



PROGRAM MATERIALS

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A Primer on International Taxation

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A Primer on International Taxation

By Jacob Stein, Esq.

Inbound Taxation – Transfer Taxes

- Who is a nonresident alien?
- Estate tax on assets in the U.S. at time of death
- Unified credit is only \$13,000 (\$60k value of assets)
- Applies to stock in U.S. corp, revocable transfers, transfers with retained interest
- Does not apply to stock of foreign corp, life insurance proceeds, bank accounts, portfolio interest loans
- Unlimited marital deduction under 2056

Inbound Taxation – Transfer Taxes

- Plan by not owning assets in U.S. directly, own through foreign corporation
- Reduce value by encumbering real estate with non-recourse debt (recourse debt is a deduction that must be apportioned b/n U.S. and non-U.S. assets)
- Tax treaties with many developed nations to prevent double taxation
- NRAs are subject to gift tax if the asset gifted is within the U.S. (intangibles are excluded)
- U.S. taxpayers must report gifts over \$100,000
- Plan for gifts by making assets non-U.S.

Inbound Taxation – Real Estate

- Sale of a USRPI subject to income tax, withholding tax and information reporting
- USRPI is any real property in the U.S. or a domestic corp that is a USRPHC
- Partnership interest may be USRPI if partnership assets are mostly (50%) real estate
- USRPHC is a domestic corp whose assets are mostly (50%) USRPIs
- Sale of a USRPI subject to 15% withholding

Inbound Taxation – Real Estate

- Exceptions to withholding (certificate of non-foreign status, small residence, no tax liability)
- Direct ownership – one level of tax on sale, but must file U.S. tax return and included in the estate
- U.S. corporation – no U.S. tax return for foreign owner, but 2 levels of tax, shares included in the estate, dividends subject to withholding
- Foreign corporation – two levels of tax (regular and branch profits), but no U.S. tax return, no withholding, no estate tax

FDAP and Capital Gains

- Fixed or determinable annual or periodical
- Mostly interest, dividends, royalties, rents, salaries and wages
- Flat tax of 30% (subject to treaty reduction)
- Interest income from exempt securities, bank deposits and portfolio interest not subject to this tax
- Capital gains are not taxable unless NRA present in the U.S. for more than 182 days

Effectively Connected Income

- Income effectively connected to a trade or business in the U.S. is subject to standard tax regime and rates
- Trade or business may be conducted directly or attributed if through a partnership
- FDAP, portfolio interest and capital gains are effectively connected if the underlying asset is used in the U.S. trade or business and is integral to such business; if from unrelated activity ignore
- All other types of income are automatically effectively connected (force of attraction rule) if there is a U.S. trade or business

Branch Profits Tax

- Foreign corporation with a U.S. sub subject to two levels of tax – on subsidiary's U.S. income and then on the dividend (30% withholding)
- Foreign corporation without an incorporated subsidiary escapes the dividend tax
- Branch profits tax imposes a de facto tax on dividend from an unincorporated sub (a branch)
- The tax applies at 30% on the effectively connected earnings reduced by net increase in U.S. assets for the year

Pre-Immigration Tax Planning

- Plan prior to acquiring U.S. tax residence
- Income tax planning:
 - Increase basis of assets
 - Strip out accumulated earnings and profits
 - Defer loss recognition
 - Accelerate income recognition
 - Shift assets to relatives who will remain outside the U.S.
- Transfer tax planning:
 - Transfer assets to offshore irrevocable trusts
 - Transfer assets to children
 - Increase basis



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There is a multitude of issues that drive a cross-border business transaction. Sale of shares versus sale of assets; statutory mergers; joint ventures; security for enforcement of representations and warranties; governing law and venue; earn-outs and holdbacks; restrictions on foreign ownership; due diligence; local customs; privacy and many other. Most non-tax considerations are not country specific. They are driven by the economics of the deal and the negotiating position of the parties. When a transaction touches the U.S., tax has the center-stage.

From a U.S. standpoint, none of the other issues are as important as the tax consequences. Taxation of an M&A transaction will very often determine the deal structure. The parties can negotiate and agree to all the other terms, but tax will determine how the transaction is structured, what is possible and what is not.

For U.S. tax purposes, cross-border transactions are divided into two classes: inbound (foreigners doing business or investing in the U.S.), and outbound (Americans doing business and investing overseas). The tax rules that apply to inbound and outbound transactions are entirely different. We will examine both, and will then delve into the related subjects of pre-immigration tax planning (foreigners immigrating to the U.S.) and expatriation (Americans emigrating from the U.S.).

INBOUND TAXATION

Income Taxation

A person we in the U.S. colloquially refer to as a “foreigner” is often referred to as a “non-resident alien” (“NRA”) for U.S. federal income tax purposes. An NRA is defined as either a foreign corporation or a person who is (1) physically present in the U.S. for less than 183 days in any given year, (2) less than 31 days in the current year, (3) physically present for less than 183 total days for a three year period (using a weighing formula), and (4) does not hold a permanent resident status (a green card or an EB-5 visa) (Code Section 7701(b)(1)(A). All Code references are to the Internal Revenue Code of 1986, as amended). A foreigner receiving a green card will become a U.S. tax resident from that day forward. A foreigner who is deemed a U.S. tax resident based on the number of days test, will be deemed a U.S. tax resident for the entire calendar year in which such test is met.

A foreigner may be deemed a U.S. resident (based on one of the above tests) and also a resident of his home country. To avoid double taxation, most income tax treaties incorporate a tie-break provision for residency. The tie-break is a hierarchy of three to five tests, with the place of permanent abode as the major factor. For example, Article 4, Section 4 of the U.S.-U.K. Income Tax Treaty provides that if an individual is deemed to be a resident of both the U.S. and the U.K., he will be the tax resident of the country where he has a permanent home, and if there is a home in both countries, the country where he has habitual abode, and if there is habitual abode in both, the country where he holds citizenship, and if in both, the tax authorities of both nations will have to reach a mutual agreement. If no mutual agreement is reached, the dual national will have to rely on the availability of the foreign tax credit (26 USC Section 901).

Withholding on FDAP Income

Income tax rules applicable to NRAs can be quite complex. As a general rule, an NRA pays a flat 30% tax on U.S.-source “fixed or determinable, annual or periodical” (“FDAP”) income that is not effectively connected to a U.S. trade or business, (Code Sections 871(a) and 881. Rental income is sourced to where the property is located. Code Section 861(a)(4).), and which is subject to tax withholding by the payor (Code Section 1441(a)). The rate of tax may be reduced by an applicable treaty to anywhere between zero and 15%. The income is taxed on a gross basis, with almost no offsetting deductions.

FDAP income includes interest, dividends, royalties, rents annuity payments, and alimony. For example, if an NRA receives interest income from U.S. sources (other than interest on bank deposits), it is subject to a 30% tax. Note that the NRA is subject to this tax but does not pay it. The 30% FDAP tax is withheld by the payor at the time of payment and remitted to the U.S. Treasury. The NRA receives the remaining 70%. The obligation to withhold is imposed on the person or entity making the payment to the NRA, and if such payor fails to withhold, it is liable to the IRS for the tax, applicable penalties and interest.

A popular planning tool to avoid withholding taxation of interest income is through the use of portfolio interest rules. Portfolio interest is interest payable only to a foreigner on a debt instrument. It is not subject to taxation or withholding (Code Sections 871(h) and 881(c)(1)). NRAs often try to fit into the portfolio interest rules by lending through equity participation loans or loans with "equity kickers" (An equity kicker is an addition to a fixed-income security (like a loan) that allows the lender to participate in equity appreciation. This may be accomplished in the form of a conversion option, allowing the lender to convert debt into

equity). These provisions usually increase interest rates on a contingent basis to mimic equity participation. Be aware, however, that in two cases IRS has successfully argued that such “loan” structures were in reality, equity investments, producing income subject to taxation and withholding (See, e.g., *Farley Realty Corp. v. Comm’r*, 279 F2d 701 (2d Cir. 1960), *Portage Plastics Co. v U.S.*, 470 F2d 308 (7th Cir. 1972)).

Capital Gains

NRAs are generally not taxable on their capital gains from U.S. sources unless (i) the NRA is present in the U.S. for more than 183 days, (ii) the gains are effectively connected to a U.S. trade or business, or (iii) gains are from the sale of certain timber, coal or domestic iron ore assets. When these exceptions apply, the NRA is taxed on U.S. source capital gains at the rate of 30% (Code Section 871(a)(2)).

Business Income

An NRA is taxed on income *effectively connected* to a *U.S. trade or business* under the same rules as all other U.S. taxpayers. Income may be reduced by appropriate deductions (connected to the U.S. trade or business) and standard tax rates apply (Code Sections 871(b) and 882).

There is no tax code definition for the term "U.S. trade or business." However, U.S. trade or business has been held to include providing personal services in the U.S., selling products in the U.S. directly or through an agent (see below), soliciting orders from the U.S. and then exporting merchandise outside the U.S., manufacturing, maintaining a retail store, and maintaining corporate offices in the U.S. The amount of the commercial activity is not as important as the fact that the NRA was active in the U.S. and its level of activity was “considerable, continuous, and regular” (*Linen Thread Co. Ltd* at 734). The U.S. business must be of an active nature, and not a mere passive investment or ownership of property (*Continental Trading, Inc. v. Comm’r*,
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265 F.2d 40, 43 (9th Cir. 1959), cert. denied, 361 U.S. 827 (1959); *Neill v. Comm’r*, 46 B.T.A. 197 (1942) (building leased on a net basis not a business); *Aktiebolaget Separator v. Comm’r*, 45 B.T.A. 243, 249–50 (1941), aff’d per curiam by unpub. op., 128 F.2d 739 (2d Cir. 1942), cert. denied, 317 U.S. 661 (1942) (mere collection of dividend income does not constitute a trade or business)).

Income is divided into two categories to test whether it is “effectively connected.” The first category, under Code Section 864(c)(2), covers FDAP income, portfolio interest and capital gains from assets located in the U.S. This income will be deemed effectively connected to a U.S. trade or business if it meets either the “asset-use” test or the “business-activities” test.

Pursuant to the asset-use test an asset is deemed “used” in a trade or business if the asset is needed in that trade or business. For example, a business maintains a large cash reserve to cover payroll. Because the cash reserve is needed to operate the business, the cash reserved is deemed used in the business, and the interest income on that reserve will be FDAP and effectively connected. That results in the interest income on the cash reserve being taxed at regular U.S. tax rates.

The business-activities test looks to whether the activity that generated income was a material factor in the realization of income of that trade or business. The business activities test is primarily used for passive assets, because such assets are not themselves often critical to the operation of a business. For example, a foreigner carries on an active trade or business in the U.S., and then invests the profits in deeds of trust. The interest income from the deeds of trust is not related to the U.S. trade or business and is not effectively connected.

All other categories of income (i.e., not FDAP, portfolio interest or capital gains) are automatically “effectively connected” under the “force of attraction” rule set forth in Code

Section 864(c)(3). Under this rule if a nonresident alien has a U.S. trade or business, all U.S.-source income (other than FDAP, portfolio interest or capital gain) is deemed effectively connected to a U.S. trade or business. This result is true even if the U.S.-source income has absolutely no connection to the U.S. trade or business. The NRA will be deemed engaging in a U.S. trade or business for the year if it was engaged in such a business at any time during that year.

Example. Pierre, a French citizen and resident, manufactures and sells chocolates in the U.S. By virtue of that business he is engaging in a U.S. trade or business. On weekends Pierre bakes croissants in his Paris apartment and sells them on the internet. It is a business entirely unrelated to the chocolate business. He has U.S. customers who place orders for chocolates over the Internet. The U.S. Internet croissant orders generate U.S.-source income that under the force of attraction rule is effectively connected to Pierre's U.S. chocolate business.

An NRA will be engaged in a U.S. trade or business if the NRA is a general or limited partner in a U.S. partnership engaged in a trade or business (Code Section 875(1)). Similarly, a beneficiary of a U.S. estate or trust will be engaged in trade or business, if the estate or trust is so engaged (Code Section 875(2)).

An often overlooked stumbling block is the attribution of a U.S. trade or business to an NRA through an agent (*Spermacet Whaling & Shipping Co. SA v. Comm'r*, 30 TC 618 (1958), *aff'd* 281 F2d 646 (6th Cir. 1960)). This is a conjunctive three-part analysis: (i) does the NRA have an agent in the U.S. (*i.e.*, is there an agent-principal relationship), (ii) are the activities of the agent attributable/imputed to the principal, and (iii) is the agent engaging in a trade or business in the U.S. (same as the U.S. trade or business test discussed above).

The agency relationship will be deemed to exist when the U.S. agent is “dependent” and (i) has the authority, which he regularly exercises, to conclude contracts in the name of the foreign principal, or (ii) carries inventory that belongs to the foreign principal from which orders are regularly filled (Treas. Reg. Section 1.864-7(d)(1)(i)). If an agency relationship exists, the Treasury Regulations provide further that the agent’s office or fixed place of business may be deemed an office or fixed place of business of the foreign investor (Treas. Reg. Section 1.864-7(d)).

An agent will be deemed independent if he is a general commission agent or broker, acting independently of the principal and in the ordinary course of his own business (Treas. Reg. Section 1.864-7(d)(3)(i); OECD Model Tax Treaty, Article 5, paragraph 6 (1977 and 1992)). A truly independent agent has his own business, acts on behalf of multiple clients (In *Taisei Fire and Marine Company, Ltd. v. Comm’r*, 104 TC 535 (1995), the Tax Court held that an agent is independent if he represents four principals who do not act jointly to control the agent) and does not receive detailed instructions from the principal. The fact that the agent and the principal are related, such as through common ownership or a parent-subsidary structure, is ignored in testing for agent’s independency (Treas. Reg. Section 1.864-7(d)(3)(ii)).

Branch Profits Tax

If a foreign corporation owns a U.S. corporation, there are two levels of tax. The U.S. corporation will be subject to the regular income tax on its profits, and there will be a 30% withholding tax on dividends paid to the foreign parent (subject to possible treaty reduction). If the same business is operated with just a foreign corporation (the U.S. operation is an unincorporated branch), there is no dividend originating in the U.S. and no withholding tax. To eliminate this disparity and to subject foreign corporations operating through a U.S. branch to a

double tax (tax on earnings and tax on dividends), Congress enacted Code Section 884, which imposes a branch profits tax.

The branch profits tax applies at the rate of 30% (same as the withholding tax on dividends), (*Id.*) but may be reduced by an applicable treaty. The U.S. has treaties covering the branch profits tax with most of the European nations, reducing the tax to between 0-10% (usually to the same rate that a dividend would be subject to under the same treaty). Qualifying for treaty benefits is difficult, as the foreign corporation must establish that it is not “treaty shopping” – meaning it is organized in the treaty country for a purpose other than tax avoidance (shareholders are resident in the treaty country, it does not distribute most of its income out of the treaty country, or it is engaging in an active trade or business in the treaty country).

The 30% tax applies to a “dividend equivalent amount” (Code Section 884(a)) which is the foreign corporation’s effectively connected earnings and profits for the year, less investments the corporation makes in its U.S. assets (money and adjusted bases of property connected with the conduct of a U.S. trade or business). Money is only counted to the extent that it is necessary to meet the operating expenses of the U.S. business.

If the equity of the U.S. trade or business drops for the year (meaning the foreign corporation divested from the U.S.), the earnings and profits are increased by such drop (but subject to some limitations) to calculate the dividend equivalent amount. Actual distributions made by the foreign corporation to its shareholders do not decrease the dividend equivalent amount (but if the dividend itself is distributed in the same year when the foreign corporation pays a branch profits tax, the dividend may escape the 30% withholding tax) (Code Section 884(e)(3)(A)).

A quick example: Bermuda Inc. has \$100 of effectively connected earnings and profits for the year. At the beginning of the year it had U.S. assets of \$500 and liabilities of \$200, resulting in

\$300 of equity in its U.S. business. At the end of the year, Bermuda Inc. has \$600 of assets and \$250 of liabilities, resulting in \$350 of equity. The dividend equivalent amount is \$50, calculated as \$100 of earnings and profits reduced by the \$50 increase in equity.

If a foreign corporation completely terminates its U.S. business, it is not subject to the branch profits tax for that year (Treas. Reg. Section 1.884-2T(a)(1)). As a planning note, if a foreign investor is planning on operating several U.S. businesses that will generate little or no earnings and profits (like depreciable real estate), it would make sense to form several foreign corporations, with each foreign corporation operating a separate branch. For example, if a foreign investor acquires two U.S. apartment buildings through a foreign corporation, on the sale of one building there may be a branch profits tax (as the resulting cash will not be necessary for the continued operation of the U.S. trade or business). If two separate corporations owned two buildings, then on the sale of one building the foreign corporation that is the seller would terminate its U.S. business and will not be subject to the branch profits tax.

FIRPTA

As if the preceding simplified summary is not enough to confound most practitioners, rules applicable to the tax on the disposition of real estate are found in a separate regime known as FIRPTA (the Foreign Investment in Real Property Tax Act of 1980) (FIRPTA is codified in Code Sections 897, 1445 and 6039C). Generally, FIRTPA taxes the disposition of an interest in U.S. real property (“USRPI”) (A USRPI is defined as any interest in (i) real property located in the U.S., or (ii) a domestic corporation that is a “United States real property holding corporation.” Code Section 897(c)(1)) as if the NRA were engaged in a U.S. trade or business (Code Section 897). This means that the traditional income tax rules that apply to U.S. taxpayers

will also apply to the NRA. Purchasers who acquire a USRPI from a NRA are obligated to withhold 15% of the amount realized on the disposition.

An interest in real property includes any ownership of land, buildings, mineral deposits, crops, fixtures, personal property used to (1) exploit natural resources, (2) construct improvements, (3) operate a lodging facility, or (4) to provide a furnished office to a tenant (like movable walls or furnishings), improvements, leaseholds, or options to acquire any of the above (Code Section 897(c) and Treas. Reg. Section 1.897-1(b)). Ownership interests include fee ownership, co-ownership, leasehold, time-share, a life estate, a remainder, a reversion or a right to participate in the appreciation of real property or in the profits from real property (Treas. Reg. Section 1.897-1(d)(2)(i)).

A partnership interest is treated as a USRPI if (1) 50% or more of the value of partnership gross assets consists of USRPIs, and (2) 90% or more of the value of partnership gross assets consist of USRPIs plus cash and cash equivalents (Treas. Reg. Section 1.897-1(d)(2)(i)). The disposition of such partnership interest will be subject to FIRPTA to the extent such partnership owns USRPIs and will be subject to withholding.

A domestic corporation will be treated as a United States Real Property Holding Corporation (“USRPHC”) if USRPIs equal or exceed 50% of the sum of such corporation’s USRPIs, foreign real estate and trade and business assets (Code Section 897(c)(2)). Disposition of an interest in a USRPHC is subject to the FIRPTA tax and withholding, but is not subject to state income tax (Code Section 897(a)(1). There are no state law equivalents to FIRPTA and under state law a sale of an interest in a domestic corporation (even if it is a USRPHC for federal income tax purposes) by a foreigner is not taxable, following the general rule of Code Section 892).

Contrast that with the disposition of a USRPI owned directly, which is subject to the lower federal capital gains rate, but is also subject to the state income tax.

The disposition of an interest in a domestic corporation will not be subject to these rules if on the date of the disposition the corporation had no USRPIs and all of the gain was fully recognized (no installment sales or exchanges) on the sale of any USRPIs sold within the past five years (Code Section 897(c)(1)(B) and Treas. Reg. Section 1.897-2(c)).

Any NRA (individual or corporation) selling a USRPI is subject to withholding of 17.5% of the amount realized; withholding applies even if the property is sold at a loss (Code Section 1445).

The withholding obligation is imposed on the purchaser, who must report the withholding and pay over the tax using Form 8288 within 20 days of the purchase. If the purchaser fails to collect the withholding tax from the foreigner, the purchaser will be liable for the tax, plus any applicable penalties and interest. The withheld taxes are later credited against the total tax liability of the foreigner.

Withholding is not required if: (1) the seller provides a certificate of non-foreign status, (2) property acquired by the purchaser is not a USRPI, (3) the transferred property is stock of a domestic corporation and the corporation provides a certificate that it is not a USRPHC, (4) the USRPI acquired will be used by the purchaser as a residence and the amount realized by the foreigner on the disposition is \$300,000 or less, (5) the disposition is not subject tax (a tax-free exchange), or (6) the amount realized by the foreigner on the disposition is zero (*Id.* and Treas. Reg. Section 1.1445-2(d)(2)(i)).

Estate and Gift Tax

For estate tax purposes, the test is completely different in determining who is an NRA – the inquiry centers around the decedent’s domicile (Treas. Reg. Sections 20.0-1(b)(1), 25.2501-

1(b)). This is a more subjective test, that looks primarily at intent, (Treas. Reg. Sections 20.0-1(b)(1), 25.2501-1(b)) and will also consider factors such as the length of stay in the U.S. and frequency of travel, size and cost of home in the U.S., location of family, participation in community activities, participation in a U.S. business, and ownership of assets in the U.S. and voting.

A foreigner can be a U.S. resident for income tax purposes, but not be domiciled for estate tax purposes. For simplicity in explaining the estate and gift tax considerations, this article will refer to foreigners who are both non-resident aliens and not domiciled in the U.S. as NRAs.

An NRA is subject to a different transfer tax (estate and gift taxes) regime than a U.S. taxpayer. The estate tax is imposed only on the part of the NRA's gross estate that at the time of death is situated in the U.S. (Code Section 2103). The rate of NRA's estate tax is the same as that imposed on U.S. citizens and resident aliens, but the unified credit is only \$13,000 (equivalent to about \$60,000 of property value) (Code Section 2102(b)(1)). These harsh rules may be ameliorated by an estate tax treaty. The U.S. does not maintain as many estate tax treaties as income tax treaties, but there are estate tax treaties in place with most Western European countries, Australia and Japan.

The following assets are specifically included by the Code in the definition of property situated in the U.S.: (1) shares of stock of a U.S. corporation, (2) revocable transfers or transfers within three years of death of U.S. property or transfers with a retained interest (described in Code Sections 2035 to 2038), and (3) debt issued by a U.S. person or a governmental entity within the U.S. (e.g. municipal bonds) (Code Section 2104).

U.S.-situs property also includes real estate in the U.S. (if debt is recourse it is ignored – gross value is included, not just equity) and tangible personal property, like works of art, furniture, cars

(and even currency in a safety deposit box) (Treas. Reg. Section 20.2104-1(a)). A beneficial interest in a trust holding U.S. property is also U.S.-situs property (Rev. Rul. 55-163, 1955-1 C.B. 674). U.S.-situs property does not include life insurance proceeds paid on the life of the NRA, bank accounts (unless connected with a U.S. business), portfolio interest loans (Code Section 2105) and shares of stock in a foreign corporation (Treas. Reg. Section 20.2105-1(f)).

The gross estate is reduced by various deductions relating to the U.S.-situs property. The estate tax returns must disclose all of the NRA's worldwide assets, in order to determine the ratio that the U.S. assets bear to non-U.S. assets. This ratio determines the percentage of allowable deductions that may be claimed against the gross estate (Code Section 2105(a)(1) and (2)).

When real estate is subject to a recourse mortgage, the gross value of the real estate is included, offset by the mortgage debt (Treas. Reg. Section 20.2053-7. If the mortgage is non-recourse, only the net value of the property is included in the estate). This distinction is irrelevant for U.S. taxpayers filing estate tax returns but is very relevant for NRAs for whom debts are subject to apportionment between U.S. and non-U.S. assets and therefore not fully deductible (Treas. Reg. Section 20.2106-2. Apportionment is also possible only if world-wide assets are disclosed on the estate tax return).

Advance planning can eliminate or reduce the U.S. estate tax obligations of NRAs. For example, U.S. real estate owned by the NRA through a foreign corporation is not included in an NRA's estate. This effectively converts U.S. real property into a non-U.S. intangible asset. Even if the real property was not initially acquired through a foreign corporation, it may be beneficial to pay an income tax today on the transfer of the real estate to a foreign corporation (usually treated as a sale) to avoid the estate tax in the future.

Gift taxes are imposed on the donor. A NRA donor is not subject to U.S. gift taxes on any gifts of non-U.S. situs property gift to any person, including U.S. citizens and residents. U.S. citizens and residents must report gifts from a NRA, in excess of \$100,000 on Form 3520 (IRS Notice 97-34, 1997-1 CB 422).

Gifts of U.S.-situs assets are subject to gift taxes, with the exception of intangibles, which are not taxable (Code Section 2501(a)(2)). Tangible personal property and real property is sited within the U.S. if it is physically located in the U.S. (Treas. Reg. Section 25.2511-3(b)). NRA donors are allowed the same annual gift tax exclusion as other taxpayers and are subject to the same rate schedule for gift taxes. However, the lifetime unified credit is not available to NRA donors (Code Section 2505(a)).

The primary thrust of estate tax planning for NRAs is through the use of (i) foreign corporations to own U.S. assets, or (ii) the gift tax exemption for intangibles to remove assets from the U.S.

If the NRA dies owning shares of stock in a foreign corporation, the shares are not included in the NRA's estate, regardless of the situs of the corporation's assets. It is important that the corporation have a business purpose and activity, lest it be deemed a sham designed to avoid U.S. estate taxes (See, e.g., *Jackson v. Comm'r*, 233 F. 2d 289 (2d Cir. 1956)).

The gift of an intangible, wherever situated, by an NRA is not subject to gift tax. Shares in U.S. corporations and interests in partnerships or LLCs are intangibles (See, e.g., *Jackson v. Comm'r*, 233 F. 2d 289 (2d Cir. 1956)). Consequently, real estate owned by the NRA through a U.S. corporation, partnership or an LLC may be removed from the NRA's U.S. estate by gifting entity interests to foreign relatives gift tax free.

Ownership Structures for Foreign Investors

An NRA can acquire U.S. assets using several alternative ownership structures. The NRA's goals and priorities dictate the type of structure that is used. Each alternative has its own advantages and disadvantages – there is no perfect structure.

Direct investment (assets owned by the NRA) is simple and is subject to only one level of tax on the disposition. If the asset is held for one year, the sale is taxed at a 15% rate (Code Section 1(h)). The disadvantages of the direct investment are: no privacy, no liability protection, the obligation to file U.S. income tax returns, and if owned at death, the U.S. asset is subject to U.S. estate taxes.

Under an LLC/LP structure, the NRA acquires the U.S. asset through an LLC or a limited partnership. The LLC may be a disregarded entity or a tax partnership for U.S. income tax purposes. This is an improvement over the direct ownership alternative, because this structure provides the NRA with privacy and liability protection and allows for lifetime transfers that escape the gift tax. The obligation to file U.S. income tax returns and the possibility for a U.S. estate tax on death remain.

Ownership of U.S. assets through a domestic corporation (the corporation will always be a “C” corporation; a foreign shareholder precludes an “S” corporation) (Code Section 1361(b)(1)(C)) will afford privacy and liability protection, allow lifetime gift tax-free transfers, and obviate the foreigner’s need to file U.S. income tax returns. Engaging in a U.S. trade or business requires a U.S. tax return; ownership of stock will not trigger a return filing obligation.

There are three disadvantages to the ownership of U.S. assets through a domestic corporation: (1) federal and state corporate income tax at the corporate level will add a second layer of tax, (2) dividends from the domestic corporation to its foreign shareholder will be subject to 30% withholding, and (3) the shares of the domestic corporation will be included in the U.S. estate of

the foreign shareholder. If the corporation owns primarily real estate in the U.S., on the disposition of the stock in the corporation the foreign shareholder will be subject to FIRPTA, because the corporation will be treated as a USRPHC (See FIRPTA and USRPHC discussion, above). This will require the filing of a U.S. income tax return and 15% tax withholding by the purchaser of the shares.

Ownership of the U.S. assets may be by the U.S. corporation directly, or through a U.S. partnership or disregarded entity owned by the corporation. The corporation may even be an LLC that checks-the-box to be taxed as a corporation. In turn, the ownership of the U.S. corporation by the NRA may be direct, or through a foreign partnership or disregarded entity.

Foreign corporation ownership offers the following advantages: (1) liability protection, (2) no U.S. income tax or filing requirement for the foreign shareholder, (3) shares in the foreign corporation are non-U.S. assets not included in the U.S. estate, (4) dividends are not subject to U.S. withholding, (5) no tax or filing requirement on the disposition of the stock, and (6) no gift tax on the transfer of shares of stock.

The disadvantages of using the foreign corporation are: (1) corporate level taxes (just like with the domestic corporation), because the foreign corporation may be deemed engaged in a U.S. trade or business; and (2) the foreign corporation will be subject to the branch profits tax, the largest disadvantage of ownership of U.S. real estate through a foreign corporation.

Because the branch profits tax is often not reduced or eliminated by a treaty, the most advantageous structure for ownership of U.S. assets by NRAs is through the foreign corporation-U.S. corporation structure. Here, the NRA owns a foreign corporation, which in turn owns a U.S. LLC taxed as a corporation. This structure affords privacy and liability protection, escapes U.S. income tax filing requirements, avoids U.S. estate taxes, allows for gift tax-free lifetime

transfers and avoids the branch profits tax. Distributions from the U.S. subsidiary to the foreign parent are subject to the 30% FDAP withholding, but the timing and the amount of such dividend is within the NRA's control.

OUTBOUND TAXATION

An American operating a business abroad, investing in foreign property or entering into an overseas joint-venture may do so as a sole proprietor (i.e., in his name directly or through an entity disregarded for income tax purposes), through an entity taxed as a partnership, through a corporation or a trust. The first two options do not present any tax planning opportunities. A U.S. sole proprietor will be taxed currently on his world-wide income (the U.S., China, Mexico, Korea and a couple other countries tax on world-wide income, all other countries tax on territorial income). Similarly, a foreign partnership will currently allocate taxable income to its U.S. partner who will in turn be currently taxed. Tax deferral may be possible when a foreign business is conducted through a foreign corporation or owned through a foreign trust.

Controlled Foreign Corporations

The United States lacks jurisdiction to tax a foreign corporation that is not engaging in business in the United States and does not have U.S.-source income. That allows for a U.S. tax deferral of foreign income earned by a foreign corporation, even when the corporation is owned by an American shareholder. To prevent tax abuse, and particularly the use of offshore tax havens, Congress enacted Subpart F of the Internal Revenue Code which deals with foreign corporations controlled by American shareholders.

Subpart F creates the concept of a controlled foreign corporation (a “CFC”), which is a foreign corporation more than 50% (by vote or value) owned by “U.S. shareholders.” A “U.S. shareholder” is a U.S. citizen or resident shareholder who owns 10% or more of the CFC. Shareholders who own less than 10% are ignored for CFC purposes entirely. Ownership by related parties may be aggregated both for the purpose of the 10% shareholder test and for the purpose of the greater than 50% control test.

A couple quick examples: A foreign corporation equally owned by 11 U.S. taxpayers is not a CFC because none of the shareholders own 10% or more. A foreign corporation owned half by a U.S. shareholder and half by a Belgian shareholder is not a CFC, because the U.S. shareholder owns only 50%, not greater than 50%.

Code Section 951, the basic Code Section upon which the rest of subpart F is built, does not assess a tax. That Code Section merely provides that the U.S. shareholder of a CFC must include in gross income certain kinds of the CFC’s income on his tax return, whether or not the CFC makes a distribution to the U.S. shareholder. Because that constructive distribution is treated by the shareholder as he treats any other form of taxable income, the remaining provisions of subpart F set forth the rules as to the kinds of income which form the basis of a constructive distribution and what happens to the corporation when a constructive dividend is deemed distributed.

NB: While the term “constructive dividend” is commonly used in this context (we may say “the U.S. shareholder will recognize a constructive dividend on its share of the CFC’s income”), there is technically no dividend. The share of the CFC’s income that a U.S. shareholder reports on his tax return is treated as ordinary income, regardless of the character of the income.

The constructive distribution is the U.S. shareholder's share of (i) earnings invested in U.S. property, (Code Section 956) and (ii) the foreign corporation's "subpart F income." (Code Section 952)

Any earnings and profits of a CFC invested in U.S. property will generate a constructive dividend to the U.S. shareholder. The amount of the constructive dividend is the average amount of U.S. property held by the CFC at the end of a quarter, reduced by earnings and profits of the CFC previously taxed by the U.S. (as a constructive or an actual dividend to the shareholder). This rule prevents CFC shareholders from avoiding a tax on a dividend distribution by having the CFC directly invest in U.S. assets in a way that may benefit the U.S. shareholders.

Subpart F income is the most complex and the most planning-rich aspect of outbound taxation. Recall that Subpart F was enacted to combat tax abuse, and not to impose a penalty. Subpart F attempts to determine when a foreign corporation is organized for a tax abusive purpose versus a business purpose. That determination is based in large part on the activities and the income of the foreign corporation.

Subpart F income consists of (i) the insurance of U.S. risks, and (ii) "foreign base company income." In turn, the foreign base company income consists of: (i) foreign personal holding company income (Code Section 954(c)); (ii) foreign base company sales income (Code Section 954(d)); (iii) foreign base company services income (Code Section 954(e)); and (iv) foreign base company oil related income (not discussed in this article). The term "foreign base company" refers to foreign companies that are organized in a low tax country (the foreign base), but conduct business in other countries. This concept is aimed squarely at the world's tax havens.

Generally, a CFC's insurance income is any income earned by a foreign insurance corporation that meets two conditions: (i) the income is from premiums attributable to issuing (or reinsuring)

a policy of insurance insuring against risks arising from or related to lives or activities in a country other than the country of the insurance company's place of incorporation, and (ii) the company would be taxed (subject to certain modifications) as a domestic insurance company if the company was a domestic corporation (Code Section 953(a)). Thus, the rule applies, of course, only to foreign insurance companies that are also CFCs.

Foreign personal holding company ("FPHC") income consists of: (i) dividends, interest, rents, royalties and annuities; (ii) gain from certain property transactions; (Pursuant to the AJCA 2004, when a CFC owns 25 percent or more of a foreign partnership, on sale of the CFC's interest in the partnership the CFC will be deemed to be selling its proportionate interest in the partnership assets. Previously, the sale of a partnership interest was always treated as FPHC income. Now, if the partnership has active business assets, then the CFC may not be generating FPHC income on the sale of the partnership interest.) (iii) gain from commodity transactions; (iv) foreign currency gain; (v) "income equivalent to interest;" (Treas. Reg. Section 1.954-2(a)) and (vi) personal services income (This new category of FPHC income was added by AJCA 2004. Specifically, the new Code Section 954(c)(1)(I) provides that FPHC income includes amounts received by a CFC under a contract under which the corporation is to provide personal services. The contract must satisfy one of the following two conditions: (i) some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or (ii) the individual who is to perform the services is designated (by name or by description) in the contract. FPHC income also includes amounts received by the CFC from the sale or other disposition of such a services contract). An exception to the definition of FPHC income for CFC purposes relates to rents and royalties derived from the active conduct of a business so long as the income is not received from a related person. That exception requires

the taxpayer to recognize the distinction between the active conduct of a business and a business which is not actively conducted.

Pursuant to Code Section 954(d), foreign base company sales income includes income derived in connection with (i) the purchase of personal property from a related person and its sale to another person; (ii) the sale of personal property to another person on behalf of a related person; (iii) the purchase of personal property from any person and resale to another person; and (iv) purchase of personal property from any person on behalf of a related person; provided, however, that the property was produced or manufactured outside the country where the CFC is created, and the property is sold for use outside the country of CFC's incorporation.

To state differently, a CFC does not realize foreign base company sales income if: (1) the purchase and resale of the personal property is not from or to a "related person;" (2) the personal property being purchased and resold is manufactured, grown, produced, or mined in the same country where the CFC is incorporated; (3) the personal property being purchased and resold is to be used or otherwise disposed of in the same country where the CFC is incorporated; or (4) the personal property is not simply purchased and resold but is altered or modified by the CFC to such a degree that the CFC can be deemed to have manufactured or produced the property.

The "manufactured" exception is an excellent illustration of the thinking behind Subpart F. If a CFC organized in the Cayman Islands manufactures funny paper hats in the Caymans, then the income derived from the sale of the hats, even if sold to a related party, does not constitute Subpart F income. There is a legitimate business reason for organizing the foreign corporation in the Caymans; the corporate structure is not tax driven. Therefore, Subpart F is not intended to apply. The earnings of the Cayman corporation are not taxed to the U.S. shareholders until distributed out.

The basic component of subpart F income is that a person related to the CFC is involved in the transaction, usually as either a buyer or a seller. Thus, if the CFC purchases the personal property from a stranger and resells it to another stranger, the income generated by the CFC from that transaction is not foreign base company income, even if all the other attributes of a tax haven operation are present (Code Section 954(d)(1)).

A “related person” includes an individual, trust, estate, partnership, or corporation. An individual, trust, estate, or partnership is related to the CFC if one of those entities even indirectly owns more than 50 percent of the total combined voting power of the CFC. In the case of corporations, the rules are somewhat more complex. Another corporation will be deemed related to the CFC if: (1) the other corporation owns more than 50 percent of the CFC’s voting stock; (2) the CFC owns more than 50 percent of the other corporation’s voting stock; or (3) a person or group of persons owns more than 50 percent of the outstanding voting stock of both the CFC and the other corporation.

A related person can be either a foreign person or a domestic person (a citizen, resident or nonresident).

Apple Inc. wholly owns a subsidiary corporation in Ireland. The Irish subsidiary co-owns all of Apple intellectual property. The Irish subsidiary is a CFC. The Irish subsidiary purchases iPads from the manufacturer in China and resells to customers throughout the world. Because the Irish subsidiary does not purchase from Apple or sell to Apple, its income does not constitute foreign base company sales income. To date, Apple’s Irish subsidiary has accumulated over \$250 billion in earnings and profits that have never been taxed by the U.S. (See below on the impact of the 2017 Tax Act)

Foreign base company services income is income derived from the performance of services, if, but only if, those services: (1) are performed by the CFC for or on behalf of a related person; and (2) are performed outside the country of incorporation of the CFC (Code Section 954(e)).

A CFC's shareholder can disregard insurance income and foreign base company income if (1) the combination of the two is less than the lesser of \$1 million or 5 percent of gross income (the *de minimis* exception), (Code Section 954(b)(3)(A)) or (2) the CFC's income is subject to a high tax (greater than 90 percent of the highest U.S. corporate tax rate) by the foreign country. Notice that the logic of Subpart F comes through again. If the CFC has very little Subpart F income, or its earnings and profits are subject to a high tax rate, then it was likely not organized for a tax avoidance purpose.

The 2017 Tax Act has introduced some important changes to the outbound tax system. First, a new Code Section 245A enables a 100% dividend received deduction for U.S. corporations that have a 10% or greater interest in a foreign corporation. The deduction is available only for those dividends that are attributable to foreign sourced income. This effectively transitions U.S. corporate taxpayers who operate overseas through corporate subsidiaries to a territorial tax system. When the new dividend received deduction is available, the foreign tax credit is not available.

Second, a mandatory tax is imposed on the unrepatriated earnings of foreign corporations. The tax is 15% for cash assets and 8% for other assets. Once the tax is paid (it can be stretched over several years) there is no reason not to repatriate offshore earnings and profits. This means that Apple, and many other large corporate taxpayers, will be able to repatriate offshore funds to the U.S.

Taxation of Foreign Trusts

For U.S. income tax purposes a trust may either be a grantor trust (Code Section 671) or a non-grantor trust; and the assets of the trust may be included in the settlor's or beneficiary's U.S. estate (Code Section 2036) or excluded from the estate. This holds equally true for both domestic and foreign trusts, with a couple of caveats.

A foreign trust settled by a U.S. person will always be a grantor trust if there is a U.S. beneficiary (Code Section 679(a)(1)). A foreign trust settled within five years prior to immigration to the U.S. will likewise be treated as a grantor trust (Code Section 679(a)(4)).

Code Section 7701(a)(30)(E) provides that the term "United States person" means any trust if (a) a court within the U.S. is able to exercise primary supervision of the administration of the trust (the "Court Test"), and (b) one or more U.S. persons have the authority to control all substantial decisions of the trust (the "Control Test"). A trust will be treated as a U.S. person on any day that the trust meets both the Court Test and the Control Test. A foreign trust is any trust other than one described in Code Section 7701(a)(30)(E).

If a trust is deemed to be a foreign trust for U.S. tax purposes, any transfer of appreciated property to the trust will be treated as a sale to the trust, and the trust will be subject to substantially increased reporting requirements (Code Sections 684 and 6048). If a foreign trust is classified as a grantor trust, then there is no tax on transfer (the grantor is deemed to sell assets to himself), but the reporting requirements still apply.

Pursuant to IRS Notice 97-34, a transfer of assets to a foreign trust must be reported on Form 3520, and the trust must annually file Form 3520-A. A beneficiary who receives a distribution from a foreign trust must likewise report the distribution on Form 3520.

Passive Foreign Investment Companies

A passive foreign investment company, commonly known as a PFIC, is any foreign corporation which meets either of two tests: (1) 75 percent or more of the corporation's gross income for the taxable year is passive; or (2) 50 percent or more of the corporation's assets are passive assets - that is, assets which do not produce business income (Code Sections 1297(a)(1) and (2)). If a foreign corporation is both a PFIC and a CFC, then as to the U.S. shareholders (the 10% or greater shareholders), the foreign corporation is a CFC and not a PFIC. PFIC classification generally applies to foreign corporations that are mutual funds, investment funds, hedge funds or private equity funds.

Note that the PFIC classification applies to all shareholders, not just the 10% or greater shareholders. Similar to foreign corporations classified as CFCs, it is not the corporation itself that is taxed by the U.S., but only those shareholders that the U.S. can tax.

As a general rule, taxation of a PFIC shareholder depends on various factors, the most important of which is the PFIC's status or nonstatus as a qualified electing fund (a "QEF") (Code Section 1295). The shareholder of a QEF is required to take his share of the PFIC's ordinary income into his own income as a constructive dividend (Code Section 1293(a)(1)). If the actual dividend distribution from the PFIC to the shareholder exceeds the constructive dividend, the shareholder pays an interest charge on the excess distribution (Code Section 1291(a)(1)).

The QEF status is elected by a shareholder, and the same foreign corporation may be a QEF PFIC as to one U.S. stockholder and a non-QEF PFIC as to another.

A shareholder who has elected QEF status follows the general rules familiar to U.S. shareholders of CFCs. Specifically, the QEF shareholder takes into income his pro rata share of the PFIC's ordinary earnings; constructive distributions from earnings invested in (i) U.S. property and (ii)

excess passive assets; and the PFIC's net long-term capital gain as a capital gain (Code Section 1298).

Another possible election for the shareholder is the mark-to-market election under Code Section 1296. The mark-to-market election allows the shareholder to report and be taxed on any year-to-year increases in the value of the securities owned by the PFIC.

A shareholder who has not made a QEF or a mark-to-market election is subject to the interest charge on his share of the constructive dividend under the Code Section 1291 "excess distribution regime." No tax is paid on a constructive distribution, but interest is paid on the deferred tax liability. The interest is the underpayment rate charge by the IRS, but is compounded daily. Same rules apply to the gain realized on the disposition of PFIC stock. Making either election starting in year two or later is pricey because the shareholder must first make a "purging election" – wherein all of the holdings of the PFIC will be deemed sold and tax gain recognized. Further, the disposition of the stock of a PFIC for which the shareholder has not made an election in year one and which was not purged will be subject to ordinary income tax rates.

The Foreign Tax Credit

U.S. taxpayers who pay foreign income or excess profits taxes to a foreign country can elect a direct credit or a deduction for foreign taxes paid (Code Section 901(a)). The decision as to whether to credit or deduct foreign income taxes is to be made each year. Although it is generally accepted that a tax credit is far superior to a deduction in the normal situation, it often requires an example to bring into focus the difference in result between the use of a credit and the use of a deduction.

Example: Assume a U.S. taxpayer has total taxable income of \$100,000, all of which is derived from France. Assume further that the overall tax rate in France is 50% and that the tax rate in the United States is likewise 50%. Without a tax credit, but allowing the taxpayer a deduction for foreign taxes paid, the effective rate of tax, on the above facts, is 75 percent, calculated as follows:

	Net Taxable Income	Tax	Net Income
after Tax France		\$ 100,000	\$ 50,000
	\$ 50,000		
United States	50,000	25,000	25,000

Because the taxpayer is a U.S. taxpayer, the taxable income for U.S. purposes is net taxable income, less the deduction allowed for the foreign taxes paid. If, however, the taxpayer chose to credit the French tax, the result (a 50 percent effective tax rate) is as follows:

	Net Taxable Income	Tax	Credit	Net Income after Tax
France	\$ 100,000	\$ 50,000	0	\$ 50,000
United States	100,000	50,000	50,000	50,000

In addition to the election to take the credit or deduct the tax, the cash basis taxpayer has the election to treat foreign taxes as if the taxpayer were utilizing the accrual method of accounting. That election is necessary in order to allow the credit to have significance to cash basis taxpayers who have uneven years of income and foreign taxes, and who might otherwise lose the foreign tax credit. Unlike the election to credit rather than deduct, the election to accrue, once made, is binding for subsequent years.

While there are strict limitations on the amount of credit allowed, within the scope of those limitation provisions, the taxpayers are allowed to reduce their federal income tax, dollar for dollar. To be creditable against federal income taxes, the levy--that is, the foreign payment--must be an income tax within the general definition of that phrase under U.S. law. The levy must also be a tax, as distinguished from a fee, a fine or other payment to a foreign governmental agency. A payment in exchange for a specific economic benefit is not a tax, nor is a subsidy a tax.

Pursuant to the deemed-paid credit, a domestic corporate shareholder, upon the receipt of dividends from a foreign corporation in which the domestic corporation owns at least a 10% interest, is allowed to credit the foreign taxes paid by that foreign corporation that relate to the dividend (Code Section 902(a)). The domestic corporate shareholder may take a credit against domestic income tax for the foreign income and excess profits taxes which have been paid by the foreign subsidiary corporation if certain conditions are met. Those conditions are that: (1) the domestic corporate shareholder owns 10% or more of the voting stock of the foreign corporation; (2) the foreign subsidiary's earnings and profits resulted from operations subject to the foreign country's or countries' income tax; and (3) some or all of those earnings and profits be distributed to the domestic corporate shareholder as a dividend.