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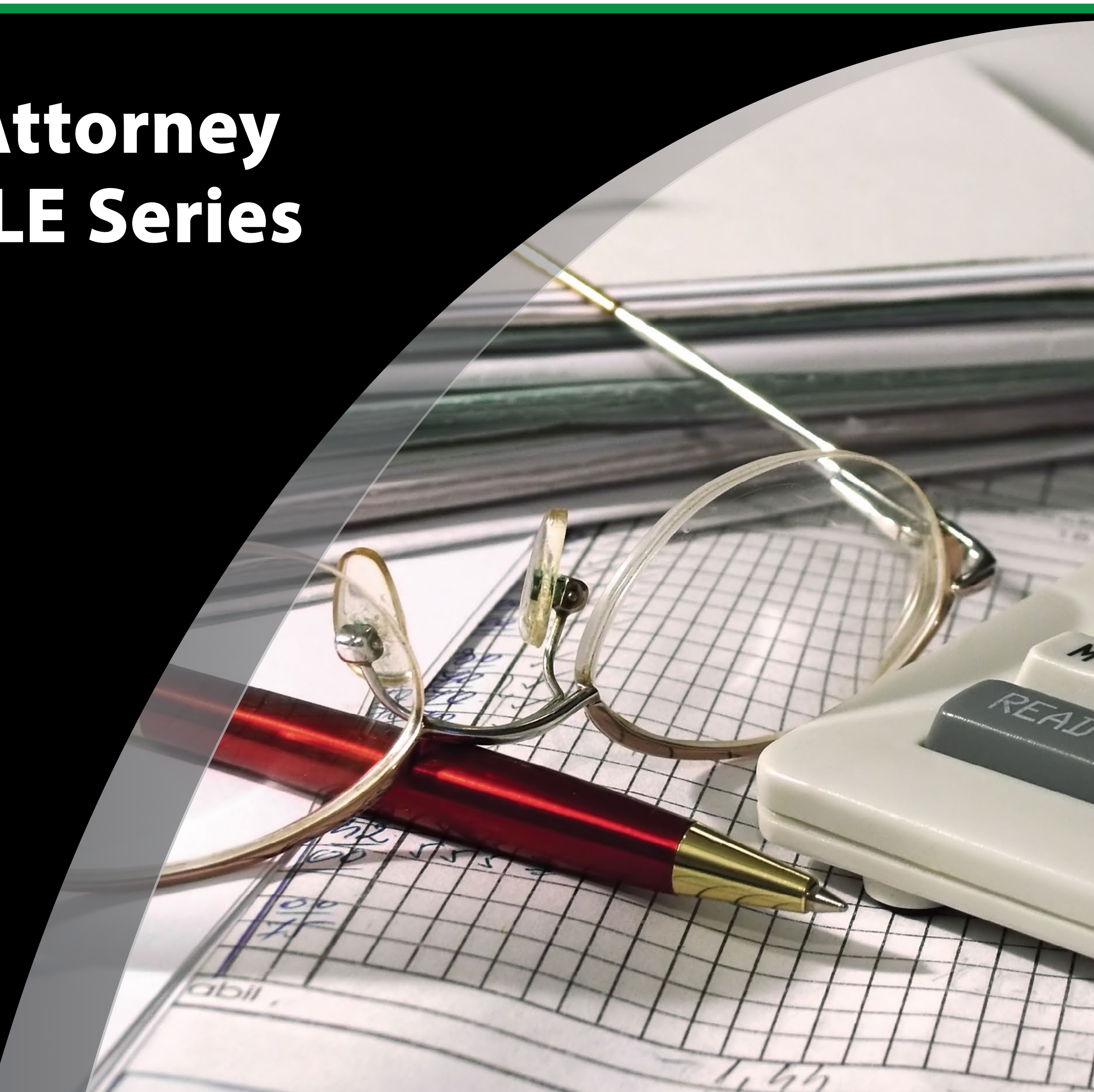

Understanding the U.S. International Tax System

presented by
the Tax Services Group of

GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

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Grossman Yanak & Ford LLP

Headquartered in Pittsburgh, Grossman Yanak & Ford LLP is a regional certified public accounting and consulting firm that provides assurance and advisory, tax planning and compliance, business valuation, ERP solutions and consulting services. Led by six partners, the 26-year-old firm employs approximately 55 personnel who serve corporate and not-for-profit entities.

Our firm was founded on the idea that the key to successful, proactive business assistance is a commitment to a high level of service. The partners at Grossman Yanak & Ford LLP believe that quality service is driven by considerable involvement of seasoned professionals on a continuing basis. Today's complex and dynamic business environment requires that each client receive the services of a skilled professional with a broad range of experience and knowledge who can be called upon to provide efficient, effective assistance.

Grossman Yanak & Ford LLP combines a diversity of technical skills with extensive "hands-on" experience to address varied and complex issues for clients on a daily basis. We pride ourselves on bringing value-added resolution to these issues in a progressive and innovative manner. Our ability to produce contemporary, creative solutions is rooted in a very basic and ageless business premise – quality service drives quality results. Our focus on the business basics of quality technical service, responsiveness and reasonable pricing has enabled the firm to develop a portfolio of corporate clients, as well as sophisticated individuals and nonprofit enterprises.

Our professionals understand the importance of quality and commitment. Currently, the majority of the professional staff in our Assurance & Advisory Services and Tax Services Groups hold the Certified Public Accountant designation or have passed the examination and need to complete the time requirements for certification. Each of our peer reviews has resulted in the highest-level report possible, attesting to the very high quality of our firm's quality control function. The collective effort of our professionals has resulted in our firm earning an exemplary reputation in the business community.

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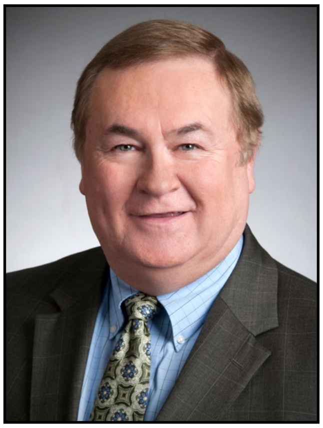
Robert J. Grossman, CPA/ABV, ASA, CVA, CBA



Bob heads our firm's Tax and Business Valuation Groups. He has over 35 years of experience in tax and valuation matters that affect businesses, both public and private, as well as the stakeholders and owners of these businesses. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth. As his career has progressed, Bob has risen to a level of national prominence in the business valuation arena.

His expertise in business valuation is well known, and Bob is a frequent speaker, regionally and nationally, on tax and valuation matters. Bob is a course developer and national instructor for both the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuators and Analysts (NACVA). He has served as an adjunct professor for Duquesne University and Saint Vincent College. He has also written articles for several area business publications and professional trade journals.

After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the AICPA. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

A member of the American and Pennsylvania Institutes of Certified Public Accountants (PICPA), Bob has previously chaired the PICPA Pittsburgh Committee on Taxation. He has also served as Chair of the Executive Advisory Board of NACVA, its highest Board; as well as Chair of NACVA's Professional Standards Committee and its Education Board.

Bob received NACVA's "Thomas R. Porter Lifetime Achievement Award" for 2013. The award is presented annually to one of the organization's 6,500 members, who has demonstrated exemplary character, leadership and professional achievements to NACVA and the business valuation profession, over an extended period.

Bob is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the American Society of Appraisers. He has held numerous offices in various not-for-profit organizations. Bob received the PICPA Distinguished Public Service Award and a Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two grown children.

Donald S. Johnston, CPA, MST

Don has spent the majority of his 27-year career serving the tax and consulting needs of privately-held organizations and their owners. He has significant experience handling tax planning and compliance-related issues for all types of entities, including corporations, LLCs and partnerships, and a wide base of clientele, ranging from small start-up organizations in the early stages of development to large, billion-dollar entities in need of technical expertise. Don's broad range of experience encompasses numerous industries, including manufacturing, nuclear energy and mining.

Don also has extensive experience working with distribution entities and has devised tax-savings strategies for income, franchise and other business-related taxes for numerous middle market clients. His skills have been utilized for special projects in various areas of expertise, including acquisition planning and due diligence; Section 338(h)(10) acquisition work; stock vs. asset sale analyses for acquisition and/or disposition scenarios; development of strategies to reduce state tax obligations of multi-state entities; complex valuation-related issues; and other tax concerns for individual clients. His background allows him to assist individuals and businesses to determine advantageous strategies for mergers, acquisitions and divestitures.

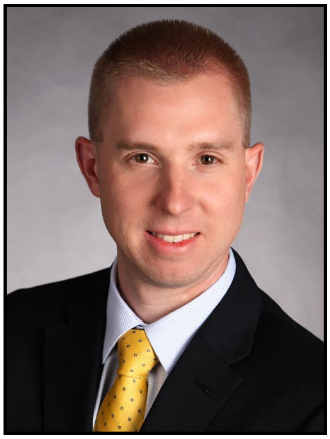
After graduating from Slippery Rock University with a B.S./B.A. in accounting and finance in 1989, Don spent four years with a large international accounting firm in Pittsburgh before joining Grossman Yanak & Ford LLP in 1993. He earned his M.S. degree in Taxation from Robert Morris University in 1998.

Don, a Certified Public Accountant, is a member of the American and Pennsylvania Institutes of Certified Public Accountants. He is also a member of the Allegheny Tax Society.

A graduate of the Leadership Pittsburgh program, Don is an active participant in community affairs. He is a passionate advocate for organ and tissue donation and supports the work of the Center for Organ Recovery & Education (CORE), a not-for-profit organ procurement organization. Don formerly served as Treasurer of EveryChild, Inc., a Pittsburgh based not-for-profit organization that serves the foster care and adoption needs of medically-fragile children.

Don resides in Wexford with his wife, Diana, and their children, Sarah, Scotty and Alaina.

Michael E. Weber, CPA, JD



Michael, a Manager in our firm's Tax Services Group, has over seven years of professional experience, including four in public accounting. His responsibilities primarily include the provision of tax compliance, planning and research services for corporations, S corporations, partnerships, limited liability companies and not-for-profit organizations, as well as individuals.

Michael has provided services for both domestic and international clients, principally in the manufacturing, real estate and service-oriented industries. He also assists new entities with formation, planning and tax compliance matters.

A graduate of Duquesne University, Michael earned his a B.S./B.A. in Accounting in 2007, and his J.D. from the University's School of Law in 2011. He is a Certified Public Accountant, as well as a licensed attorney, in the Commonwealth of Pennsylvania.

Michael is a member of the Pennsylvania Institute of Certified Public Accountants (PICPA) and the Allegheny County Bar Association (ACBA), with membership in its Tax Section and Young Lawyers Division. He is also a member of GlobalPittsburgh, a nonprofit organization that brings together global-minded people in the Pittsburgh region.

He resides in the South Hills of Pittsburgh with his wife, Jill.

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Understanding International Taxation

Introduction

International tax may draw more focus and attention than almost any other topic in U.S. taxation. Unfortunately, a massive amount of misunderstanding also accompanies this focus and attention. This misunderstanding is driven not only by the U.S. Internal Revenue Code, which is quickly approaching 80,000 pages, but also from the dynamic that requires planning under those rules to be integrated with the governing tax law, regulations, judicial decisions, treaties and common practices of foreign countries from around the world.

Moreover, in a never-ending attempt to attract the economic benefits of business development within their specific borders, more countries than ever before are looking to modify, refine and generally lower their tax rates as one form of competitive advantage to secure that new business. The unfortunate result of these efforts is a broad base of tax and tax-related statistical information that can be misinterpreted or misapplied in attempts to understand the impact of international transactions. It certainly does not help that politicians from both sides of the aisle use the tax code and the current tax rules as fodder for grandstanding, especially in light of high-visibility transactions, such as corporate inversions. Lastly, the media, long on sound bites and short on technical knowledge, only seems to fuel the misconceptions related to international business and the tax implications related to the conduct of that business.

To be sure, interpretation of statistics is an arduous undertaking, and care must be at the center of any analysis. However, sharing some fundamental statistics can serve to hush some of the noise that seems to surround this subject.

Before one can compare the current status of the U.S. tax system against the rest of the world, it is critical to first define "the rest of the world." In most conversations and commentary, the most advanced, industrialized countries, which belong to the Organization for Economic Co-operation and Development (OECD) are deemed to serve as that proxy. The mission of the OECD, headquartered in Paris, France, is to "promote policies that will improve the economic and social well-being of people around the world." Among the economic factors OECD considers in carrying out is mission are the taxes and tax policies promoted within the group's 35 member countries.

The OECD publishes an annual report titled, *Revenue Statistics*[1]. The 2015 edition, the most-recent version available, compiles 2014 data from among its member countries. A quick look at some of the published statistical information provides insight as to why misconceptions about international taxation can arise.

[1] http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/revenue-statistics-2015_rev_stats-2015-en-fr

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One of the indicators for which OECD collects information is tax on corporate profits, which for these purposes, is defined as follows:[2]

> *"Tax on corporate profits is defined as taxes levied on the net profits (gross income minus allowable tax reliefs) of enterprises. It also covers taxes levied on the capital gains of enterprises. This indicator relates to government as a whole (all government levels) and is measured in percentage both of GDP and of total taxation."*

Based on the *2015 Revenue Statistics* data, the OECD countries collected 33.7% of their tax revenues through taxes on income and profits (personal and corporate income taxes taken together). Taxes on personal and corporate incomes are the primary source of revenues used to finance public spending in 15 OECD countries, and in nine countries (including the United States), the share of income taxes in the mix exceeds 40%. Another important statistic is the share of tax imposed by state and local jurisdictions. In the United States and Switzerland, these tax jurisdictions comprise 15% of the total tax assessments on revenue earned in each country.

It should be common knowledge that the United States has one of the highest general statutory marginal rates on corporate earnings in the world, a fact confirmed in the OECD publication. In fact, the U.S. rate is the highest corporate income tax rate among the industrialized nations included in the OECD membership.

A more-significant statistic, published in the Tax Foundation's *International Tax Competitiveness Index 2015,*[3] shows how the U.S. corporate tax rates compare to a sample of 173 countries and tax jurisdictions throughout the entire world. The data shows that the U.S. corporate tax rate "all in" of 39% is the third-highest in the world (tied with Puerto Rico), lower only than the United Arab Emirates and Chad, which have rates of 55% and 40%, respectively. The U.S. corporate tax rate exceeds the next-closet country (Austria) by five percentage points. This gap equates to a spread of nearly 15% in the rate structures of just these two countries.

The United States' tax rate is 16 percentage points higher than the worldwide average of 22.8%, and a little more than nine percentage points higher than the worldwide GDP-weighted average of 29.8%. As with the average tax rate among industrialized nations, the average worldwide tax rate has been declining in the past 10 years, pushing the United States farther from the norm. This worldwide decline in corporate tax rates can be seen in all regions of the world.

Confusion begins to take hold when comparing the statutory corporate tax rates noted above to the actual tax rates (the "effective" tax rates) paid by those corporations theoretically subject to the top statutory rates.

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[2] https://data.oecd.org/tax/tax-on-corporate-profits.htm

[3] http://taxfoundation.org/sites/default/files/docs/TF_ITCI_2015.pdf

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In a whitepaper prepared for Congress by the Congressional Research Service, a nonpartisan division of the Library of Congress, titled, *International Corporate Tax Rate Implications,*[4] the authors note:

> *"Although the U.S. statutory tax rate is higher, the average effective rate is about the same, and marginal rate on new investment is only slightly higher. The statutory rate differential is relevant for international profit shifting; effective rates are more relevant for firms' investment levels. The 13.7 percentage point differential in statutory rates (a 39.2% rate for the United States compared with 25.5% in other countries), narrows to about 9 percentage points when tax rates in the rest of the world are weighted to reflect the size of countries' economies."*

It is impossible to determine, with any level of certainty, the effect of reducing the top corporate income tax rates in the United States over the long run. Discussion regarding reducing that federal statutory rate to 25% would likely require concessionary reductions in allowable deductions and use of credits in modifying net taxable income calculations as they currently exist. Much argument is made of the narrower tax base allotted corporations as a result of a variety of deductions and allowances. In fact, it is these deductions and allowances that ultimately lead to a reduction in the statutory rates to any specific corporation's effective rates. Thus, to maintain a balanced approach to a rate reduction, it is most reasonable to expect modifications in the current tax regime, thus widening the tax base to which the lower rates will apply.

The difference and spreads in corporate tax rates across the world provide a simple example of what the United States is up against in competing for new business in a global economy. However, it is just one challenge. There are a myriad of other complexities and issues one might expect to encounter in conjunction with doing business outside the borders of the United States. Such endeavors must include strategy development related to fundamental economic issues, such as selecting the proper currency preferences for any particular business and industry, as well as managing the potential fluctuations in foreign currency exchange rates. Companies must also consider the broad variety of differing tax systems, leading to determinations of tax liabilities that may, and do, vary widely from what most businesses have come to expect in the United States.

In addition to the many tax issues associated with doing business abroad, companies must face challenges in meeting employment needs, along with understanding the business environment in the country overall and the mechanics of doing business in the local jurisdiction. It is also critical for the business to fully understand the cultural differences it might expect to encounter in the foreign country and to consider how best to conduct the planned operations while respecting that culture. Though beyond the scope of today's program, these "soft issues" are every bit as important as understanding the economic and tax issues related to doing business abroad.

[4] https://www.fas.org/sgp/crs/misc/R41743.pdf

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Similarly, inbound business investment and operation presents a huge shift in thinking for many foreign businesses contemplating an attempt to do business within the United States. The same challenges apply to inbound workers. The transition can be particularly difficult for companies based in less-sophisticated parts of the world as they find themselves required to comply with a very broad and sophisticated (and complicated) U.S. tax system that involves tax regimes promulgated at local, state and federal levels. Successfully navigating this tax system can present many foreign investors and workers with a formidable challenge, requiring both legal and financial advisors to intervene and assist.

Today's program is not intended to make anyone an expert in international taxation. It is, as is the case with all of our programs, intended to introduce participants to the basic precepts of international taxation, as those precepts apply to both inbound and outbound taxpayers. As such, we would hope that the takeaway from this program will be a better ability to identify an international tax issue and determine when that issue is sufficiently complex so as to require the services of a professional, such as an attorney or an accountant specializing in these matters.

To accomplish this task, we have carved today's program into three broad sections – Fundamentals of International Taxation, Outbound Taxation and Inbound Taxation – which are further divided into eight chapters:

<u>Fundamentals of International Taxation</u>

I. *International Taxation Basics* – basic patterns of taxation for inbound and outbound transactions

II. *Individual Taxation Basics* – nationality and taxation, dual citizenship status, loss of citizenship, expatriation and residency issues

<u>Understanding Inbound Taxation</u>

III. *Determination of Source of Income* – general system of taxation, residency and income sourcing issues

IV. *Special Considerations* – effectively-connected income (ECI) as well as fixed, determinable, annual or periodical (FDAP) income

V. *Taxation and Filing Requirements* – compliance requirements for resident and nonresident aliens

<u>Understanding Outbound Taxation</u>

VI. *Taxation of U.S. Citizens and Businesses* – general system of taxation, the foreign tax credit and foreign earned income exclusion

VII. *Special Rules and Reporting* – foreign financial asset reporting and FBAR compliance

VIII. *An Overview of Income Tax Treaties* – the importance of such treaties and the role of in-place treaties

Understanding International Taxation

As noted earlier, the program today is designed for the novice in international taxation and is intended to provide an introduction into that topic area. The content, however, does assume a certain understanding of the U.S. tax system. We realize that many of those in the audience lack this expertise as they specialize in other areas of the law and, as such, we have tried to keep references to any particular technical U.S. tax statutes to a minimum. Should you find that a provision that is referenced or discussed is unclear during the presentation, please feel free to ask for clarification.

Additionally, many of the fundamental concepts in this program are addressed from the standpoint of individuals, both domestic and foreign. The purpose of this presentation is to set the concepts in the simplest light possible to enhance participant understanding. Note that most of the concepts adapt to business entities, as well. However, much of the planning surrounding business entities in the international tax arena can take on a significantly greater level of complexity, as there are numerous issues to consider beyond the scope of today's program.

We certainly appreciate each of you taking time from your busy schedules to attend this presentation. As always, we are hopeful that your entire experience with us and our program is positive, and that you are able to take something away from the program that aids you in your professional practice going forward.

Should you have questions, comments or observations not fully addressed today, the authors will be available after the presentation to answer any questions you may have, or please do not hesitate to contact them at a later date. Their phone numbers and email addresses are listed below.

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We appreciate the support you have shown our Firm in the past, and we look forward to working with each of you in the future. Thank you again!

Understanding International Taxation

I. International Taxation Basics

Many tax practitioners spend their entire careers attempting to figure out the intricacies of the Internal Revenue Code (IRC) and its related Treasury regulations with respect to the taxation of U.S. citizens who are gainfully employed and/or conducting their business entirely within the borders of this country. However, all professionals should have a basic understanding of the fundamental concepts of international taxation as individuals and businesses become more globally intertwined.

With the evolution of the digital age and its profound effect on commerce, specifically electronic commerce, businesses and their employees find themselves touching many parts of the globe. Not all that long ago, the environment of international operations was primarily limited to the biggest and most lucrative companies. But now, with the development and advancement of the internet, it is becoming almost abnormal for any enterprise to not explore the opportunity to conduct business in a foreign jurisdiction. Though many companies may consider doing business internationally, not as many decide to take the leap.

The problems and hesitation with the outreach to international markets are numerous. Issues could arise in hiring employees and following import/export compliance procedures. And, because every country has its own set of laws, it can be cumbersome to research and, ultimately, abide by all of the applicable rules.

Obviously, each country has its own set of laws and regulations that govern practices within its borders. This course and related material is not designed to expound upon, illustrate or explain in any detail the manner in which a foreign jurisdiction applies its tax regime to commerce or business activity within that country's borders, nor will it speak to the taxation of the same country's citizens or residents. The primary focus will be on the U.S. taxation of investments and business activity of foreign persons in the United States, as well as the investments and business activity of U.S. persons outside of the United States. These concepts are commonly referred to as "inbound" and "outbound" transactions, respectively. The tax implications of each set of transactions are what make up the U.S. international taxation system.

Included below are key terms and concepts that will be discussed in the context of international taxation:

- ***United States Person*** (or "U.S. person") – means a citizen or resident of the United States, a domestic partnership, a domestic corporation, any estate (other than a foreign estate) and any trust – if a court within the United States is able to exercise primary supervision over the administration of the trust, and one or more U.S. persons have the authority to control all substantial decisions of the trust.

- ***Foreign Person*** – individuals or entities who are not U.S. persons as described above. This includes nonresident aliens, foreign corporations, foreign partnerships and foreign trusts and estates.

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- ***United States Citizen*** (or "U.S. citizen) – any person born or naturalized in the United States and subject to its jurisdiction.
- ***Expatriate*** – any U.S. citizen who relinquishes his citizenship, and any long-term resident of the United States who ceases to be a lawful, permanent resident of the United States.
- ***Resident Alien*** – foreign citizen who is a resident of the United States under either the "green card" or "substantial presence" test.
- ***Nonresident Alien*** – an individual who is neither a citizen nor a resident of the United States.

Inbound System

Foreign persons are taxed in the United States under two separate structures: (1) U.S.-sourced income not connected with a U.S. trade or business; and (2) income effectively connected with a U.S. trade or business. A brief overview of each of these structures follows. They will be described in greater detail in Chapter IV.

U.S.-sourced income not connected with a U.S. trade or business, often referred to as "fixed, determinable annual or periodical income" or FDAP income, is taxed at a flat 30% rate. This category of income would include U.S.-sourced interest, dividends, rents, royalties and compensation. The 30% tax is on a "gross" basis and does not allow for any deductions or modifications to reduce the income. Foreign persons may be subjected to graduated tax rates on the disposition of certain real property located in the United States.

Foreign persons are also subject to U.S. tax on income effectively connected with a U.S. trade or business. In determining whether someone is engaged in a U.S. trade or business, relevant facts and circumstances will dictate the resulting conclusion. Furthermore, because these situations are highly-specific and unique to each particular situation, the IRS has been reluctant to issue any rulings on the determination procedures. Oftentimes, courts will look to the nature of the activities, the level, extent and continuity of the activities, and the time required to perform the activities. As an aside, the examination of the conduct of the activities is not limited to the foreign persons, but also includes those individuals who are acting as agents on their behalf.

Outbound System

The United States taxes its citizens and residents on their worldwide income, which is otherwise known as a worldwide taxation system. In contrast, some countries will implement a territorial taxation regime, whereby individuals are taxed only according to the source of their income or solely within that country's borders. In the U.S. worldwide taxation regime, every dollar earned, absent an applicable exclusion from income, will make its way onto a individual taxpayer's Form 1040 or an entity's related tax return.

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If a U.S. citizen is working in a foreign country, earning compensation for the services provided, the IRS will expect the taxpayer to report that income and pay the applicable tax on Form 1040. However, opportunities exist to reduce the U.S. tax figure. For example, if the U.S. citizen must also pay in tax in the foreign country on the income earned while overseas, the U.S. will allow the taxpayer to take advantage of a foreign tax credit on his or her individual income tax return. The credit will be explained further in Chapter VI. Additionally, U.S. citizens who are working overseas and meet the specific requirements for the foreign earned income exclusion may be able to wipe out up to $101,300 (for 2016) of taxable income on their tax returns. The specific requirements and calculations to this methodology will be discussed in greater detail in Chapter VII.

While not directly a part of the outbound system, Congress has implemented additional reporting requirements with respect to certain foreign activities. The Report of Foreign Bank and Financial Accounts (FBAR) requires taxpayers with an interest in, or signature authority over, foreign financial accounts whose aggregate value exceeded $10,000 at any time during the calendar year to the file FinCEN Form 114. [The form is now due for calendar year 2016 on April 15, 2017.] These reporting requirements will be detailed in Chapter VII.

In addition to these new bank account reporting requirements, Congress also instituted the Foreign Account Tax Compliance Act (FATCA), which requires taxpayers to report their financial interest in certain specified foreign financial assets. The specified assets are reported on Form 8938, which is attached to and submitted with an individual taxpayer Form 1040. Further details of these requirements will be discussed in Chapter VII.

Concluding Thoughts

Each international transaction starts and ends with two basic questions: (1) what is the taxpayer's filing status? (2) is it an inbound or outbound transaction? Once these questions are answered, the task becomes a little easier. Because the application of the rules depends so heavily on the answers to these questions, this is the starting point in determining the ramifications of the decisions ultimately made.

As can be inferred from the basic concepts introduced in this chapter, international taxation is not an easy area to navigate. Each transaction or deal can have many intricacies, which are not always apparent on the surface. Diving into the details can be a time-consuming and costly project. However, the issues encountered in this area deserve this level of attention because of the cross-border nature and the ultimate outcomes. Failure to consider all the relevant items could result in a catastrophic state of affairs.

Understanding International Taxation

II. Individual Taxation Basics

In trying to analyze any U.S. international tax issue, the first question that should be running through any tax practitioner's mind is how to determine the appropriate classification of the individual or entity in question. Knowing a taxpayer's classification is essential in determining the proper tax treatment of any source of income. The Internal Revenue Code separates individuals into one of three groups: (1) citizen, (2) resident alien, and (3) nonresident alien (as defined in Chapter I). Specific tests, theoretical and formulaic, are used to determine the status of taxpayers.

Nationality in Taxation

As noted previously, the United States taxes its citizens on their worldwide income, whether they reside in the United States or abroad. This might seem like a simple statement, but upon close examination of the rules, citizenship determination for tax purposes is identical to nationality laws. The Treasury regulations clearly state, "every person born or naturalized in the United States and subject to its jurisdiction is a citizen." Therefore, meeting those qualifications subjects a person to a worldwide tax regime. The bigger issues arise when an individual has either dual citizenship with another country or loses his or her U.S. citizenship. The residency rules may be altered due to income tax treaties, which will be further discussed in Chapter VIII.

Dual Status Citizenship

More difficult situations occur when an individual meets the requirements for citizenship under the rules of two or more countries. This circumstance, however unique, does not independently absolve a taxpayer from paying U.S. tax on his or her worldwide income. However, as is often the case with any cross-border transaction, it is likely that the United States has entered into an income tax treaty with the second country in question. Other countries in the world have the same general mindset as the United States when it comes to double taxation. In fact, many of the income tax treaties with the United States include in the title some language about the prevention or avoidance of double taxation. Thus, the income tax treaties with certain countries may depart from federal law and allow for income in exclusive situations to be taxed in one country or the other, and not both.

Loss of Citizenship

As soon as an individual loses his or her status as a U.S. citizen, he or she is no longer subject to U.S. taxation on his or her worldwide income. The individual's status converts to that of a nonresident alien, and he or she will be subjected to taxation under the rules for this status category. The question, however, is in determining when, or in some instances, whether, an individual has lost his or her citizenship.

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In the past, the established rule was one where the outcome of any citizenship question was applied retroactively. Under the old rules, taxpayers who believed they had lost their status as U.S. citizens were left to the mercy of the legal process in determining their tax consequences. If it was later determined that an individual never lost his or her status as a citizen, the worldwide taxation of his or her income never stopped. Obviously, if these unfortunate circumstances occurred, the taxpayer could be facing significant tax issues.

More recently, however, the rules have changed with respect to whether the government or taxpayer initiated the determination action. For example, if the U.S. government attempts to prove loss of citizenship, U.S. taxation is suspended until a resolution is reached. On the other hand, if an individual brings an action to prove loss of citizenship, U.S. taxation is not suspended. However, in the end, the American Jobs Creation Act of 2004 requires taxpayers to go a step further and to notify certain governmental agencies, including the Secretary of State, along with providing certain information to the IRS, to officially renounce their citizenship.

Interestingly, a situation could arise whereby an individual loses his or her citizenship for immigration purposes, but not for tax purposes. With the thought that the tax rules for citizenship closely follow nationality laws, logic would dictate this is not possible. However, with the added requirement to notify the appropriate government agencies of the change in status, a taxpayer cannot officially relinquish citizenship for tax purposes without completing this step.

Expatriation to Avoid Tax

Can innovative thinkers circumvent the U.S. tax regime by simply renouncing their citizenship status and moving to another jurisdiction? This was an opportunity to explore until 1966, when IRC Section 877 was adopted. Prior to that time, the rules were advantageous for former U.S. citizens, especially wealthy ones. A bright individual who thought through the convoluted rules system could greatly reduce his or her tax on certain U.S.-sourced passive investment income, including interest and capital gains, as they were excluded from taxable income. As Congress began to catch wind of this loophole, they put together IRC Section 877, which only partially reduced the tax opportunities available to expatriates. The key determination of these rules (and as modified in 1996) was set off by determining that the taxpayer's move was for tax avoidance purposes.

The test for determining the application of IRC Section 877 was formula-based and primarily objective for individuals who expatriated on or before June 16th, 2008. These special rules apply if the individual: (1) has average U.S. income tax payments greater than $124,000 for the five years preceding expatriation, (2) has net worth of $2 Million or more on the date of expatriation, or (3) has failed to certify, under penalty of perjury, that he or she has met the income tax filing requirements for the preceding five years.

IRC Section 877 allows the U.S. government to impose tax on the individuals described above for 10 calendar years after the loss of citizenship. IRC Section 877(b) permits the United States to tax the expatriate's U.S.-sourced income and income effectively connected with a U.S. business. That might not seem cumbersome as a nonresident alien would be taxed on those classifications of income. However, IRC Section 877(d) expanded the income base to include: (1) gains on the sale or exchange of property (other than stock) located in the United States, (2) gains on the sale or exchange of stock issued by a domestic corporation or debt obligations of U.S. persons or of the United States, a State of political subdivision, or the District of Columbia, and (3) any income or gain derived from stock in a foreign corporation (more than 50% ownership at any point during the two years preceding the date of loss of citizenship.)

With the implementation of the American Jobs Creation Act of 2004, expatriates who decide to return to the United States for more than 30 days during a calendar year will be subjected to U.S. tax on their worldwide income. This is slightly different than the tax base under IRC Section 877(b) as described above, and would include additional sources of income. However, there are certain bona-fide reasons why a particular day would not be counted towards the 30-day threshold. For example, if an expatriate returns to the United States in his or her official capacity as an employee for a foreign employer, those days are exempted from the computation.

From a tax perspective, only a few reasons remain why a taxpayer would want to purposefully exceed the 30-day rule. A taxpayer who had significant foreign losses may intentionally exceed the 30-day limitation in order to utilize the foreign losses to offset U.S.-sourced income. However this decision may have other ramifications, tax and otherwise, that could outweigh the need to utilize certain foreign losses. A full analysis should be calculated before breaking the 30-day rule.

Congress again took a shot at revising the provisions surrounding expatriates when they chose to enact IRC Section 877A, which applies to individuals who expatriate on or after June 17, 2008. The effect of this provision is to treat all property as having been sold for its fair market value on the date of expatriation. There is a $600,000 exemption amount (adjusted for inflation) for any gain as a result of this computation.

Residence of Individuals

In deciding which rules and regulations apply to a particular taxpayer, properly determining an individual's residency status is critical. U.S. citizens and resident aliens are subject to U.S. tax on their worldwide income, while nonresident aliens are only subject to tax on their income that is connected to the United States.

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Prior to 1984, the residency determination test was entirely subjective and based on all the facts and circumstances. The presence of an alien normally would have been sufficient to establish residency, as long as he or she was not a mere transient. The regulations go on to elaborate with respect to "intent" and "length of stay," but the bottom line reflected a subjective interpretation of an individual's actions.

In contrast, and starting in 1984, IRC Section 7701(b) came into existence and codified the term "resident alien." Under the new rules, the determining factors for "residency" are either the immigration status of foreign individuals or, using a more calculated approach, a set number of days present in the United States. The number-of-days test is often referred to as the "substantial presence test."

For tax purposes, foreign nationals who are lawful permanent residents during the calendar year are also considered to have achieved resident alien status for the same period. A lawful permanent resident, under immigration laws, is nothing more than holder of a "green card," which allows the individual to remain in the United States on a permanent basis.

As an alternative to the green-card test, a foreign national can also achieve resident alien status by meeting the requirements of the substantial presence test. The substantial presence test is broken down into two subsections. First, a foreign national will achieve residency status by remaining in the United States for at least 183 days during the calendar year. Alternatively, many look to not only the time spent in the United States during the present calendar year, but also include time spent in the United States for the two previous calendar years. This alternate scenario treats the days in the previous calendar years with less weight in the overall computation – each day counts as 1/3rd of a day in the first preceding year and 1/6th of a day in the second preceding year. However, an individual cannot obtain residency based solely on those days from prior periods. In addition to the foregoing, to attain residency status, an individual must be present in the United States for at least 31 days during the present calendar year.

Compounding the confusion, an individual whose "tax home" is in a foreign country or who has a "closer connection" to another country will not achieve residency status even if he/she otherwise would have qualified under the substantial presence test. In determining a taxpayer's tax home, the statutes and the courts have not been entirely clear on the consideration of the proper attributes and characteristics. The long-held belief of the Internal Revenue Service is that a taxpayer's tax home is synonymous with his or her place of employment or business and is not related to his or her abode or place of dwelling. The determination of whether a taxpayer has a closer connection to a foreign country than to the United States is one based upon unique facts and circumstances; a process that is similar to the rules and regulations as set forth before 1984.

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Even though many of the determination statutes and regulations are fairly straightforward, additional rules should be carefully considered by a taxpayer at the beginning and end of his or her residency.

Taxpayers who achieve residency via the green-card test are considered to be resident aliens on the day they become lawful permanent residents, and their residency will extend to the end of the calendar year as long as they are physically present for at least one day during the period in question. If he/she is not present during that period, residency status begins on the first day of the following year. Individuals who meet the substantial presence test become a resident alien on the first day of presence for the period in question. On top of these qualifiers, taxpayers may make an election to be treated as a resident alien for the entire length of the calendar year in which they achieve their residency. Since certain exemptions and deductions are only available to citizens and resident aliens, the first-year election presents a potential tax planning strategy for practitioners.

Regarding the final year of residency, a taxpayer's last day of presence in the United States as a lawful permanent resident (green-card holder) is the residency ending date. With respect to individuals who have achieved residency status via the substantial-presence test, the ending date is typically the last day of presence in the United States, followed by a period where the taxpayer: (1) is not present in the United States, (2) has a closer connection to a foreign country than the United States, and (3) is not a resident of the United States during the calendar year following that of his or her last day of presence in the United States. Thus, generally, the end date is December 31 of the calendar year in which the taxpayer departs from the United States. Again, there are exceptions to this rule. A taxpayer's ending date may be prior to December 31, with a proper showing of his or her tax home in a foreign country and maintaining a closer connection to that foreign country as compared to the United States.

Concluding Thoughts

Essentially, there are two sets of rule systems for U.S. international taxation. One rulebook contains the details and qualifiers for U.S. citizens and resident aliens; the other rulebook contains the provisions for nonresident aliens. As has been explained, it can often become difficult to ascertain into which category an individual falls. Issues can arise when individuals are considered citizens or residents of more than one country for the same period. Typically, income tax treaties will break this tie. Additional issues arise when an individual intentionally or unintentionally seeks to renounce his or her U.S. citizenship status. Because the rules are based on the determination of filing status, identifying the point of time when the taxpayer's status changes is critical to reporting the appropriate income and paying the requisite tax.

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III. Determination of Source of Income

Since foreign persons are only subject to U.S. tax on their income that is connected to the United States, another critical component (in addition to the questions surrounding residency status) is to determine the source and underlying character of the income in question. On one side of the equation, foreign persons are very interested in properly evaluating the nature and source of the income stream because foreign-sourced income never becomes subject to U.S. taxation. On the other side, U.S. citizens and residents are somewhat less concerned with the source of the income stream because those individuals are subject to U.S. taxation on their worldwide income. However, a primary area of concern for both U.S. citizens and resident aliens regarding the classification of income relates to the foreign tax credit. Determining whether the income is classified as foreign or U.S.-sourced will impact the foreign tax credit limitation and the available credit. The credit will be discussed in detail in Chapter VI.

A major issue regarding income classification is the lack of clarity and global acceptance regarding how to determine the proper source of a stream of income. Obviously, one country's tax regime may not treat a transaction in the same manner as another country. The following sections detail various characters of income and items for consideration in determining their sources for U.S. tax purposes.

Interest

Interest payments originate from the individual or the underlying business activity of the entity which remits payment. Payments made by nonresident individuals of the United States, by default under IRC Section 861(a)(1), are sourced to the United States. Foreign branches of U.S. banks make foreign-sourced interest payments.

Somewhat more-difficult to determine is the source of income from partnerships that remit interest payments. The rules for determining the proper situs of the source for these entities changed in 2004. Prior to that time, the analysis was relatively simple. If the partnership was, in fact, engaged in a U.S. trade or business, it paid U.S.-sourced interest. Conversely, if the partnership was not engaged in a U.S. trade or business, the source was deemed to be foreign. In 2004, the rules for partnership interest sourcing were modified so that all foreign partnerships made foreign-sourced interest payments if their business operations were predominantly engaged outside of the United States, and the income was not allocable to income which was effectively connected to U.S. operations. In theory, these rules put partnerships and corporations on a semi-equal playing field.

From a corporate standpoint, the basic idea sources interest payments to the place of incorporation, subject to a few exceptions including obligations issued before August 10, 2010. Under this special provision, interest

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received from a resident alien was considered to be foreign-sourced if 80% of the domestic corporation's gross income was from foreign trades or businesses. These types of domestic corporations are often referred to as "80/20 corporations" because the remaining 20% of activity was related to U.S. activity.

Dividends

Dividend payments follow the same general principle as interest payments where the situs of the corporation is controlling, absent an exception. Foreign corporations that issue a dividend receive U.S.-sourcing if 25% or more of the gross income for the corporation in the three preceding years to declaring the dividend is effectively-connected income with the United States. In addition, the amount of the U.S.-sourced dividend is adjusted based upon the ratio of U.S.-sourced income to the corporation's entire income for the same period. For example, if a foreign corporation issued a $500 dividend, and 50% of its previous three years' income was 50% effectively connected to the United States, the original $500 dividend would be sourced one half to the United States.

Compensation for Personal Services

Sourcing compensation for personal services is relatively easy to understand. The general rule sources income to the location where the services were performed. In light of technology, the problem lies with employees who work from all around the globe, which can lead to confusion surrounding the performance location. As always, there are certain exceptions to the general rules.

A 90-day rule excludes certain compensation from the breadth of the U.S. tax system when the services are actually performed in the United States. This rule considers all compensation earned by a foreign person to be foreign-sourced if: (1) the individual is present for 90 days or fewer in the United States during the current taxable period, (2) the services are for a foreign person not engaged in a trade or business in the United States, and (3) the total compensation does not exceed $3,000. Practically speaking, the 90-day rule is never utilized as the dollar threshold is considerably low.

In determining the performance location and the proper allocation method when services are performed in multiple locations, the Treasury regulations allocate compensation on the basis of time. In contrast, other employee benefits are determined on the basis of geography. Housing, transportation and education benefits are determined based upon the employer's business location. Moving expense reimbursements are sourced to the employee's new location.

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Rental and Royalties

Sourcing of the use of tangible property is relatively straight-forward as the place of use is controlling. However, also included in this category are rents and royalties from the use of intangible property such as patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises and other like property, which can create difficult scenarios to work through. For starters, intangible property has no physical location. In addition, intangible property can be used in many locations, with multiple licenses, across multiple jurisdictions. The Internal Revenue Code has attempted to simplify the approach. Under IRC Section 861, royalties from the same stream of licenses and sublicenses that are derived from the same intangible property could all be sourced to the United States.

Consider the following: a foreign entity creates intangible property and licenses it to another user in a different foreign county; then, that user sublicenses it to a customer in the United States. IRC Section 861 suggests that it is possible that the royalty income generated from all the contracts and licenses could be sourced to the United States because the "use" of the ultimate intangible property is derived in the United States. It is not difficult to imagine how unintended consequences can occur, which could potentially expose foreign persons to U.S. taxation.

With careful planning, foreign persons can limit their exposure as courts have not been receptive to the idea of "cascading royalties" in certain circumstances. To defeat this argument, a taxpayer would need a showing of separate transactions with respect to each license and sublicense, therefore, making the determination of the "place of use" potentially different under each contract. For example, using the same set of facts as above, if the original founder of the intangible property can prove that the initial license is a separate and distinct transaction from the middle-user and the end-user, the original license and corresponding royalty stream should not be sourced to the United States. These kinds of circumstances can produce different results depending on the exact factual pattern.

Gains from the Sale of Property

Within this category of transactions, there are several types of property that carry different sets of rules. In its simplest form, the sourcing of the sale of property is tied to the place of sale. Obviously, certain transactions and deals are easy to figure out when all of the elements to a contract occur at the same location. However, some transactions can be more complicated. Sales of real property create the easiest situations, while the sale of personal property, intangible property and inventory present considerable challenges.

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Sale of Real Property

IRC Section 861(a)(5) sources to the United States, "gains, profits, and income from the disposition of a United States real property interest." U.S. real property interests include directly-owned real property and ownership of stock of a domestic corporation that owns an interest in U.S. real property. Gains attributable to each of these situations produce U.S.-sourced income.

Sale of Personal Property

In its simplest form, the Internal Revenue Code sources gains from the sale of personal property by a citizen and resident alien to the United States. The sale of personal property by a nonresident alien is sourced outside the United States. For these purposes, the rules for determining resident and nonresident alien status are different than those previously discussed and do not include the substantial presence test for foreign individuals.

Under the sourcing and status rules, IRC Section 865(g) states that a resident is any U.S. citizen or resident alien with no tax home outside of the United States or any nonresident alien with a tax home inside of the United States. Since the rules are different, certain individuals can be treated as resident aliens for some sections of the tax code, but as nonresident aliens for other parts.

Again, there are exceptions to the general rule. Citizens and resident aliens who pay an income tax equal to less than 10% of the gain from the sale of personal property to a foreign country can never be treated as nonresident aliens. Additional exceptions apply to the sale of depreciable property, intangible property and goodwill.

For depreciable property, past depreciation is recovered with the same source of income it was used to offset. In determining the U.S.-sourced gain from the recovered depreciation, it bears the same proportion to the total gain as U.S. depreciation to total depreciation.

The rules surrounding the sale of intangible property contain their own caveats and exceptions. The main qualifier in this area is in the terms of the pricing included in the final contract. For fixed sales, residency rules control. The sale of intangible property by U.S. residents generally results in U.S.-sourced gain. The reverse occurs with foreign persons. For contingent sales, royalty rules control, meaning the income is sourced to the place of use of the intangible property. Additionally, where the sale of intangible property contains returns of capital, the rules differ based upon the taxpayer. For a U.S. resident, the installment sale provisions would apply, and gain would be recognized accordingly. Conversely, payments to foreign persons are allocated first to return of capital. After that is exhausted, then gain may be recognized.

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Regarding the sale of inventory, IRC Section 861(a)(6) looks to the place of sale in assigning the source. The problem in international transactions, as in all transactions, is that a number of steps are involved to complete a deal. For starters, some point of inquiry and negotiation needs to take place to arrive at the terms, but the terms of the final contract may be determined at another place. The final goods and title may also be set at a different location. Fortunately, the United States has determined and codified that the source of the sale is at the same time and location as the passage of title unless the rules were manipulated as a tax-avoidance scheme. Title passes at the point of delivery by default.

However, as with any contract, terms can be negotiated to reflect the will of the parties or to depart from standard procedures. Because of the ability to control the terms of a contract, taxpayers are presented with an opportunity to determine the sourcing of the sale of inventory. This is very important for all interested parties. For foreign persons, crafting the title to pass outside of the United States will allow the income associated with the deal to escape U.S. taxation. For U.S. persons, shifting the passage of title to a foreign jurisdiction is also very important. In any scenario, the income would be taxable in the United States. However, for purposes of the foreign tax credit, it is advantageous for U.S. residents to push as much income as possible to the foreign-sourced category to take advantage of the foreign tax credit and its related limitation computation.

Concluding Thoughts

Determining the source of income is an essential step in every international tax matter. Though every U.S. citizen and resident alien is taxed on his or her worldwide income, the determination of the income's source becomes a critical component in properly computing the foreign tax credit for any taxpayer. This issue carries additional weight for nonresident aliens since they are only taxed on their U.S.-sourced income. In the areas where planning can occur, pushing as much income as possible into the foreign-sourced category can be advantageous on many levels.

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IV. Special Considerations

As discussed earlier, the United States taxes citizens and resident aliens on their worldwide incomes. For U.S. citizens and other covered individuals, the tax on worldwide income is typically imposed regardless of the country or jurisdiction in which the income is earned. However, nonresident aliens are subject to different U.S. tax rules. If an individual is a nonresident alien, he or she is taxed only on the income earned or derived within the United States. In general, a nonresident alien's income is categorized into two separate categories:

1. Effectively connected income (ECI), and
2. Fixed, determinable, annual or periodical (FDAP) income that is not effectively connected with the conduct of a trade or business. These items of income (discussed in detail below) include, but are not limited to: interest, dividends, services, rents, royalties, wages, etc.

The main difference in taxation between these two categories of income is the tax rate at which the income is taxed. Generally, if the income is treated as ECI, the tax rate on the net income will be graduated and will range from 10% to 35%, depending on the amount of taxable income and the entity that generated the taxable income. If the income is treated as FDAP, the tax and withholding rate will generally be a flat 30%. Treaty provisions could apply to both tax regimes which could reduce the rate of tax. Once it has been established that a foreign person has sufficient presence in the United States to be considered engaged in a trade or business, it is necessary to determine if the income received by such person is effectively connected with such trade or business (or not) and, thus, determine which tax regime is applicable.

<u>Understanding Effectively-Connected Income (ECI)</u>

Nonresident alien individuals that are engaged in a trade or business within the United States are subject to U.S. income tax on any "effectively-connected" income, from sources both within and outside the United States. Effectively connected means that the trade or business conducts any management, production, distribution, or other major business functions within the borders of the United States, that is regular, substantial and continuous. Another strong determinant of the income source is if the nonresident alien has an office in the United States.

While ECI is essentially a type of income, the mechanics of its taxation requires attention to the activities engaged in by the nonresident alien. A nonresident alien cannot have ECI unless he or she participated at some point in a U.S. trade or business. The general rule is that income will be taxed in the jurisdiction (the United States, in this case) where such income is earned. The ECI of a nonresident alien is taxable in the United States

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on a net basis at graduated income tax rates. Deductions from the income are allowed for business expenses, and specific itemized deductions are allowed. U.S.-sourced passive income (FDAP income that is not ECI) is not included in this ECI calculation, and such income, if any, will generally be taxed at a flat rate, or not at all.

If income is effectively connected with a U.S. trade or business, then the taxable income is computed in the same manner that applies to U.S. persons, with the exception that the gross income that is not effectively connected with a U.S. trade or business is excluded from ECI, and deductions are then limited to those that are directly connected with the ECI.

Generally, a nonresident alien must be engaged in a trade or business during the tax year to be able to treat income received in that year as ECI. The nonresident alien is usually considered to be engaged in a U.S. trade or business when he or she performs personal services in the United States. Whether one is engaged in a trade or business in the United States depends on the nature of the activities performed by that individual. Deductions are allowed against ECI, and net ECI is taxed at graduated tax rates, similar to taxation of a citizen or a resident alien.

The following are examples of situations where a nonresident alien would be considered connected with a trade or business in the United States, and ECI would exist:

- A nonresident alien is a member of a partnership that, at any time during the tax year, is engaged in a trade or business in the United States.
- A nonresident alien owns and controls the business activity of a single-member operating LLC that is organized and conducts business in the United States.
- A nonresident alien performs personal services are performed in the United States.
- A nonresident alien owns and operates a business in the United States selling services, products or merchandise. For example, profit from the sale in the United States of inventory, purchased either in the United States or in a foreign country, is effectively-connected trade or business income.
- A nonresident alien realizes gains from the sale or exchange of U.S. real property interests (whether or not they are capital assets.)
- A nonresident alien owns real property that generates rental income (if the taxpayer elects to do so.)
- A nonresident alien is temporarily present in the United States as a nonimmigrant on an F, J, M or Q visa. The taxable part of any U.S.-sourced scholarship or fellowship grant received by a nonimmigrant in F, J, M or Q status is treated as effectively connected with a trade or business in the United States.

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Generally, if a nonresident alien's only U.S. business activity is trading in stocks, securities or commodities (including hedging transactions) through a U.S. resident broker or other agent, he or she is NOT engaged in a trade or business in the United States.

Understanding Fixed, Determinable, Annual or Periodical (FDAP) Income

The definition of FDAP income is very broad and defined by the Internal Revenue Service (IRS) by what it is not. Thus, according to the IRS, FDAP is all income except:

- Gains derived from the sale of real or personal property (including market discount and option premiums, but not including original issue discount)
- Items of income excluded from gross income, without regard to the U.S. or foreign status of the owner of the income, such as tax-exempt municipal bond interest and qualified scholarship income

Pursuant to the IRS:

"Income is fixed when it is paid in amounts known ahead of time. Income is determinable whenever there is a basis for figuring the amount to be paid. Income can be periodic if it is paid from time to time. It does not have to be paid annually or at regular intervals. Income can be determinable or periodic, even if the length of time during which the payments are made is increased or decreased."

Since this category can include income that is fixed or otherwise determinable, and is income that is paid annually or is periodically in non-regular intervals, FDAP income encompasses many types of income. The IRS website lists the following examples of FDAP income:

- Interest
- Dividends
- Compensation for personal services
- Original issue discount
- Alimony
- Pensions and annuities
- Real property income, such as rents, other than gains from the sale of real property
- Royalties
- Scholarships and fellowship grants

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- Other grants, prizes and awards
- A sales commission paid or credited monthly
- A commission paid for a single transaction
- The distributable net income of an estate or trust that is FDAP income, and that must be distributed currently, or has been paid or credited during the tax year, to a nonresident alien beneficiary
- A distribution from a partnership that is FDAP income, or such an amount that, although not actually distributed, is includible in the gross income of a foreign partner
- Taxes, mortgage interest or insurance premiums paid to, or for the account of, a nonresident alien landlord by a tenant under the terms of a lease
- Prizes awarded to nonresident alien artists for pictures exhibited in the United States
- Purses paid to nonresident alien boxers for prize fights in the United States
- Prizes awarded to nonresident alien professional golfers in golf tournaments in the United States

FDAP income can also include income gained from the sale of intellectual property if compensation for the intellectual property is contingent upon the use, productivity or sale of the property. Capital gains from the sale of personal property may also be considered FDAP income if the nonresident alien has been in the United States for 183 days or more in the tax year.

By default, FDAP income, is income that is not connected with a trade or business (i.e., not ECI), and is taxed on the gross amount, at a flat rate of 30%. However, FDAP income may be taxed at a lower rate, if a tax treaty provides for it, or if other permissible reductions are available. By contrast, ECI is taxed at normal graduated income tax rates and deductions and credits are available. By categorizing income as ECI, and by utilizing other strategic measures, it is possible for a nonresident alien to reduce his or her overall tax obligation.

As a practical concern, it is important to note that if an FDAP income obligation exists, the 30% tax payment on the income is collected by withholding at the source. This may require a nonresident alien to withhold and remit tax to the Internal Revenue Service.

FDAP income can be considered either effectively-connected income or not effectively-connected income. The determination of such will ultimately determine how this income is taxed.

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Tax Treatment of FDAP Income That Is Also ECI

Even if an item of income, gain or loss is from foreign sources, certain items may be treated as being effectively connected with the conduct of a trade or business within the United States if the nonresident alien has an office or other fixed place of business in the United States to which the item is attributable.

Items of income that are FDAP income and capital gain income are considered ECI if they meet the requirements of a two-pronged test. The two tests that are applied to determine if items are effectively connected to a trade or business in the United States are:

- The ***asset-use test*** – generally applied where there is not a direct relationship of the gain, income or loss to the business, and
- The ***business-activities test*** – generally applied where there is a direct relationship between the gain, income, or loss to the business.

For purposes of determining if investment income is effectively connected with respect to a U.S. trade or business under the asset-use or the business-activities test, there are three principal categories of income that should be tested:

- FDAP income, which would include interest income, dividend income, rental income, royalty income and income from annuities.
- Gains realized from the sale or exchange of:
  - Intangibles, such as patents and copyrights, on which contingent payments are received.
  - Original issue discount.
  - Timber, coal or domestic iron ore with a retained economic interest.
- Capital gains and losses.

Asset-Use Test

The asset-use test is usually applied to various passive income items. It is used to see if the item is effectively connected to the trade or business when the trade or business does not give rise directly to the realization of the income. The test determines if the item of income, gain or loss is derived from assets that are either used or held for use in the United States. If the income is derived as a result of the use of the assets that are within the trade or business, then the income is included within the ECI bucket.

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Business-Activities Test

The business-activities test is ordinarily applied where the item of income, gain or loss, though passive, arises directly from the active conduct of a trade or business in the United States. The test may be used when:

- Dividends or interest are derived by a dealer in stock or securities,
- Gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business,
- Royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, or
- Service fees are derived in the active conduct of servicing a business.

You will note that these items of income are considered normal income type items for the specific trade or business. If FDAP income is determined to be ECI, such income is taxed in the United States on a net basis, using graduated income tax rates, similar to other income that is inherently ECI.

Tax Treatment of FDAP Income That Is Not ECI

Any FDAP income that is determined to not be ECI will be taxed at a 30% (or the lower tax treaty) rate. The 30% (or lower treaty) rate applies to the gross amount of U.S.-sourced fixed, determinable, annual or periodical gains, profits or income. Deductions and netting are not allowed against FDAP income that is not ECI.

General U.S. Taxation of Individuals Who Are Owners of Certain U.S. Entities

U.S. Partnership with Foreign Partners

If a partnership is engaged in a U.S. trade or business, then each of its foreign partners is deemed to be so engaged, and the partners will have ECI. A partnership that generates ECI must withhold tax on each foreign partner's "applicable percentage" of the ECI. Income effectively connected with a U.S. trade or business will be separately stated on a reporting statement, and the partnership will be required to withhold taxes based on the applicable percentage of ECI associated with each foreign partner. Generally, the withholding rate will be at 30%.

The ECI will be taxed to the partner at the graduated tax rates that apply to U.S. citizens and residents. The rates range from 10% to 35%. Any withholding from the partnership will apply against the tax due, along with any foreign tax credits allowed.

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U.S. Corporation with Foreign Shareholders

A U.S. corporation with foreign ownership is taxed the same as a U.S. domestic corporation, at graduated tax rates between 15% and 35%. This tax is at the entity (i.e., the corporate) level. Distributions from U.S. corporations to foreign shareholders will generally have withholding at 30%, unless a reduced treaty rate applies.

Foreign Partnership

A foreign partnership that has U.S. ECI is required under U.S. taxation to file the same income tax returns as a U.S. domestic partnership. In addition, the foreign partners with allocable ECI are required to file a U.S. income tax return and pay any applicable U.S. income tax.

Foreign Corporation

The tax treatment of foreign corporations is substantially similar to that of nonresident alien individuals. A foreign corporation is taxed on its ECI at graduated tax rates between 15% and 35%.

Concluding Thoughts

The classification of one's residency, as well as making certain that the sourcing of income is carefully structured, is critical in determining how foreign persons are taxed in the United States. Proper planning and an understanding of the statutory rules are essential to ensuring that the required reporting is done and the necessary taxes are paid.

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V. Taxation and Filing Requirements for Resident and Nonresident Aliens

When filing their taxes, resident and nonresident aliens will need to follow a different set of rules than those who are citizens of the United States. Filers who are not citizens may be exempt from reporting certain types of income, depending on their circumstances. This section considers the definition and tax treatment of these filers, and takes its material substantially from the information provided at www.irs.gov – Topic 851.[5]

Taxation of Resident Alien Income and Filing Requirements

If an individual is a foreign national (i.e., not a U.S. citizen), he or she is generally considered a resident alien of the United States for tax purposes if he or she meets either the green-card test or the substantial-presence test for any calendar year. These tests were detailed in Chapter II of these materials. If either of these tests is satisfied, the foreign national is considered a resident alien, and the individual is required to file a U.S. income tax return as a resident alien.

A U.S. resident alien's income is generally subject to tax in the same manner as a U.S. citizen's. As such, a resident alien is required to file income, estate and gift tax returns in the same manner that a U.S. citizen would file. A resident alien can use the same U.S. tax forms as U.S. citizens (Form 1040), and the original due date for the annual return is April 15th.

A resident alien must report all interest, dividends, wages or other compensation for services, income from rental property or royalties and other types of income on the U.S. tax return. Because worldwide income is subject to U.S. income tax for resident aliens as it is for U.S. citizens, these amounts must be reported whether from sources within or outside the United States. If any part of this income is also taxed in another taxing jurisdiction, foreign tax credits should be available to ensure that there is no double tax paid on this income.

A resident alien can use the same filing statuses available to U.S. citizens and can claim the same deductions allowed to U.S. citizens as long as he or she is a resident alien for the entire tax year. Personal exemptions and exemptions for dependents are permitted based on the dependency rules for U.S. citizens.

A resident alien can claim the same tax credits, using the same rules that apply to U.S. citizens. Resident aliens can claim the same itemized deductions as U.S. citizens, or they can claim the standard deduction based on their particular filing status. These deductions, which include certain medical and dental expenses, state and local income taxes, real estate taxes, interest paid on a home mortgage, charitable contributions, casualty and theft losses and miscellaneous itemized deductions, can be claimed using Schedule A of Form 1040.

[5] https://www.irs.gov/taxtopics/tc851.html?_ga=1.100371610.528304451.1431019441

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Taxation of Nonresident Alien Income and Filing Requirements

An alien is any individual who is not a U.S. citizen or a U.S. national. A nonresident alien is an alien who has not passed the green-card test or the substantial-presence test, as described in Chapter II of these materials.

Nonresident aliens are generally subject to U.S. income tax only on their U.S.-sourced income. As discussed in detail in Chapter IV, a nonresident alien's income that is subject to U.S. income tax must generally be divided into two categories: ECI and FDAP income.

ECI, after allowable deductions, is income earned in the United States from the operation of a trade or business or personal service income earned in the United States (including wages or self-employment income). ECI is taxable to a nonresident alien at the same graduated rates as would be used for a U.S. citizen, and is reported on page one of Form 1040NR, *U.S. Nonresident Alien Income Tax Return*.

FDAP income generally consists of passive investment income; however, in theory, it could consist of almost any sort of income. FDAP income is taxed at a flat 30% (or lower treaty rate, if it so qualifies), and no deductions are allowed against such income. FDAP income should be reported on page four of Form 1040NR.

Nonresident aliens are only required to pay income tax on the income that is earned or realized from a U.S. source. A nonresident alien does not have to pay tax on any foreign-earned income. For example, an individual from China who owns a business in China, as well as one in the United States, will only be taxed in the United States on the income earned in the United States. The income from the Chinese business will be ignored for U.S. tax purposes. Nonresident aliens should keep careful records to show the sources of all of their income so that the IRS can clearly see what should be taxed in the United States and what is exempt from U.S. taxation.

Nonresident aliens engaged in a trade or business in the United States at any time during a tax year, or who have income subject to U.S. taxation, must file a return on Form 1040NR or 1040NR-EZ. It is irrelevant if the gross income for the tax year is less than the minimum amount specified for citizens, since U.S. nationals and resident aliens must still file a return.

Generally, the standard deduction is not available to nonresident aliens (except in special cases). The single filing status is available to nonresident aliens, similar to U.S. citizens, U.S. nationals and resident aliens. The use of the married-filing-jointly status is limited. The rules specify that a nonresident alien may not file a joint return if either of the taxpayers is a nonresident alien at any time during the tax year. Also, nonresident aliens cannot use head-of-household filing status. Note that there are special rules for each of these general rules that would allow alternative filing options.

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Nonresident aliens who are required to file a tax return must complete and file Form 1040NR or Form 1040NR-EZ, along with supporting schedules and forms, with the appropriate IRS service center by the required due date. The filing is due on the 15th day of the fourth month following the end of the tax year (generally, April 15) if the taxpayer is an employee with wages subject to withholding or a self-employed individual maintaining a place of business within the United States with nonemployee compensation subject to withholding. The due date for all other nonresident taxpayers is the 15th day of the sixth month (generally, June 15.)

The Bottom Line

The information outlined in this chapter only constitutes a summary of the tax rules that apply to resident and nonresident aliens. These rules can be quite complex in some cases, and the rules that a given taxpayer ultimately falls under may depend on his or her specific details. For more information, consult IRS Publication 519, *U.S. Tax Guide for Aliens*,[6] or contact a GYF tax professional.

[6] https://www.irs.gov/publications/p519/index.html

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VI. Taxation of U.S. Citizens and Businesses

Two specific concepts serve as a foundation for the taxation of outbound individuals and businesses. A firm grasp of these two concepts will better allow for understanding much of what occurs when a person elects to work outside the country or a when U.S. business decides to open a foreign operation or relocate its headquarters.

The first of these concepts is that requirement imposed under U.S. tax law that mandates the reporting of all worldwide income derived by U.S. persons working outside the country. In other words, U.S. persons working outside of the United States must include all income earned both inside and outside of the United States in their total income reported on their income tax returns.

One issue encountered under such a broad fundamental concept is the potential for double taxation on al least a portion of that U.S. person's income. Most countries have a tax system designed and adopted to tax income earned by a U.S. person within the borders of that foreign country. Thus, inclusion of that income on the U.S. person's U.S. tax returns works to subject the same income to taxation twice.

The second important point to understand is that where U.S. tax law allows for treating a corporation as a separate taxable entity, U.S. income taxes on income earned by the corporation can be deferred until the corporation is repatriated to the United States. The general essence of the concept is based upon the separate identity of corporations for U.S. tax purposes and, specifically, from the status of foreign corporations as foreign persons.

The first concept requires the inclusion of all income earned worldwide, while the second allows for a deferral of the U.S. tax where monies earned are not repatriated, thus, leading to a potential for under-taxation. As such, the structure of U.S. outbound taxation is a mix of worldwide taxation and tax deferral.

To remediate the risk of double taxation and its implications, and to slow the permanent deferral of taxes by foreign corporations (that could, thereby, avoid even paying a single tax in the United States), the U.S. tax laws have been shaped to address these two specific matters.

The U.S. tax system includes a foreign tax credit to mitigate the possibility of double taxation. This credit, which is at the heart of U.S. outbound taxation, reduces the U.S. taxes on income earned outside the country that has been subjected to a tax in the foreign jurisdiction. In effect, the foreign tax credit allows for a full offset for any foreign taxes paid, up to the level of tax that would be assessed on that same income in the United States.

Because the potential to defer payment of U.S. taxes on a corporation's foreign earnings can lead to the possibility of permanent deferral and under-taxation, several provisions in the U.S. tax system extend to the incomes of foreign corporations with U.S. ownership. The primary device by which this income is attached for purpose of U.S. taxation is via "controlled foreign corporations." A controlled foreign corporation is most often used when earnings and income have been routed to low-tax environments for purpose of tax avoidance.

Though discussion of the topic is beyond the scope of today's session, it is important to note that deferral is available under U.S. tax law for active business operations conducted in a foreign country. However, the same deferral does not apply for any number of "tax haven" operations, conducted in controlled foreign corporations.

Given the breadth and reach of these two opposing concepts and the remedies included in the U.S. tax law, it should be apparent that the primary planning for outbound taxation must focus on ensuring that the full benefits to be garnered from proper application of the foreign tax credit are attained.

On the deferral side, planning extends to structuring operations and foreign entities in such a way as to ensure that the deferral benefits associated with active operating businesses are optimized where possible. A simple example of a deferral tax strategy is the Mylan inversion. Moving the company's headquarters to Ireland (where the income tax rate is 12%) significantly lowered Mylan's home country tax rate. So long as the earnings are not repatriated to the United States, there is no immediate taxation of that income in this country.

Overview of the Foreign Tax Credit

The foreign tax credit [IRC Section 901(a)] allows U.S. taxpayers to reduce U.S. tax paid on foreign income by the amount of foreign taxes paid on that income to avoid double taxation. Generally, taxpayers are prevented from using foreign tax credits to reduce U.S. tax liability on income from sources within the United States. The amount of the foreign tax credit that can be applied against U.S. tax liability is subject to limitation under the foreign tax credit limitation [IRC Section 904]. Note, that as an alternative to claiming the foreign tax credit, a taxpayer may choose to deduct the foreign taxes paid or accrued.

The credit against U.S. income tax is allowed for any income, war profits and excess profits taxes paid or accrued by the taxpayer to a foreign country or United States possession during the tax year. This includes taxes paid in lieu of income, war profits and excess profits taxes [IRC Section 903]. The credit may not be claimed against any U.S. tax, such as the accumulated income tax, that is not treated as a regular income tax. The credit is nonrefundable.

A foreign tax credit may be claimed for taxes paid directly, as well as indirectly. A domestic corporation that owns at least 10% of the voting stock of a foreign corporation from which it receives dividends is deemed to have paid a percentage of the foreign corporation's foreign taxes. Additionally, domestic corporations (or individuals electing to be taxed at corporate rates) that are 10% shareholders in foreign corporations are entitled to claim the foreign tax credit with respect to amounts attributable to the foreign corporation's earnings and profits that are included in gross income.

Taking Advantage of the Foreign Tax Credit as a Credit or as a Deduction

The taxpayer can choose whether to take a deduction or claim a credit. Generally, it is more advantageous to credit qualified foreign taxes than to deduct them because the credit, which is taken against a taxpayer's U.S. tax liability, reduces U.S. income taxes on a dollar-for-dollar basis. In contrast, a deduction merely reduces the taxpayer's income subject to tax.

Further, the foreign tax credit can be claimed by an individual taxpayer regardless of whether the taxpayer itemizes deductions. Individual taxpayers who deduct foreign taxes must claim the taxes as an itemized deduction on Schedule A, Form 1040. Also, a taxpayer may not deduct foreign taxes paid on income exempt from U.S. tax; whereas, within certain limitations, this restriction does not apply to taxes credited.

A simple example from IRS publication 514-2015, *Foreign Tax Credits for Individuals*,[7] works to illustrate the difference between the options of taking the foreign tax credit as a deduction versus a credit.

- Joe and Jane Smith have adjusted gross income of $80,300 for 2015, including $20,000 of dividend income from foreign sources. None of the dividends are qualified dividends. The Smiths file a joint return and claim two personal exemptions of $8,000 (2 × $4,000). The Smiths paid $1,900 in foreign tax on the dividend income. If the Smiths decide to deduct their foreign taxes, itemized deductions (including the foreign taxes) are $15,000. The Smith's taxable income is $57,300 and their tax is $7,676.
- If the Smiths were to claim the foreign tax credit, instead, their itemized deductions total $13,100. The Smith's taxable income is $59,200, and their tax is $7,961 (before the foreign tax credit is applied.) After the foreign tax credit is claimed, their tax is $6,061. The Smith's tax is $1,615 lower if the foreign tax credit is claimed as a credit rather than as a deduction($7,676-$6,061).
- Dividends paid to an individual by either a domestic corporation or a qualified foreign corporation are taxed as net capital gains. Taxation of foreign dividends at a lower rate results in a "capital gains rate differential" that must be taken into account when calculating the foreign tax credit.

It should be noted that in certain circumstances, particularly with lower-level adjusted gross income, there will be cases where a deduction yields a more advantageous tax position. However, in almost every situation

[7] https://www.irs.gov/pub/irs-pdf/p514.pdf, page 3

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with somewhat-normal parameters, taking the foreign tax credit as a credit rather than a deduction will provide a greater benefit. Clearly, there is no way to provide a blanket recommendation. Taxpayers, or their advisors, simply have to crunch the numbers to ensure that they have attained the best possible tax position.

Note, that no portion of the taxes subject to the credit is allowable as a deduction from gross income for the tax year or any succeeding tax year.

Taxpayers Able to Claim the Credit

Taxpayers entitled to claim the foreign tax credit, with respect to taxes paid or accrued to foreign countries and U.S. possessions, generally include:

- U.S. citizens, whether residents or nonresidents;
- Domestic corporations;
- Alien residents of the United States; and
- Alien individuals who are bona fide residents of Puerto Rico for the entire tax year.

Note, that any of these potential claimants may claim the foreign tax credit for that taxpayer's share of taxes of a partnership in which the taxpayer is a partner, or of an estate or trust, in which the claimant is a beneficiary.

For purposes of the foreign tax credit, an S corporation is treated as a partnership, with its shareholders treated as partners. Accordingly, the foreign taxes paid by an S corporation will pass through to its shareholders who may claim the foreign tax credit. An S corporation is ineligible for the foreign tax credit with respect to foreign taxes paid by a foreign corporation in which the S corporation is a shareholder.

Creditable Taxes

When determining the possible benefits of utilizing the foreign tax credit, it is important to fully understand which taxes assessed by the foreign country are considered (creditable) in calculating the foreign tax credit. Foreign taxes that are creditable are generally those that are based on net gain.

The term "foreign tax" is mainly defined by Treasury regulations. However, even with this detailed information, it can be exceedingly difficult to immediately ascertain which foreign taxes fall within this definition. The IRS has issued a number of specific rulings to address whether various foreign taxes are creditable.

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According to the IRS, the following apply when considering which taxes are creditable:

- The term "paid" means "paid or accrued;" the term "payment" means "payment or accrual;" and the term "paid by" means "paid or accrued by or on behalf of"
- The term "foreign country" means any foreign state, any possession of the United States and any political subdivision of any foreign state or of any possession of the United States; the term "possession of the United States" includes Puerto Rico, the Virgin Islands, Guam, Mariana Islands and American Samoa
- The term "foreign levy" means a levy imposed by a foreign country

Under the regulations, a foreign levy is a creditable tax only if (1) it is a ***tax***; and (2) its ***predominant character*** is that of an income tax in the sense of the U.S. tax system. A tax either is or is not an income tax in its entirety - credibility is an all-or-nothing proposition, and the law does not permit bifurcation of a single levy by a foreign country into multiple types of taxes.

Is the Levy a Tax?

A levy is a tax only if it requires a compulsory payment pursuant to a foreign country's authority to levy taxes, as determined by principles of U.S. law and not principles of law of the foreign country.

A payment to a foreign government in exchange for a specific economic benefit is not a tax. A taxpayer who receives a specific economic benefit is a dual capacity taxpayer and must establish the portion (if any) of the payment to the foreign government that is tax.

A dual capacity taxpayer may use either the *facts and circumstances method* or the *safe harbor method* to establish the tax amount. A taxpayer that uses the facts and circumstances method must establish by all the facts and circumstances, the portion (if any) of the levy "that is not paid in exchange for a specific economic benefit." The safe harbor method uses a formula to determine the creditable tax.

Is the Predominant Character that of an Income Tax?

In determining whether the predominant character of a foreign tax is that of an income tax in the U.S. sense, the normal way in which the tax applies is controlling. Thus, the characterization of the tax by a foreign government does not control; rather, the controlling factor is whether, if enacted in the United States, the tax would be an income tax.

The *realization test* is met if the predominant character of the foreign tax is that of a tax imposed on income at the time, or after the time, income would be realized under the Code. The realization test can also be

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satisfied: (a) if the tax is imposed prior to a realization event if the tax recaptures a tax deduction, tax credit or other tax allowance previously accorded the taxpayer; (b) if the foreign tax is imposed on the appreciation in value of property or on the value of certain inventory property at the time of transfer, processing or export, but only if such amounts are not subject to tax, and a credit is given for the earlier tax; and (c) by certain foreign taxes imposed on the deemed distribution of profits.

The *gross receipts test* is satisfied if the predominant character of the foreign tax is that of a tax imposed on the basis of gross receipts. Also allowed is a tax imposed on the basis of estimated gross receipts if the method used is likely to produce an amount that is not greater than fair market value.

The *net income test* is met if the predominant character of the foreign tax is that of a tax on net income. A tax imposed on the basis of gross receipts, reduced by significant costs and expenses (including capital expenditures) attributable to that income, is a tax on net income. Certain methods of computing taxable income satisfy this test. In infrequent cases where income is of a type that generally does not have significant related expenses, a foreign tax may be considered to be imposed on net income even if no deductions are allowed.

Note that the complexity of determining which taxes are creditable for purposes of the foreign tax credit is also accompanied by a significant number of specific provisions addressing certain taxes where the credit may be limited or unavailable. These provisions are very precise and require great care to ensure they are considered in conjunction with the determination of the foreign tax credit in any situation.

Examples of these limiting provisions (not all inclusive) include:

- Mutual life insurance companies are denied the foreign tax credit with respect to foreign taxes on excluded income from Canadian and Mexican branches.
- Foreign taxes on foreign mineral income must be reduced in certain cases.
- Foreign taxes on certain oil and gas payments are not eligible for the foreign tax credit.
- Taxes paid to a foreign corporation or possession on certain distributions from a possession corporation are not eligible for the foreign tax credit.
- Foreign taxes used to provide subsidies are not eligible for the foreign tax credit.
- Foreign taxes paid to certain sanctioned foreign countries are not eligible for the foreign tax credit.
- Foreign withholding taxes on dividends or income-producing property if the holding period is not met with respect to the stock or the property are not eligible for the foreign tax credit.

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- Foreign taxes paid or accrued with respect to foreign income not subject to U.S. tax due to covered asset acquisitions are not eligible for the foreign tax credit.
- Foreign taxes paid or accrued that exceed the foreign tax credit limitation are not eligible for the foreign tax credit.
- Nonresident aliens and foreign corporations are generally not entitled to a foreign tax credit, except with respect to foreign tax imposed on income effectively connected to a U.S. trade or business.
- Foreign oil and gas taxes paid or accrued during the tax year are subject to a special limitation.
- The foreign tax credit is reduced for taxpayers who participate or cooperate with an international boycott.
- Foreign taxes and credits are suspended until the corresponding income is taken into account.
- Foreign taxes that are allocable to income excluded under the foreign earned income exclusion are not eligible for the foreign tax credit.
- Failure to supply information required for controlled foreign partnerships and controlled foreign corporations may result in the reduction of the foreign tax credit.

Other limitations, both general and specific, apply to determinations of the foreign tax credit. Though beyond the scope of today's program, the authors will be happy to discuss these at your request after the presentation.

Payment

As a general rule, amounts of foreign income, war profits or excess profits taxes that are creditable must be paid or accrued to the foreign country by, or on behalf of the taxpayer. The amount of tax paid is determined separately for each taxpayer. The person who is considered to pay the tax is the person on whom the foreign law imposes legal liability (the legal liability rule) even if another person, like a withholding agent, remits the tax. The beneficial owner of income on which tax is withheld is the taxpayer even if the income is collected by an agent or nominee. A tax is considered paid by a taxpayer even if another party to a transaction with the taxpayer agrees to assume the tax liability.

There are a number of special rules for determining who pays foreign tax imposed on partnerships and disregarded entities. For purposes of determining who has the legal liability for paying the foreign tax, special rules apply in the case of partnerships and disregarded entities, for foreign taxes paid or accrued in tax years beginning after February 14, 2012. If the foreign law imposes tax at the entity level on the income of a partnership, the partnership is considered to be legally liable for the tax under the foreign law and, as such,

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is the person considered to pay the tax under the federal income tax law. The rules apply regardless of who the person is, who is obligated to remit the tax, who actually remits the tax, or who the foreign country could take action against to collect the tax.

There are a number of additional special rules that may affect the computation of the foreign tax credit associated with the conduct of foreign business activities in a partnership. The complexity of those rules is such that a presentation of this length cannot include the in-depth discussion that would be required to fully understand them. The authors of these materials suggest that such questions be referred to them at a later point, should you wish to discuss these rules.

Amount of Creditable Payment

For purposes of determining the amount of a qualifying tax that is creditable, certain limitations (again, beyond the scope of today's presentation) apply. Amounts of tax paid or accrued to a foreign country do not include amounts that are: (1) reasonably certain to be refunded, credited, rebated, abated or forgiven; (2) used directly or indirectly as a subsidy to the taxpayer, a related person or any party to the transaction or a related transaction; or (3) not compulsory payments (i.e., the extent to which the amount paid exceeds the amount of liability under foreign law for the tax.)

An amount is not reasonably expected to be refunded, credited, rebated, abated or forgiven if the amount does not exceed the reasonable approximation of the final tax liability to the foreign country. For example, if a foreign country imposes a 25% tax on interest, but the treaty between the United States and the foreign country reduces the tax to 10%, 15% of the 25% tax withheld on the payment is reasonably certain to be refunded and will not be creditable

Reporting Tax Paid or Accrued

The amount of taxes paid or accrued to a foreign country must generally be reported in U.S. dollars. If taxes were paid in foreign currency, the value of the currency must be translated into U.S. dollars. The translation is made using the exchange rate that exists on the date that the foreign taxes were paid or withheld. For foreign estimated tax payments, the rate of exchange in effect on the date that the estimated tax is paid used. Taxpayers on the accrual basis must use the rate of exchange in effect for the last day of the tax year to translate accrued and unpaid foreign liabilities.

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Tax Treaties and the Foreign Tax Credit

The United States is a party to numerous tax treaties that are designed, in part, to prevent the double taxation of the same income by the United States and the treaty country. Many of these treaties accomplish this goal by allowing U.S. taxpayers to treat U.S.-sourced income as foreign-sourced income. These treaties will be discussed in more detail in Chapter VIII.

In general, a foreign tax credit may be claimed for foreign taxes that meet the statutory and regulatory requirements. However, foreign taxes may be creditable, even if those requirements are not met, under the terms of an income tax treaty between the United States and a foreign country (see, for example, Article 23 of the U.S. Model Income Tax Convention[8]). If a taxpayer claims a foreign tax credit based on a tax that is specifically listed as creditable, the taxpayer must report the necessary information on Form 8833, *Treaty-Based Return Position Disclosure*.

An additional credit, separate from the credit for foreign taxes imposed upon foreign-sourced income, may be allowed to U.S. citizens residing in certain foreign countries that have income tax treaties with the United States. The credit is allowed for the portion of the foreign tax imposed by the foreign country on U.S.-sourced income. The countries that currently provide for this additional credit (for 2015 returns) include: Australia, Austria, Bangladesh, Belgium, Bulgaria, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Ireland, Israel, Italy, Japan, Luxembourg, Malta, Mexico, the Netherlands, New Zealand, Portugal, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland and the United Kingdom.[9]

Covered Asset Acquisitions

The foreign tax credit is limited to the extent that any potion of a foreign income tax is determined with respect to income or gain attributable to certain relevant foreign assets. The general rule provides:

With respect to covered asset acquisitions, the disqualified portion of any foreign income tax determined with respect to the income or gain attributable to the relevant foreign assets is not taken into account:

- In determining the foreign tax credit allowed, and
- For purposes of the deemed paid credit under IRC Section 902, or Section 960 in the case of foreign income tax paid by certain corporations

[8] https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf, page 52-53

[9] https://www.irs.gov/pub/irs-pdf/p514.pdf, page 23

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The term ***covered asset acquisition*** means:

- A qualified stock purchase, as that term is defined under IRC Section 338;
- Any transaction that is treated as an acquisition of assets for U.S. tax purposes, and is treated as the acquisition of stock of a corporation (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction;
- Any acquisition of an interest in a partnership that has a basis adjustment election in effect under IRC Section 754; and
- To the extent provided by the Secretary, any other similar transaction.

With respect to any covered asset acquisition, for any tax year, the term ***disqualified portion*** means the ratio (expressed as a percentage) of:

- The aggregate basis differences (but not below zero) allocable to such tax year with respect to all relevant foreign assets, divided by:
- The income on which the foreign income tax is determined (or, if the taxpayer fails to substantiate such income to the satisfaction of the Secretary, such income shall be determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to such income in the relevant jurisdiction.)

Holding Period – Foreign Stock

A holding period requirement is imposed for purposes of crediting foreign taxes associated with foreign-sourced dividends. The holding period is intended to prevent tax-motivated transactions designed to facilitate the transfer of foreign tax credits from those who cannot benefit from the credits (i.e., tax-exempt organizations) to those who can.

In general, a taxpayer is not entitled to a tax credit for foreign withholding taxes paid with respect to a dividend if a 16-day holding period for the dividend-paying stock (or a 46-day holding period for certain dividends on preferred stock) is not satisfied. The holding period generally does not include any period during which the taxpayer is protected from risk of loss.

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Holding Period – Income Producing Property

A foreign tax credit can be claimed with respect to income-producing property only if certain holding period requirements are met. Many of the rules are identical to those that apply with respect to foreign stock, discussed above.

Generally, no foreign tax credit will be allowed for any withholding tax on any item of income or gain with respect to any property: (1) if the property is held by the recipient for 15 days or fewer during the 31-day period beginning 15 days before the right to receive payment arises; or (2) to the extent that the recipient is under an obligation to make related payments with respect to positions in substantially-similar or related property.

This rule applies whether or not the obligation arises in connection with a short sale or otherwise. For this purpose, a withholding tax includes any tax determined on a gross basis but does not include any tax that is in the nature of a prepayment of tax imposed on a net basis.

Foreign Earned Income Exclusion

U.S. citizens or residents who work abroad may claim either the foreign tax credit or the foreign earned income exclusion. The foreign earned income exclusion allows a U.S. citizen or resident to exclude, from his or her U.S. taxable income, a certain portion of their income that is earned in a foreign country. Thus, it is a mechanism by which to decrease the amount of income that would otherwise be subjected to double taxation.

The amount of available exclusion is adjusted each year for inflation, but currently sits at $100,800 and $101,300 for the 2015 and 2016 taxable periods. Additionally, while housing cost amounts are included in an employee's foreign earned income, an additional housing cost allowance exclusion, which is part of the earned income exclusion, may be claimed.

Before any individual takes advantage of the foreign earned income exclusion, they must ensure they have a "tax home" in a foreign country and meet the qualifications and attributes as set forth under either the bona fide residence or physical presence test. Normally, one's tax home can easily be identified as his or her principal place of business. If a taxpayer has no principal place of business, his or her normal place of abode is controlling.

The *bona fide residence test* is satisfied when a taxpayer can establish that he or she resided in a foreign country for an uninterrupted period that includes an entire tax year. Since taxpayers file their returns on a calendar-year basis, any individual who moved to a foreign country during the middle of year XXX1 would then have to wait until the end of year XXX2 to qualify under this test.

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A taxpayer would also qualify for the foreign earned income exclusion if he or she passed the *physical presence test.* This test can be met by being physically present in a foreign country for at least 330 days during the 12 consecutive months. Provided a taxpayer meets all of the requisite conditions, he or she will qualify for the foreign earned income exclusion.

Once a taxpayer has qualified for the foreign earned income exclusion, it is time to crunch the numbers to determine the actual exclusion amount. By and large, the exclusion calculation starts by first assessing how many days are in the tax year of the period where the taxpayer meets the 330-day test. This number is divided by 365, and multiplied by the exclusion limit ($101,300 for 2016.) For a taxpayer who meets the qualifications based on the bona fide residence test, the exclusion limitation would be at its maximum. A taxpayer would only get the benefit for his or her actual foreign earned income up to the exclusion limitation. Thus, the exclusion is the lesser of the actual foreign earned income or the exclusion limitation amount.

If the individual claims the foreign earned income exclusion, a foreign tax credit may be claimed for the foreign taxes paid or accrued on income that is not excluded. In this situation, foreign taxes available for the foreign income tax credit must be reduced by taxes paid or accrued on income that is excluded from U.S.-sourced income under the foreign earned income exclusion or the foreign housing exclusion.

To determine the amount of foreign taxes that are allocable to the excluded income, the amount of foreign taxes paid or accrued on the excluded income is multiplied by a limiting fraction. The numerator of the limiting fraction is the total of all foreign earned income and housing amounts that are excluded from income along with the housing exclusions, minus the definitely-related and properly apportioned expenses, excluding the foreign housing deduction. The denominator of the limiting fraction is total foreign earned income, minus all deductible expenses allocated to the income, including the foreign housing deduction.)

An example from IRS Publication 514[10] illustrates this requirement:

- In 2015, Joe Smith, a cash basis taxpayer, works for Worldwide Corp. in a foreign country.
- Joe has the following:
  - Foreign earned income received...$ 125,000
  - Unreimbursed business travel expense...$ 20,000
  - Income tax paid to the foreign country ....$ 30,000
  - Exclusion of foreign earned income and housing allowance.........$ 100,800

[10] https://www.irs.gov/pub/irs-pdf/p514.pdf, pages 7-8

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- Because Joe can exclude part of his wages, he cannot claim the foreign tax credit for part of the foreign taxes. To find that part, the following steps must be taken:
- Joe first determines that $16,128 of business expenses are not deductible because they are allocated to his excluded wages ($20,000 × $100,800 ÷ $125,000). Joe determines the numerator of the limiting fraction ($84,672) by subtracting $16,128 of expenses allocated to $100,800 of excluded wages.
- Joe then determines the denominator of the limiting fraction ($105,000) by subtracting all $20,000 of expenses from $125,000 total foreign earned income.
- Joe is not entitled to claim a foreign tax credit for $24,192 ($30,000 × $84,672 ÷ $105,000).

Year of the Foreign Tax Credit

The foreign tax credit may ordinarily be taken either in the year when the taxes are accrued or in the year in which they were paid, depending upon whether the taxpayer is on the accrual or the cash basis. However, a cash-basis taxpayer may elect to claim the credit on an accrual basis. Unused credits, which cannot be claimed for a tax year because of the limitations on claiming the foreign tax credit, may be carried back to the two preceding years and forward to the five succeeding years. Further, a taxpayer may elect the foreign tax credit at any time during the 10-year period of limitations.

Claiming the Foreign Tax Credit

Individuals, nonresident aliens and estates and trusts compute the foreign tax credit on Form 1116, *Foreign Tax Credit*. An individual with de minimis foreign tax credits may elect to be exempt from the foreign tax credit limitation rules. An individual who makes the election is not required to file Form 1116; the credit is claimed directly on Form 1040.

An individual is not required to file Form 1116 to claim the credit if: (1) all of the individual's income is foreign-sourced gross income in the passive category; (2) all income and foreign taxes paid were reported on a qualified payee statement, for example, Form 1099-INT; and (3) total creditable taxes do not exceed $300 ($600 if married, filing jointly). Individuals who elect to be exempt from the foreign tax credit limitation cannot carryforward excess foreign tax credits to or from the year for which the election is made.

Corporations compute the foreign tax credit on Form 1118, *Foreign Tax Credit – Corporations*. Corporations in an affiliated group must compute the foreign tax credit on a consolidated basis for a consolidated return year.

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Summary

Determination of a foreign tax credit is fraught with complexity. However, in most instances, it is clear that a careful and detailed assessment will yield a significant income tax benefit for the claimant taxpayer. The primary effort required to claim these tax benefits is in developing an understanding of the rules and ensuring that systems are put in place to gather the appropriate information to garner the maximum allowable credit.

One great resource for learning more about the foreign tax credit and the many nuances associated with its proper determination is IRS Publication 514,[11] which has been referenced numerous times in this chapter. This 30-page document is fairly comprehensive in its presentation of general concepts related to the determination of the credit. The document even includes a worksheet to assist taxpayers with manually computing the credit. A new version is expected to be released soon, for use in preparing 2016 tax returns.

Note, in computing the foreign tax credit for individuals on passive foreign earnings that broker, Forms 1099 almost always include the detail necessary to capture the credit allowable.

Determination and planning for using the foreign tax credit for corporations and operating companies is more complex than for individuals and requires experienced advisors to ensure that those steps required to optimize use of the credits are properly undertaken in a timely manner. Much of the challenge in dealing with the conduct of offshore business that results in taxation is the foreign tax credit and the need to avoid a double up of the taxes assessed on economic income and gains.

[11] https://www.irs.gov/pub/irs-pdf/p514.pdf

VII. Special Rules and Reporting

Foreign Financial Asset Reporting

On March 18, 2010, Congress passed the Foreign Account Tax Compliance Act (FATCA), which was part of the Hiring Incentives to Restore Employment Act. FATCA requires specified persons to file an information return, Form 8938, with their annual federal tax returns for any year in which their interests in foreign financial assets exceed the applicable reporting threshold.

Per the instructions to Form 8938, specified persons have an interest in a specified foreign financial asset if any income, gains, losses, deductions, credits, gross proceeds or distributions from holding or disposing of the asset are (or would be) required to be reported, included or otherwise reflected on their income tax returns.

There are two types of specified persons: (1) specified individuals; and (2) specified domestic entities.

A ***specified individual*** is any one of the following:

- A U.S. citizen
- A resident alien
- A nonresident alien who makes an election to be treated as a resident alien for purposes of filing a joint income tax return
- A nonresident alien who is a bona fide resident of Puerto Rico or a U.S. possession.

A ***specified domestic entity*** is a domestic corporation, a domestic partnership or a trust, if such corporation, partnership or trust is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets. Whether a domestic corporation, a domestic partnership or a trust as described is a specified domestic entity is determined annually. [IRC Section 7701(a)(30)(E)]

"Financial account" and "foreign financial institution" are given their meanings consistent with those described in IRC Section 1471, relating to withholding requirements on payments to foreign financial institutions. Generally, stock or security issued by a person other than a U.S. person or any other interest in a foreign entity is a foreign asset if it is held for investment. One important distinction with the investment rules is to determine whether the asset is *held for investment* or *held for use in the conduct of a trade or business of a specified person*. Any assets held for use in the conduct of a trade or business of a specified person will not qualify as a foreign financial asset and, thus, will not subject the specified person to a filing requirement.

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Specified persons must determine their filing requirements based on the threshold amounts described below:

Taxpayer Type	Total Value of Specified Foreign Financial Assets Exceeds
Unmarried taxpayers living in the United States	$50,000 on last day of tax year/$75,000 at any time during tax year
Married taxpayers living in the United States, filing a joint return	$100,000 on last day of tax year/$150,000 at any time during tax year
Married taxpayers living in the United States, filing separate returns	$50,000 on last day of tax year/$75,000 at any time during tax year
Taxpayers living abroad, filing other than a joint return	$200,000 on the last day of the tax year/$300,000 at any time during the tax year
Taxpayers living abroad, filing a joint return	$400,000 on the last day of the tax year/$600,000 at any time during the tax year

All values must be determined and reported in U.S. dollars on Form 8938. For accounts that are reported in foreign currency, the value is converted into U.S. dollars at year-end using the U.S. Treasury Department's Financial Management Service's foreign exchange rate.

Foreign Bank and Financial Accounts Reporting (FBAR)

The Currency and Foreign Transactions Reporting Act of 1970, commonly referred to as the "Bank Secrecy Act," requires U.S. financial institutions to assist U.S. governmental agencies in detecting and preventing money laundering. The regulations that govern the Bank Secrecy Act are issued by the Treasury Department's Financial Crimes Enforcement Network (FinCEN). These regulations require all financial institutions to submit five types of reports to the U.S. Government: (1) Currency Transaction Report, (2) Report of International Transportation of Currency or Monetary Instruments, (3) Suspicious Activity Report, (4) Designation of Exempt Person FinCEN Form 110, and (5) Report of Foreign Bank and Financial Accounts (FBAR).

Of all the reports, the FBAR has probably garnered the most attention over the course of the past couple of filing seasons. Not only do U.S. financial institutions have a requirement to file a FBAR, each U.S. person having a financial interest in, or signature authority over, a bank account, securities or other financial account in a foreign country must report such relationship to the Commissioner of Internal Revenue for each year in which such relationship exists [and the aggregate value of the accounts exceeds $10,000] and must provide such information as shall be specified in a reporting form prescribed under 31 U.S.C. 5314. The current reporting form is known as FinCEN 114 and is due April 15th of the calendar year following the calendar year being reported.

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The following terms and rules related to FBAR qualifications are detailed in [31 CFR §1010.350](https://www.gpo.gov/fdsys/pkg/CFR-2015-title31-vol3/xml/CFR-2015-title31-vol3-sec1010-350.xml).[12]

United States Person

U.S. persons are required to file FinCEN 114, provided they meet the qualifications prescribed above. A ***U.S. person*** is defined by the regulations as: (1) [a] citizen of the United States, (2) [a] resident of the United States, or (3) [an] entity including, but not limited to, a corporation, partnership, trust, or limited liability company created, organized or formed under the laws of the United States, any State, the District of Columbia, the Territories and Insular Possessions of the United States, or Indian Tribes.

Reportable Accounts

The regulations define ***reportable accounts*** as bank accounts, securities accounts and "other" financial accounts. Bank accounts are defined under the regulations as savings deposit, demand deposit, checking or any other account maintained with a person engaged in the business banking. Securities accounts encompass those accounts with a person engaged in the business of buying, selling, holding or trading stock or other securities. Various examples of "other accounts" are listed in the regulations. With respect to whether an account is a reportable account, the reporting requirements do not apply to, among other examples, accounts of international financial institutions of which the U.S. government is a member.

Another issue to consider to determine if a financial account is a reportable account is to analyze its location to determine whether it is located in a foreign country. A ***foreign country*** includes all geographical areas located outside the United States, as defined in the regulations. By way of example, if a U.S. person maintains a foreign financial account with a branch of a U.S. Bank that is physically located outside of the United States, that account is a reportable account. Alternatively, if a U.S. person maintains a foreign financial account with a branch of a foreign bank that is located in the United States, that account is not a reportable account.

Financial Interest In or Signature or Other Authority

One of the most confusing elements of the reporting requirements is for a U.S. person to determine whether he/she has a ***financial interest in or signature authority over*** a foreign financial account. At a minimum, a U.S. person has a financial interest in a foreign financial account if he or she is the owner of record or the holder of legal title. Additionally, a financial interest can be created by way of a person's status as a constructive owner of a foreign financial account Generally, a constructive owner is a person acting on behalf of a U.S. person with respect to the account. A U.S. person can also be a deemed owner of a foreign financial account. The regulations further elaborate on which persons may be a deemed owners of a foreign financial account.

[12] https://www.gpo.gov/fdsys/pkg/CFR-2015-title31-vol3/xml/CFR-2015-title31-vol3-sec1010-350.xml

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A U.S. person has signature or other authority over an account if that person controls the disposition of money, funds or other assets held in a financial account by direct communication to the person with whom the financial account is maintained. There are many exceptions to this requirement, which apply to officers and employees of financial institutions that have federal functional regulators. The regulations include a list of the specific exceptions.

Reporting Threshold

If U.S. persons meet all of the requirements described above, these individuals are required to file FinCEN Form 114 if, at any point during the calendar year, the aggregate value of their accounts exceeds $10,000. When aggregating accounts, the maximum value of each account is added together. If a foreign financial account is reported in a foreign currency, it must be translated into U.S. dollars by using the Treasury's Financial Management Service Rate from the last day of the calendar year.

Concluding Thoughts

Once a taxpayer begins working in or makes an investment in a foreign country, additional compliance procedures could apply. As soon taxpayers start to move money or make investments in certain foreign financial assets, they should assess whether additional international tax compliance forms must be submitted to requisite governmental authorities.

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VIII. Overview of Income Tax Treaties

Every country has developed its own set of rules and regulations that govern the tax implications of earning income within and outside that country's borders. Obviously, the rules are different depending on the affiliation, connection and business dealings with a particular country. As such, income earned by one individual may ultimately be subjected to taxation in more than one jurisdiction. In order to alleviate this issue, the United States and other foreign jurisdictions have entered into income tax treaties.

While avoidance of the double taxation of income is a primary objective of each income tax treaty, the treaties also address other topics, including the sourcing of income, scope of available foreign tax credits, residency rules and exemption from income of certain enumerated income classification categories. All of these items, and more, are negotiated and agreed to by the countries involved in the income tax treaty. Each treaty takes on its own identity as some countries are willing to agree to certain provisions that other countries will not consider.

Two model treaties form the basis and starting point for most income tax treaties. First, the Organization for Economic Co-Operation and Development (OECD) has developed the *Model Tax Convention on Income and on Capital,*[13] which is often used between two developing countries. While the United States is member of the OECD, it uses the *U.S. Model Income Tax Convention,*[14] which was developed from certain principles and components of the OECD model, along with further provisions on items which are particularly important to the United States. This items include, amongst others, special provisions to curtail for tax haven operations.

Embedded inside each U.S. income tax treaty are certain operating rules to assist taxpayers and nations in complying with and enforcing the components. For example, the U.S. model treaty contains an article on "Competent Authorities," which provides procedures to challenge determinations for citizens and residents who are denied treaty benefits. The provision allows citizens and residents to call upon the taxing authority in their own jurisdictions to intervene on their behalf to another country's taxing authority. For a U.S. citizen or resident to utilize this provision, he or she would first need to communicate to the Internal Revenue Service under the procedures as set forth by the Service.

Another provision found in the U.S. model treaty deals with the principle of nondiscrimination. Generally speaking, citizens of each treaty country are afforded the ability to be treated no worse by the other country than they would have otherwise been treated by their own country.

[13] http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-2015-full-version_9789264239081-en

[14] https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf

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Another significant topic in the income tax treaty arena is its relationship to prior, current and future U.S. federal law. At a high level, there is no directive that affords treaties or federal statutes any greater weight than the other. Essentially, they are on equal footing with the "later in time" prevailing. More-recent federal statutes and income tax treaties will supplant previously-enacted and inconsistent federal statutes and income tax treaties.

Residency Determinations

The determination of the appropriate tax classification is extremely important in figuring out which rules apply to each tax-specific situation. Since many countries' rules tend to overlap and could result in one taxpayer achieving residency status in more than one jurisdiction at the same time, provisions are often added to income tax treaties to deal with this scenario. However, before an individual can begin to realize the treaty benefits, he or she first must be a resident of one of the countries participating in the treaty. From the U.S. viewpoint, it is those persons who are exposed to worldwide taxation who are "residents" for purposes of the U.S. model tax treaty. As a reminder, U.S. citizens and resident aliens are subject to worldwide taxation; thus, they are eligible to claim any of the benefits associated with a pertinent income tax treaty.

Whenever an individual becomes a resident of more than one country for the same taxable period, the applicable income tax treaty will almost always break the tie, allowing the taxpayer to achieve residency status in only one jurisdiction. While the rules associated with the analysis are somewhat formulaic, each situation tends to turn on the facts. Most of the U.S. income tax treaties contain clauses that describe the attributes that should be considered in determining the proper residency status. Typically, the nations involved would first make an inquiry as to the "permanent home" of the individual. Second, his or her "center of vital interests" would be analyzed to ascertain where the taxpayer's personal and economic relationships exist. Third, income tax treaties will often look to the "habitual abode" of an individual. Finally, the competent authorities of each nation have the ability to make the final determination.

Savings Clause

Even though the United States is a party to many income tax treaties, the country never relinquishes the ability to tax its citizens and residents. In other words, the United States reserves the right to tax its citizens and residents as if there were no income tax treaty in place. The provision that retains this power is often referred to as the "Savings Clause." However, the U.S. model treaty does afford treaty benefits to its citizens and residents. For example, social security benefits are only taxable to by the jurisdiction paying them out, and child support is never taxable.

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Compensation from Personal Services

In the U.S. model treaty, as well as in many of the actual income tax treaties, compensation from personal services is often broken down into two separate and distinct classifications: (1) independent personal services and (2) dependent personal services. The former refers to those services performed as an independent contractor, and the latter means services performed as an employee or at the direction of another person.

Under the U.S. model treaty, independent personal services are taxable only in the country of residence unless the services are performed in the other treaty country and are attributable to a permanent establishment. However, this exemption only applies to income earned in the country of source for the first 183 days.

Dependent personal services also take on a 183-day rule. Generally speaking, countries retain the right to tax income from services performed within their borders. However, when a resident of one treaty country performs dependent personal services in the other treaty country, those services are not taxable in the country of performance if: (1) the employee is present there for 183 days or fewer during any 12-month period commencing or ending in the taxable year concerned, (2) the compensation is paid by an employer who is not a resident of the country of performance, and (3) the compensation is not borne by a permanent establishment that the employer has in that country.

Oftentimes, income tax treaties will include special provisions for athletes and entertainers. Since these individuals are more transient than your average worker, they would never exceed the 183-day rule and, thus, could bounce from country to country and still avail themselves of the treaty benefits that would not subject their income to tax in the other treaty countries. Many income tax treaties contain threshold clauses to circumvent this rule. If a performer or athlete exceeds the specified dollar figure for monies earned in the other treaty country, he or she cannot claim treaty benefits under the 183-day rule (in that country).

Interest, Dividends, Royalties and Gains

Each income tax treaty is unique in its own respect regarding the particulars of taxing interest, dividends, royalties and gains. While there are certainly some model provisions available in the U.S. model treaty, there are vast intricacies associated with determining the proper sourcing of income and related tax treatment. One area of note is in the rules surrounding withholdings with respect to these forms of payments.

The United States has a set framework in place for the withholding rates on international cross-border payments. However, as mentioned throughout these materials, an income tax treaty allows two treaty countries to agree to terms outside the normal set of rules. For example, a treaty between the United States and another country may remove the need for withholding rates with respect to cross-border interest payments. While each

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U.S. income tax treaty starts from the same base point, the final product typically evolves through negotiations between the interested parties. Each treaty tends to shake out in different ways and with different rates, and should be examined carefully for further explanation and technical examples related to the specific situation.

Concluding Thoughts

Even though it has its own vast set of rules and regulations to assist taxpayers in determining the treatment of various situations, the United States has entered into income tax treaties with many nations around the world. These treaties serve to simplify and streamline the rules between the countries to the treaties. Whenever a practitioner is presented with a cross-border situation, he or she should consult the applicable income tax treaty to assess whether there are different rules that will govern the transaction in question.

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Conclusion and Practical Considerations

One need only attend a brief presentation on international taxes to begin to understand the many difficult provisions of the tax laws, not only in the United States, but also abroad. The level of complexity inherently built into these multinational tax systems makes planning substantially more complicated but, nevertheless, an absolute must. In a world where multinationals, as well as individuals, are constantly engaging in tax avoidance and tax planning strategies to reduce their "worldwide" tax bills, those failing to do so will almost certainly find themselves at a competitive disadvantage in the global marketplace.

The goals and targets of adequate planning in the international tax arena are obvious. Taxpayers, whether corporate or individual, are looking at ways to defer and minimize the payment of taxes. In addition, sizable efforts are expended on looking at strategies designed to maximize the benefits of the foreign tax credit and avoid any double taxation. Such strategies work to reduce government revenues at a time when most countries can scarcely afford such an outcome. On the other hand, and as noted earlier, governments around the world often encourage foreign direct investment through what has become known as "tax competition."

Another important consideration is the need to bring the overall international tax system into alignment with the changes in the global economy. Just one example of a recent improvement is the international crack-down on tax havens. While much discussion and debate has taken place as to how and where multinationals report income and pay taxes, little real progress has been made. To that end, numerous countries are dissatisfied with the current systems and have expressed concern that cross-border tax systems have simply not kept pace with how business is conducted in a global economy.

During the G-20's June 2012 meeting, the focus was on certain multinational businesses found to be paying reduced taxes by shifting income reporting to low-tax jurisdictions from high-tax jurisdictions. Sounds like corporate inversions? The OECD referred to this phenomenon as "base erosion and profit shifting," which gave birth to the acronym, BEPS, a term bantered about regularly in the media.

Though the term is relatively new, the problem is not. In a 1961 message to the U.S. Congress, President Kennedy indicated his concern about growing use by companies of "artificial arrangements between parent and subsidiary" to shift profits in order to lower or eliminate tax liabilities both at home and abroad. This discussion led to the enactment of the U.S. Controlled Foreign Corporation tax regime the following year.

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In 2013, as a follow up to its BEPS project, the OECD set out a plan of 15 actions that they intended to focus on in the future. These 15 actions are grouped into six broad target areas:

1. Address concerns with respect to the digital economy
2. Establish international coherence of corporate income taxation
3. Restore the full effects and benefits of international standards
4. Assure that transfer pricing outcomes are in line with value creation
5. Ensure transparency while promoting increased certainty and predictability
6. Address the need for swift implementation

Given G-20 and OECD support, one might think that progress on these target areas will occur quickly. Unfortunately, such is not the case. While the overall project is labeled BEPS and has a focus on base erosion and profit shifting, the true issue is international tax reform in individual countries. The difficulties in achieving aligned international tax reform on a country-by-country basis can only be imagined.

Transparency and execution, as those terms are addressed in the BEPS plan, stand at the forefront of international tax reform. Elements of these transparency initiatives include establishing methodologies to collect and analyze data, as well as requiring taxpayers to disclose aggressive tax planning arrangements and strategies. Key components of the execution initiatives include the creation of more effective dispute resolution mechanisms and the development of a multilateral instrument for amending bilateral tax treaties. However, as one might expect, progress is slow in moving these initiatives forward.

The only practical solution is for taxpayers, both individual and business, to focus on the tax laws as they currently exist and to avail themselves of the best possible tax position under these rules. Given the nature of the tax system in the United States and abroad, it is clear that tax is an ever-changing environment that requires fluidity in planning and strategy development.

Grossman Yanak & Ford LLP houses a team of individuals who are acutely familiar with the international tax implications of working or conducting business abroad as well as those related to foreign investment in the United States. Included in the services offered by our firm are those related to foreign citizens working in the United States on a permanent or temporary basis.

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Our tax professionals have provided services of the highest quality to businesses and executives, alike. Some of the professional services we provide are listed below (not all inclusive):

- Business tax compliance of foreign investors in the United States, including investors from Great Britain, France, Spain, Austria, Italy, Germany, Canada and others
- Individual tax compliance for resident and nonresident alien taxpayers filing in the United States
- Individual tax compliance for U.S. citizens electing to work abroad
- Merger and acquisition assistance for foreign acquirors
- Merger and acquisition assistance – cross-border targets, for U.S. buyers
- Transfer pricing valuation and strategy development
- Foreign tax credit strategy development and implementation
- Foreign presence planning – both within the United States and abroad

Should you identify a potential international tax issue, one of our tax professionals would be happy to speak with you on a complimentary basis. Please feel free to contact Bob Grossman, Don Johnston or Mike Weber at 412-338-9300.

It has been our pleasure to host this program, and we are exceedingly pleased with the turnout and support we have garnered from our friends and contacts in the legal community. We hope you find that your time spent with us today was worthwhile, and that you are able to return to your practices and businesses better able to understand some of the fundamental aspects of international taxation.

Thank you once more for attending. Have a great day!