries have their own rules
 - Possibility for conflict – hence possibility for double taxation
 - Treaty competent authority and OECD rules attempt to ameliorate conflict
- Why does it matter ?
 - Ability to shift profits from high taxed jurisdiction to low-tax, no-tax jurisdiction through less-than-arms-length pricing
- Simple statute; exceedingly complex area
 - Entire cottage industry devoted to just this area and “transfer pricing studies”
 - Involves disciplines far beyond tax law
- Where the money is – in the view of the revenueurs
- Where the planning opportunities are – in the view of the taxpayer

Synopsis (continued)

- Who does it apply to ?
 - Everybody
 - No “little guy” exception – must adhere, no matter business size
 - Failure to comply raises possibility of significant penalties (20%/40% of tax liability – substantial valuation understatement)
- When does it likely arise ?
 - Typically, anytime there are two separate but commonly controlled or related taxpayers providing services or products to the other
 - Control is not based on objective voting rights, ownership
 - Can arise in “practical” control situations – e.g. sole and exclusive vendor relationship
 - Most frequently arises with parent/subsidiary relationship
 - But same arms-length principle applies in determining income of permanent establishment/branch
 - Also shareholder/corporation – partner/partnership

The Statute

“In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of [section 936\(h\)\(3\)\(B\)](#)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.”

Overview of Regulations

- 151 pp. Final/Temporary Regulations
 - Merten's Federal Tax Regulations – Vol. 3 (Thomson Reuters/West 2010)
- Areas covered
 - Best method of pricing – comparable uncontrolled price method (“CUPM”)
 - Alternative methods (if no CUPM can be found)
 - Comparable profits method
 - Profit split method, resale price method, cost plus method, etc.
 - Great deal of subjectivity
 - Specific rules for tangibles, services, intangibles
 - Cost sharing arrangements
 - Hot topic – deals with group members' development of property (e.g. intellectual property)
 - Who contributes what to the development effort ?
 - Where should resulting income be allocated ?

Advance Pricing Agreements / Treaty Issues

- U.S. (and other countries) have administrative procedures allowing taxpayers to obtain “pre-approved” intercompany pricing – APA process
 - Expensive and time consuming
 - Stakes must be high to pursue – and they usually are
 - Consider Glaxo SmithKline case – \$3.4 billion (oh, but that included interest)
 - Somewhat successful
- Treaty partner countries have competent authority procedure to work out and avoid double taxation

Penalties – 6662 – Application

- Relevant penalties are 6662(e) – substantial valuation misstatement
 - 20% of tax understatement if:
 - Transfer price 200% or more, or 50% or less of “correct” price (transactional penalty)
 - or
 - Transfer price adjustment more than lesser of \$5,000,000 or 10% of gross revenues (net adjustment penalty)
 - 40% of tax understatement if:
 - Transfer price 400% or more, or 25% or less of “correct” price (transactional penalty)
 - or
 - Transfer price adjustment more than lesser of \$20,000,000 or 20% of gross revenues (net adjustment penalty)

Penalties – 6662 – Avoidance: Specific Price Method

- Reasonable cause defense of 6664(c) is available (and adjustment amounts will not be counted toward thresholds) if specific price method is used under 482, but only IF:
 - Taxpayer determined the transfer price in accordance with a specific pricing method set forth in the 482 regulations and that the taxpayer's use of such method was reasonable,
 - Taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of transfer price in accordance with such a method and which establishes that the use of such method was reasonable, and
 - The taxpayer provides such documentation to IRS within 30 days of a request
- If no documentation, no reasonable cause defense – you can't wait for audit.

Penalties – 6662 – Avoidance: Other Than Specific Price Method

- Reasonable cause defense of 6664(c) is available (and adjustment amounts will not be counted toward thresholds) if specific price method is NOT used under 482, but only IF:
 - Taxpayer establishes that no specific pricing method would clearly reflect income, the taxpayer used another pricing method to determine such price and such other pricing method was likely to result in a price that would clearly reflect income,
 - Taxpayer has documentation (in existence as of the time of filing the return) which sets forth the determination of such price in accordance with such non-specific method and which establishes that the requirements above were satisfied
 - Taxpayer provides such documentation to the Secretary within 30 days of request for such documentation.
- Again, if no documentation, no reasonable cause defense – you can't wait for audit.

Penalties – 6662 – Avoidance: List of Documentation Required

- Documentation to reduce threshold and make reasonable cause defense available is extensive
 - See 1.6662-6 – (excerpt from regulation next page in very small print)
- IRS will take into account numerous factors in determining reasonableness of pricing methodology including:
 - The experience and knowledge of the taxpayer,
 - The extent to which reliable data was available and the data was analyzed in a reasonable manner.
 - The extent to which the taxpayer reasonably relied on a study or other analysis performed by a professional qualified to conduct such a study or analysis, including an attorney, accountant, or economist
 - Etc.

Penalties – 6662 – Avoidance: List of Documentation Required (language)

- Overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its property or services;
- Description of the taxpayer's organizational structure (including an organization chart) covering all related parties engaged in transactions potentially relevant under section 482, including foreign affiliates whose transactions directly or indirectly affect the pricing of property or services in the United States;
- Any documentation explicitly required by the regulations under section 482;
- Description of the method selected and an explanation of why that method was selected, including an evaluation of whether the regulatory conditions and requirements for application of that method, if any, were met;
- Description of the alternative methods that were considered and an explanation of why they were not selected;
- A description of the controlled transactions (including the terms of sale) and any internal data used to analyze those transactions. For example, if a profit split method is applied, the documentation must include a schedule providing the total income, costs, and assets (with adjustments for different accounting practices and currencies) for each controlled taxpayer participating in the relevant business activity and detailing the allocations of such items to that activity. Similarly, if a cost-based method (such as the cost plus method, the services cost method for certain services, or a comparable profits method with a cost-based profit level indicator) is applied, the documentation must include a description of the manner in which relevant costs are determined and are allocated and apportioned to the relevant controlled transaction.
- Description of the comparables that were used, how comparability was evaluated, and what (if any) adjustments were made; An explanation of the economic analysis and projections relied upon in developing the method. For example, if a profit split method is applied, the taxpayer must provide an explanation of the analysis undertaken to determine how the profits would be split;
- A description or summary of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return, which would help determine if a taxpayer selected and applied a specified method in a reasonable manner; and G
- General index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.

In General

- An agreement between two sovereign nations
 - U.S. party to 55+ income treaties; 60+ countries
 - Estate/gift tax treaties exist also, but fewer in number
- Purpose: avoidance of double taxation, avoidance of fiscal evasion, promotion of international trade and investment, information exchange
- Common treaty methods to avoid double taxation:
 - Foreign tax credits - may allow certain foreign levies that would not be eligible for the FTC under IRC provisions to qualify
 - Reduction of statutory tax rates
 - Reduce 30% withholding on certain items of U.S. source income
 - Reduce branch profits tax
 - Exclusion from U.S. taxation on certain other U.S.-source income that would otherwise be ECI

Interaction with Domestic Law

- U.S. law grants treaties status of “supreme law of the land,” meaning they have equal standing with U.S. domestic laws
 - If there is inconsistency with domestic laws, courts will try to give meaning to both
 - If inconsistency cannot be resolved, “last in time” will usually control
- Certain provisions of IRC are considered statutory overrides of treaty obligations
 1. FIRPTA gain on USRPI,
 2. earnings stripping rules limiting deductibility of interest paid to certain related FPs where interest is not subject to 30% withholding due to treaty or other reasons.

U.S. Model Treaty: Outline

- Chapter I: scope, application, taxes covered
- Chapter II: definitions
- Chapter III: taxation of various types of income
- Chapter IV: taxation of capital
- Chapter V: methods for elimination of double taxation
- Chapter VI: nondiscrimination articles, competent authority disputes
- Chapter VII: entry into force, termination

U.S. Model Treaty: General Provisions

- Taxation of dividends
 - Usually 15%; may be reduced to 5% if substantial ownership by recipient (10 or 25%)
 - Some treaties reduce to 0%: Japan, Australia, UK, Mexico
- Taxation of interest
 - Rate between 5% and 17.5%
 - Grants exclusive right to tax to recipient's country of residence
- Taxation of Royalties
 - Rate between 5% and 10%
 - Grants exclusive right to tax to recipient's country of residence
- Capital Gains on Personal Property
 - Exclusive right to tax granted to country in which seller is resident
 - Exception: FIRPTA

Residence

- Eligibility for treaty benefits determined initially by residency
 - “resident of a contracting state”
 - Individuals: liable to tax by reason of domicile, residence, citizenship
 - Corporations: country of incorporation, also place of management
 - Does not include persons liable for tax in a state solely due to existence of a permanent establishment in that state
 - Tiebreakers
 - Individuals: permanent home, personal and economic relations (“center of vital interests”), habitual abode, citizenship, competent authority
 - Corporations: if resident of both contracting states, state of incorporation determines residency for treaty purposes

Residence & ECI: Business Profits Rule

- Foreign corporations can avoid tax on ECI by application of the business profits rule
 - A resident of a contracting state will be exempt from U.S. tax on “business profits” except to the extent attributable to a “permanent establishment” maintained in U.S. by foreign taxpayer
 - Must satisfy limitations on benefits article
 - Must elect to be taxable under a treaty, and not IRC
 - Business profits definition is similar to IRC definition of ECI, although a bit more limited
 - Permanent establishment definition varies from treaty to treaty

Residence & ECI: Business Profits Rule: Permanent Establishment

- “Permanent Establishment”
 - Fixed Facility
 - Place of business (does not need to be owned by FP)
 - Fixed - Needs certain degree of permanence
 - Business activity carried on through fixed place of business
 - Dependent Agent in U.S. having and habitually exercising authority to conclude contracts in the name of the principal
 - Agent: one who acts on behalf of another party
 - Dependent vs. Independent: independent agent is legally (control over tasks) and economically (entrepreneurial risk) independent of principal
 - Authority to conclude contracts- watch out for apparent authority
 - Taisei case: 104 TC 535

Limitations on Benefits

- Treaty benefits are limited in various ways:
 - LOB provisions in treaty
 - 7701(l); 1.881-3
 - 894(c)
- Purpose of limitation of benefits:
 - To ensure that beneficiaries of treaties have adequate connection with the treaty countries

Limitations on Benefits: LOB Treaty Article

- The “treaty shopping” game: structure operations so as to obtain benefits of a favorable treaty between country in which investment made and country other than that of which taxpayer is a resident.
- To obtain treaty benefits, one of the following criteria must be met by resident:
 - If individual, must be resident of contracting state
 - Governmental body of contracting state, or political subdivision
 - If a corporation, shares are traded on exchange of contracting state
 - Non-profit the beneficiaries of which are residents of contracting state
 - Resident meeting ownership/base reduction test
 - 50% beneficial ownership by resident of contracting state
 - No conduit through which income is stripped out to non-qualifying persons
- If no treaty benefits available under above tests, may qualify under active trade or business test
 - Must qualify separately for each item of income
 - Uses 367(a) definition of “trade or business”
- Issue: derivative benefits by residents of other treaty countries with similar benefits

Limitations on Benefits: Anti-Conduit Financing Rules

- 7701(l) & 1.881-3(a)(1) permit IRS to ignore existence of an intermediary entity in a financing transaction for purposes of tax imposed under 881, 871, or withheld under 1441, or 1442
- Aimed to prevent use of conduit entities to reduce withholding taxes under tax treaties
- Effect is to ignore conduit entity and recast transaction as occurring between USP and ultimate foreign owner

Limitations on Benefits: Oh, Canada...application of 894(c)

- 894(c) denies treaty benefits for certain payments through hybrid entities
- Congress concerned that the interaction of the tax laws and the applicable tax treaty may structuring opportunity that would allow Canadian corporations with U.S. subsidiaries to avoid both U.S. and Canadian income taxes with respect to those U.S. operations
- The scheme (prior to 894(c)):
 - Canadian parent corp. with U.S. LLC between itself and U.S. subsidiary
 - Interest paid by U.S. sub through U.S. LLC (passthrough for U.S. tax purposes/corporation for Canadian tax purposes) to Canadian parent is deductible interest to U.S. sub for U.S. tax purposes, not taxed by U.S. at U.S. LLC level, not taxed by Canada because it is considered a U.S. corporation, and interest payment is recharacterized as dividend to Canadian parent for Canadian tax purposes.
 - Only tax imposed is reduced 10% treaty rate on interest paid to Canadian parent under U.S. Canada income tax treaty

Limitations on Benefits: Oh, Canada...application of 894(c) (continued)

- The solution: 894(c):
 - Amounts derived by FP through entity that is transparent for U.S. tax purposes will not receive the benefit of treaty relief from U.S. withholding if:
 - Income item is not treated for purposes of the foreign treaty country's tax laws as an income item of the FP
 - U.S. income tax treaty does not have a provision addressing the applicability of the treaty in the case of an income item derived through a partnership or other fiscally transparent entity
 - Foreign treaty country does not impose a tax on a distribution of income from the transparent entity to the FP

Limitations on Benefits: Oh, Canada...application of 894(c) (continued)

- Regulations issued under 894(c) apply to three types of entities
 - Entities that are hybrids under resident and source country laws
 - Entities that are transparent under U.S. law but not under treaty country law (hybrids)
 - Entities that are transparent under treaty country law but not U.S. law (reverse hybrids)
- 1.894-1(d)(2)(i): Payments to domestic reverse hybrids
 - No application of treaty to reduce tax on payments to domestic reverse hybrid
 - Foreign interest holder of domestic reverse hybrid not entitled to treaty benefits on income item received from U.S. sources by domestic reverse hybrid.

Limitations on Benefits: Oh, Canada...application of 894(c) (continued)

- 1.894-1(d)(2)(ii)(A): Payments from domestic reverse hybrid
 - Character of payment made by domestic reverse hybrid to interest holders is determined under U.S. tax law, provided interest holder is not also fiscally transparent
- 1.894-1(d)(2)(ii)(B): Payments made through domestic reverse hybrids
 - Recharacterization as dividends:
 - If related domestic sub makes dividend payment to domestic reverse hybrid, and owner of hybrid is deemed to receive proportionate share of such payment, and
 - The domestic reverse hybrid makes a payment to related foreign interest holder that is deductible for U.S. purposes (i.e., interest) and for which a treaty reduction applies, then
 - To the extent the deductible payment doesn't exceed the dividend payment, such deductible payment will be treated as a dividend for purposes of IRC and treaty provisions.
 - Related party= 267(b)/707(b)(1) constructive ownership rules, substituting 80% for 50%
 - Can be a good planning tool in situations in which treaty dividend withholding rates are lower than interest withholding rates

Limitations on Benefits: Oh, Canada...5th Protocol issues

- 5th Protocol to U.S.-Canada Income Tax Treaty attempts to stop perceived continued abuses of hybrid structures:
 - US LLCs
 - Canadian “unlimited liability companies” (ULCs)
- Anti-hybrid rules:
 - Article IV(a): applies to entities fiscally transparent to source state, not fiscally transparent under laws of resident state
 - Article IV(b): applies to entities not fiscally transparent to source state, fiscally transparent to resident state
 - Deny treaty benefits to certain persons by deeming amounts of income, profit, or gain not to be considered to be paid to or derived by a person who is a resident of a contracting state
- Overreaching

Limitations on Benefits: Regular Hybrids

- Reduced U.S. withholding available under income tax treaty on items of income paid to an entity that is treated as fiscally transparent only if item is derived by resident of applicable treaty jurisdiction
 - “Derived by”
 - Treaty explicitly identify entities as residents of treaty partner country
 - If entity claims reduced withholding, can’t be fiscally transparent under laws of treaty partner country
 - If interest holder of an entity claims withholding, it can’t be fiscally transparent

Treaty Traps & Planning

- Before relying on a treaty to claim benefits, check:
 - Is the treaty ratified?
 - Has it entered into force?
 - Are their protocols or supplementary conventions in place?
 - If not in place, are protocols being negotiated?
 - Has it terminated?
 - Has either treaty country instituted legislative overrides?
 - Are benefits available under the limitation on benefits article?
 - Know thy client
 - Do anti-conduit or anti-hybrid provisions of IRC apply to the transaction?

The U.S. Inbound Investor: Synopsis (Very Limited Review)

- U.S. estate and gift taxation of FP depends on “domicile”
 - Different test than for income tax purposes
 - Possible for FP to be subject to income tax but not estate/gift tax and vice-versa
- Fairly easy for non-domiciled FP to avoid U.S. estate and gift tax (but see 877A)
- Property of non-domiciled FP subject to varying estate and gift tax rules
- When dealing with inbound business FP individuals, consider estate/gift tax implications when choosing entity

The U.S. Inbound Investor: Specific Rules - Domicile

- U.S. transfer tax system based on “domicile” and “situs” of assets
 - Domicile depends on intent
 - Subjective - not the same for determination of USP for income tax purposes
 - No “substantial presence test”
 - Domicile vs. Non-Domicile
 - FP “domiciled” here is taxable worldwide on property for gift and estate tax
 - FP not domiciled here
 - Taxable estate only includes U.S. situs tangible property and some intangible property
 - Taxable gifts only include gifts fo U.S. situs tangible property

The U.S. Inbound Investor: Specific Rules – Property Classification

- Property Classification
 - U.S. Situs Tangible
 - Real estate
 - Cash in bank but only if connected with U.S. trade or business
 - Arts, collectibles, autos, furnishings
 - U.S. Situs Intangible
 - Intellectual property if “filed” in U.S.
 - Annuities issued by U.S. insurance compan
 - Partnership interest if partnership doing business in U.S.
 - Debt issued by USPs
 - Same portfolio interest exemption, however
 - Stock in company organized in U.S
 - Non U.S. Situs Property
 - Real estate and personal property not in U.S.
 - Cash (with exception above)
 - Life insurance
 - Stock in foreign corporation
 - Interest in partnership doing business outside U.S.

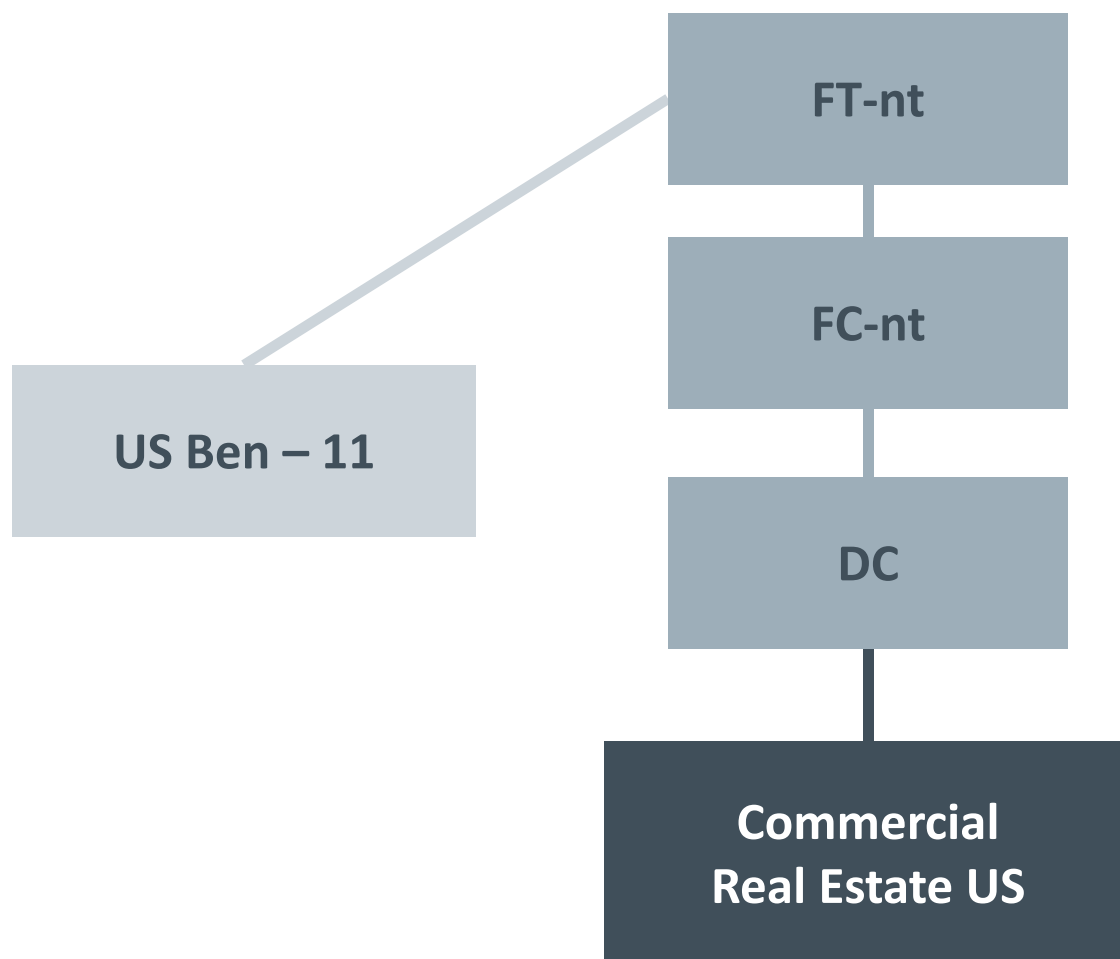
The U.S. Inbound Investor: Planning for Non-Domiciled FP - General

- Make gifts
 - Gifts of intangible property tax free (but consider 877A)
- Wrap otherwise taxable property in nontaxable form
 - In foreign corporation
 - But if holding company for U.S. stock case law might hold U.S. situs)
 - Also, consider double-tax
 - Foreign partnership (situs where doing business)
 - Might avoid double tax
 - But consider whether real estate partnership with U.S. real estate can be considered doing business outside U.S.
 - Private placement life insurance policy
- See treaties for other planning possibilities

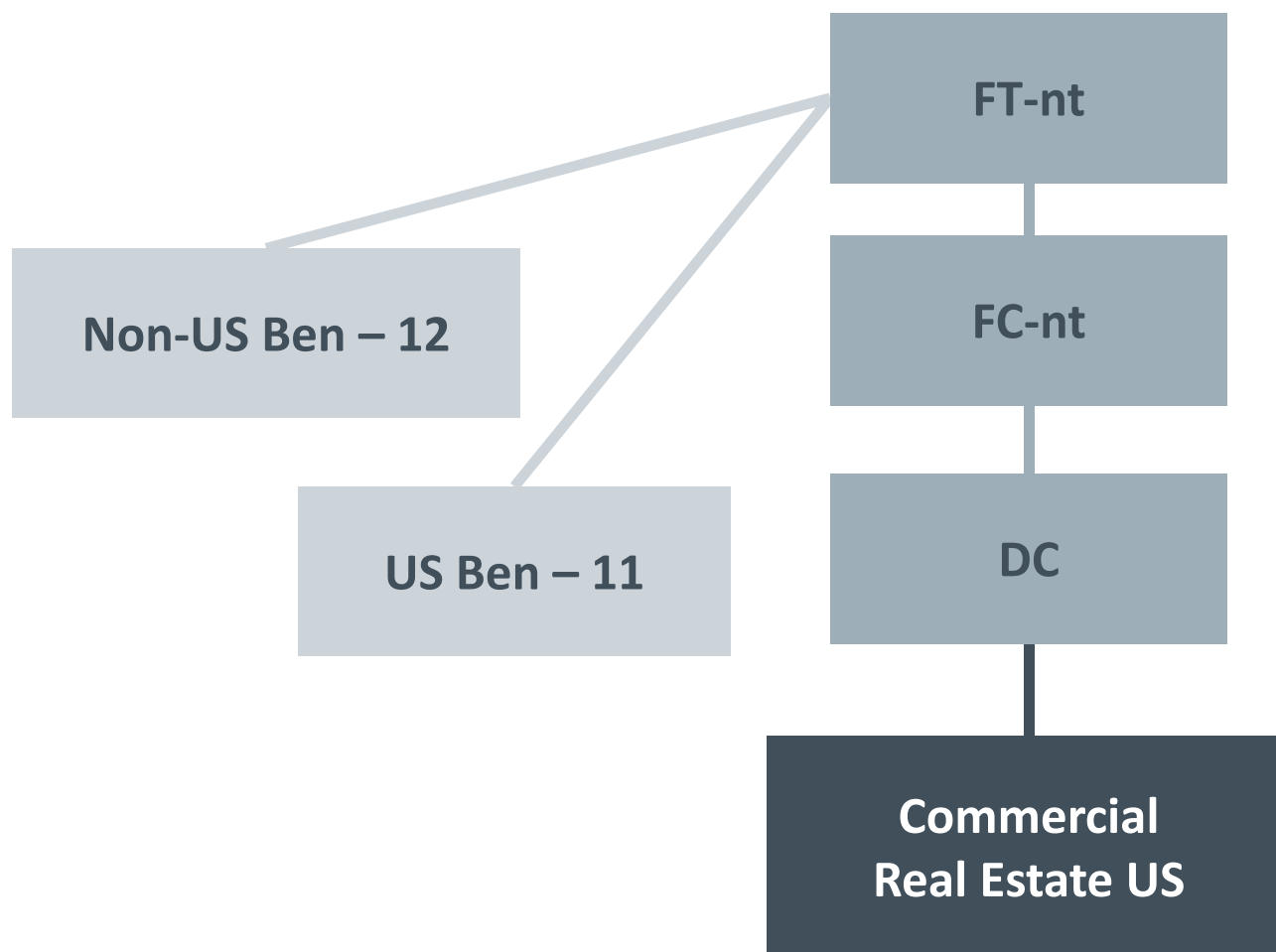
The U.S. Inbound Investor: Planning for Non-Domiciled FP - Debt

- Debt problem:
 - Non-Domiciled FP can only deduct proportion of debt based on U.S., non U.S. property
 - Even if debt attributable solely to U.S. debt
 - Similar fungibility rule under interest allocation rules for income tax purposes
- Possible solution – wrap debt and asset in single business entity
 - E.g. contribute real property to partnership along with purchase money debt

Example 1



Example 2





Triaging the Cross-Border Transaction

A Primer and Beyond

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