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Moore
Outslay

U.S. Tax Aspects of Doing Business Abroad

Fifth Edition

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

U.S. Tax Aspects of Doing Business Abroad

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Michael L. Moore, CPA, Ph.D.
Edmund Outslay, CPA, Ph.D.

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Preface

U.S. Tax Aspects of Doing Business Abroad is designed to provide an introduction to the intricacies of the federal tax laws that apply to U.S. persons doing business or investing outside of the United States and foreign persons doing business or investing inside the United States. The presentation is intended to provide the reader with a general knowledge of these areas as an aid in identifying important variables that can affect compliance and planning.

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As authors, we accept full responsibility for any errors or omissions in the manuscript.

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1

Introduction

Purpose and Scope of the Study

U.S. and non-U.S. persons intending to embark on business and investment ventures abroad will find the foreign setting very different from that in the United States. The foreign landscape differs considerably in tax, economic, political, legal, and cultural conditions. Moreover, the U.S. tax laws applicable to income earned within or without the United States have peculiarities of their own. The purpose of this publication is to provide an introduction and practical guide to the intricacies of the federal income tax laws that apply to U.S. persons investing or doing business outside the United States and to non-U.S. persons investing or doing business within the United States. This study seeks to explain these applicable tax laws, identify problems, and provide tax planning suggestions and caveats.

The scope of the analysis is limited primarily to the federal income tax laws applicable to the taxation of foreign income earned directly and indirectly by U.S. persons (here defined as U.S. corporations, U.S. citizens, U.S. trusts and estates, and resident aliens). This publication also reviews the U.S. tax laws applicable to the taxation of nonresident aliens and foreign corporations.

The wide scope of this publication does not permit in-depth analyses of the areas mentioned above. Rather, the presentation is intended to provide readers with a general working knowledge of the areas so that they can identify important variables, analyze a problem or situation in its proper perspective, and be able to focus and continue research on points not discussed here.

The study is divided into five parts. The first part (chapters 1 through 4) contains an overview of the U.S. taxation of overseas operations. Readers unfamiliar with this subject should read these chapters to gain a better understanding of the technical matters in this area and to put the laws in a proper perspective. Chapter 1 highlights the general policy considerations that influence the formation of host country tax laws, discusses problems created between governments when they tax income outside their own countries, and treats those necessary jurisdictional links used by the United States to tax foreign income associated with U.S. persons, as well as income arising from sources within the United States associated with foreign persons.

Chapter 2 discusses the importance of a careful selection of a taxable or flow-through entity through which to channel foreign-source income, including the timing of income or loss recognition for U.S. tax purposes, as well as the amount to be recognized. In chapter 2, the selection of tax entities available for operating abroad is identified, and the entities are classified according to their tax-saving or tax-deferral potential.

Transacting business in the United States can be quite different from transacting business abroad. Nontax factors such as market, political, and legal structures and the skills and availability of labor forces can vary considerably from country to country. Nontax factors germane to the international environment must be given proper attention in the total decision-making process. In chapter 3, several points regarding the foreign environment are discussed, salient differences between countries are pointed out, and factors to keep in mind when choosing a country or countries in which to base operations are suggested.

Different tax systems in the countries that are major trading partners with the United States are compared in chapter 4. Similarities and differences between foreign tax systems and the U.S. system are examined. Relevant tax statistics of those countries that are members of the Organization for Economic Cooperation and Development (OECD) are shown. In chapter 4, various tax issues in doing business abroad are examined, such as tax accounting issues, dividend repatriations, tax rates, tax

incentives, and taxation of noncitizens. The final section of chapter 4 contains an overview of the value-added tax.

The second part of this book (chapters 5–7) covers source rules for income and deductions, income tax treaties, and the foreign tax credit. Readers should be cognizant of the pervasive effect of these provisions on special entities such as controlled foreign corporations (CFCs) or on U.S. persons working abroad, as well as their effect on the minimization or deferral of U.S. income taxes.

The geographical source of income and deductions can affect the amount a U.S. taxpayer must recognize, as well as the rates of taxation, the timing for recognition, and the amount of the foreign tax credit. The source of income and deductions can also have a significant impact on the U.S. tax liability of foreign persons with U.S. business operations or U.S. investments. Criteria for determining the source of income and deductions vary, depending on the types of income and deductions involved. Chapter 5 provides an analysis of the source rules.

The international tax scene is multidimensional, encompassing the unilateral tax laws of the United States and foreign countries and possibly bilateral tax treaties between the United States and a foreign country that modify various laws. The United States has entered into more than fifty income and estate tax treaties, as well as nontax treaties, such as friendship and commerce, that contain provisions with tax implications. Chapter 6 provides an analysis of provisions contained in most U.S. tax treaties and their effect on (1) the foreign tax liabilities of U.S. taxpayers having economic contacts in the foreign country and (2) the U.S. tax liabilities of foreign persons with economic contacts in the United States.

The foreign tax credit is the principal vehicle in U.S. tax law that ensures that income from foreign sources will not be subject to full multiple taxation by two or more countries. Considered in chapter 7 are such issues as whether to take foreign income taxes as a credit or a deduction, what kinds of taxes qualify for the credit, who can take the credit, how to calculate the credit, when credits can be taken, and limitations to the amount of the credit.

The third part of the study (chapters 8–14) focuses on taxable entities unique to the foreign scene and provides an analysis of tax rules pertaining to these entities, along with suggestions for tax planning. The taxable entities discussed in these chapters are the controlled foreign corporation (CFC) (chapter 8), the foreign sales corporation (FSC) and domestic international sales corporation (DISC) (chapter 12), the for-

eign personal holding company (FPHC) (chapter 9), the passive foreign investment company (PFIC) (chapter 10), and possessions corporations (chapter 14). These chapters contain discussions on qualification requirements, how income is taxed, and other advantages or disadvantages of treatment under these provisions. Because the measurement of earnings and profits of these various entities is extremely important for a determination of ultimate tax liability to U.S. persons owning stock in these entities, this topic is examined in chapter 11. In addition, provisions relating to bribe and boycott activities are discussed in chapter 13.

The fourth part of the study (chapters 15 through 18) deals with additional laws and problems arising in the international tax area. These chapters can be read selectively as they apply to a particular situation. Chapter 15 covers the special rules applicable to formation, liquidation, and reorganizations involving foreign corporations. These rules are somewhat different from those governing these transactions involving solely domestic corporations. The treatment presumes that the reader has knowledge of the laws pertaining to these transactions as they relate to domestic corporations and their U.S. shareholders.

Foreign operations need capable and experienced personnel (especially for strategic positions). Opportunities frequently arise for U.S. citizens or residents to be sent by their employers to work abroad. In addition, there are considerable numbers of expatriate Americans who choose to live and work outside the United States, either in their own business or for a foreign entity. Such citizens and residents are subject to U.S. income tax laws on their worldwide income, but special exclusions and rules exist that affect their U.S. tax liabilities. Chapter 16 considers those special tax provisions applicable to U.S. citizens or residents working abroad.

One area that has received considerable attention in recent years is intercompany transfer pricing. The Internal Revenue Service (IRS) frequently investigates, and makes recommendations for, adjustments of the prices charged in intercompany transactions involving commonly controlled companies, particularly for cross-border transactions. The law related to section 482 of the Internal Revenue Code is analyzed in chapter 17. Section 482 allows the IRS to reallocate income, deductions, and credits among related taxpayers when such allocation is necessary to clearly reflect the income of each taxpayer.

Floating currencies carry both economic and tax consequences to taxpayers who are exposed to these risks. Chapter 18 discusses the tax aspects of currency fluctuations as they affect transactions in foreign cur-

rency, borrowing or lending in foreign currency, hedging exposure to currency fluctuations, maintenance of branch records, translation of dividends from foreign corporations, and related foreign tax issues.

Investments in the United States by nonresident aliens and foreign entities provide an additional dimension to international taxation. In the fifth and last part (chapters 19–21), the tax aspects of both passive investments and operations of active U.S. trades or businesses by foreign interests are discussed. The final chapter (chapter 22), which deals with filing and record keeping requirements, relates to most of the previous chapters in the book.

Tax Bases Applicable to Foreign Income

A tax is generally levied on a person, item, transaction, or event. In international taxation, the jurisdictional authority to levy tax on various entities and events is part of the domestic law of a country. The more common entities or events over which the U.S. government claims jurisdictional authority are presented in table 1.1.

Table 1.1

United States Jurisdictional Authority to Tax Foreign Income

Entity or Event	*Applicable to*	*General Tax Significance*
Citizenship and place of formation	U.S. citizens; domestic corporations; domestic trusts	Federal government taxes on worldwide income
Residence	Resident aliens	Federal government taxes on worldwide income
Source of income	Nonresident aliens; foreign entities	Federal government taxes only on income derived within the United States
Income effectively connected with a U.S. trade or business	Nonresident aliens; foreign entities	Federal government taxes on income derived within the United States and certain income derived outside the United States

The import of table 1.1 for U.S. citizens, domestic corporations, and trusts is that, with minor exceptions, their incomes, regardless of where

earned, will at some point be taxed by the federal government. It should be noted, however, that exceptions affecting the timing, rate, and extent of taxation do exist.

Regarding foreign corporations, there are two points to be noted in table 1.1. First, the worldwide income of foreign corporations can be taxed by the federal government indirectly through U.S. persons who own stock in the foreign corporation, although U.S. persons may defer this tax until dividend distributions are made. Second, a foreign entity operating in the United States is taxed on income derived within the United States and on certain foreign-source effectively connected income (section 864(c)(4)), whereas foreign individuals residing in the United States (that is, resident aliens) are taxed on their worldwide income and otherwise subject to the same rules that apply to U.S. citizens.

Problems Unique to Taxation of Foreign Income

Most of the problems that arise in the taxation of foreign income can be attributed to the fact that the income is subject to taxation in more than one taxing jurisdiction. Unlike domestic business operations, which are generally subject to only one national taxing jurisdiction, a business operating in one or more countries is often subject to the tax laws of each country in which it operates and of the country in which it is organized. Some of the specific problems that overlapping taxation can create are discussed below.

Additional Taxes

Foreign income of U.S. taxpayers and U.S. income of foreign entities may be subject to taxation by both the host country and by the country that exercises primary jurisdiction because of organization, citizenship, or the like. The income may be taxed as it is earned, as it is transferred from one nation to another, or both. Some taxes may be imposed on the same event or entity, creating degrees of double or multiple taxation. Foreign tax credits, allowed to most entities involved in cross-border business or investment activities, are a unilateral policy instituted by many countries to mitigate some problems of multiple taxation. Foreign tax credits are generally allowed to U.S. taxpayers for this reason. (However, see the comments in chapter 7 for specific situations in which the foreign tax credit does not eliminate the multiple-taxation burden.) One problem

with the U.S. foreign tax credit mechanism is that credits are permitted only for payments of foreign income taxes, whereas many foreign governments levy other types of taxes to raise much of their revenues. Although the United States allows deductions for other foreign taxes incurred and not eligible for credit, the deduction usually does not provide the degree of benefit that a credit does.

Allocation of Tax Revenues Between Countries

Whether it is developed or less developed, capital-exporting or capital-importing, relying heavily on exports or on imports, each country or taxing jurisdiction has its particular economic situation and problems with which it must deal. To help solve these individual problems, each country or taxing jurisdiction employs a variety of tax laws and policies to accomplish its social and economic objectives. These variations increase with the number of jurisdictions in which an entity operates.

Whenever economic activities are spread out in such a manner as to involve more than one taxing jurisdiction, the nontrivial problem of how the tax revenues from the transactions are shared among the taxing jurisdictions arises. Figure 1.1 illustrates a typical set of international transactions.

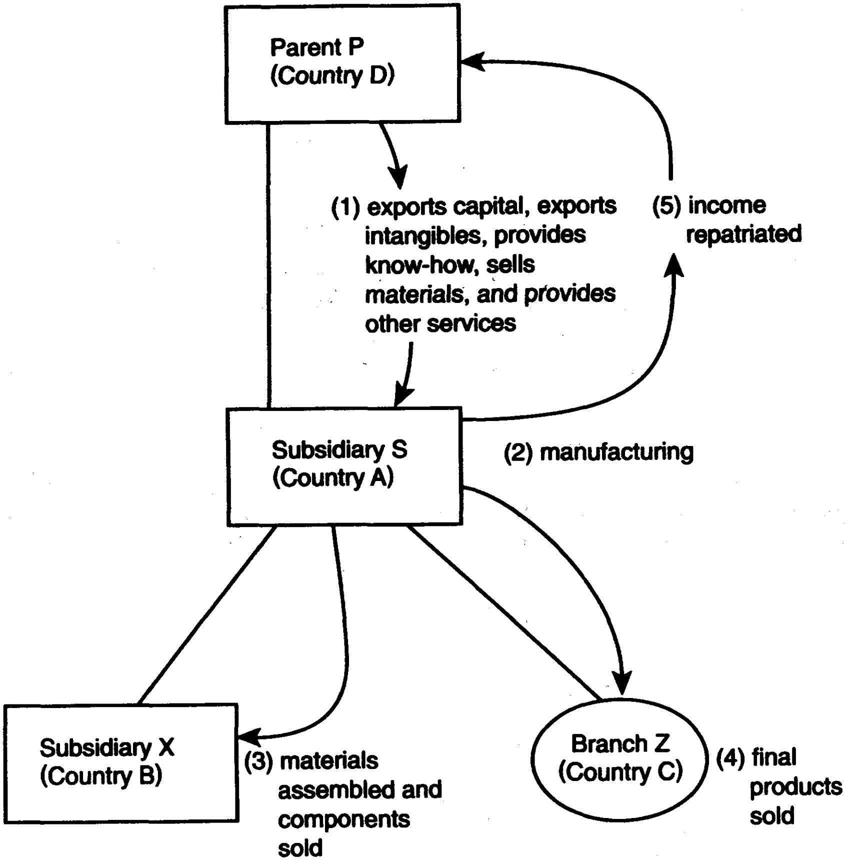
The production of wealth involves four countries. The difficult issue is how income for the various components involved in generating it are measured and how taxes are shared relating to the four countries involved in the production of that income. In other words, how is income measured in country D for the capital and services provided by P to S? How is the income split between the two countries in which the manufacturing and sales activities take place? How should the profit of X be measured? Should the profit be measured by treating X as a contract manufacturer or by some other basis? These are the many difficult issues faced by the practitioner and tax administrator in the international tax area.

Enforcement of Laws and Collection of Revenues

When income is earned or assets are located outside the home country, problems of enforcement of tax laws and collection of taxes occur. The U.S. government attempts to minimize these problems by imposing strict reporting requirements on U.S. persons with foreign income, investment, or dealings with nonresidents for certain transactions that take place in the United States; by imposing withholding taxes on nonresidents with

Figure 1.1

Typical Example of International Transactions



U.S. income; by entering into reciprocal agreements with other countries such as tax treaties or tax disclosure requirements in other agreements; or by a combination of these means.

U.S. Policy Objectives Governing Foreign Taxation

As economic and political conditions change, certain policy objectives influence the laws passed by Congress and changes that are made in the

existing laws. The following are some of the U.S. foreign policy objectives:

1. Provide relief to taxpayers from multiple taxation of the same income.
2. Aid the U.S. trade and balance-of-payments position.
3. Encourage development of U.S. possessions.
4. Accomplish certain foreign policy objectives such as penalizing those with business dealings with countries on which the United States is attempting to impose economic sanctions.
5. Ensure that foreign persons doing business in the United States pay their "fair" share of U.S. taxes.
6. Achieve tax neutrality.

The first five objectives are self-explanatory. The last item, tax neutrality, is a controversial objective although generally recognized to be desirable. In theory, tax neutrality should enhance world welfare by allowing capital to flow to where it can receive the highest return. The problem is how best to achieve tax neutrality in a world composed of multiple autonomous governmental units, each having different needs and political priorities. Unfortunately, there are two different types of tax neutrality, which tend to be mutually exclusive: domestic neutrality and foreign neutrality.

Those who advocate domestic neutrality believe that the federal government should tax foreign income earned by U.S. taxpayers and domestic income similarly. Thus, the tax variable should be a neutral economic factor in a U.S. taxpayer's decision to invest at home or abroad. Opponents of domestic neutrality argue that competition from other countries is constantly increasing. They point out that income tax systems in other countries may provide incentives for foreign investment that are not matched by the United States, which makes U.S. taxpayers less competitive in international business.

Advocates of foreign neutrality argue that foreign markets and foreign business are vital to the economic health of the nation. Therefore, for U.S.-based businesses to remain competitive, the United States should impose no greater tax burdens on U.S. businesses operating abroad than the tax burden imposed on our major international competitors by their countries.

Obviously, these are irreconcilable positions. U.S. tax law has tilted more toward the domestic-neutrality position in recent years, with the

result that more income earned abroad has been taxed to U.S. taxpayers on a current basis.[1]

[1]For a more in-depth discussion of these policy issues, see Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS-6-91), May 30, 1991, and Joint Committee on Taxation, *Description and Analysis of Present-Law Rules Relating to International Taxation* (JCX-40-99), June 28, 1999.

2

Choice of Entity

The federal government taxes U.S. citizens, resident aliens, and domestic corporations on worldwide income. Consequently, such taxpayers can expect at some point in time to be subject to U.S. income taxation on foreign-source income even if tax is not levied at the time the income is earned. When foreign-source income must be reported, it is combined with domestic income, and the applicable federal tax rates are applied to the total amount. Even though the U.S. tax rates applicable to foreign-source income are generally the same as for domestic-source income, there may be advantages to postponing the recognition of such foreign income (tax deferral) if the current foreign tax rate is lower than the U.S. rate. The taxpayer may also plan to use the tax laws in particular jurisdictions or tax treaties to lower the total tax liability (tax savings).

The choice of entity through which to conduct foreign operations significantly affects tax deferral and tax savings on foreign income. This chapter identifies the various types of tax entities and categorizes them to the extent each results in current taxation, tax deferral, or tax savings.

Current Taxation

All income from the following operations and entities is taxed currently by the federal government; that is, it is taxed in the year such income is earned.

Direct Export

A foreign market can be supplied through direct export from an already existing domestic business. Often companies that are new to the foreign scene, or that are in the process of developing a foreign market, service their foreign customers directly from the United States. Sometimes a department or division is set up within a U.S. company to handle the responsibilities of overseas business. Income from direct export operations is taxed by the federal government in the year such income is earned.

A variation of direct export is to use a commission merchant (commissionaire) in countries in which goods are sold but not manufactured. The commissionaires, which could be sales branches or subsidiaries, execute sales contracts in their own names on behalf of the manufacturer. Title does not pass to the commissionaire, nor does the commissionaire assume risk of loss or credit risk. The commissionaire does not generally provide any aftersales service and is paid a commission based on a percentage of the sales price.

License Arrangements

Technology can be transferred directly into profits by taxpayers who use it themselves to make and sell products or to provide technical services and consulting. One party can also profit from the ownership of technology indirectly by licensing another party the right to use the technology in exchange for royalties.

The owners of technology may prefer to license it into foreign markets for a variety of reasons. They may not have adequate capital, knowledge of foreign markets, or capable management personnel for overseas employment to exploit the technology abroad. Alternatively, a company may be extremely sophisticated in dealing with foreign markets and may wish to fully exploit its technology in a foreign subsidiary it controls. In this case, the licensee would be the foreign subsidiary. Transfers of developed intangibles to a foreign subsidiary are subject to deemed royalty payment rules under section 367(d)(2), which is discussed in chapter 15.

Branch of a Domestic Entity

A *branch* is an office, division, or other extension of a domestic entity that is established in a foreign country. The branch is a convenient form for conducting foreign operations such as gaining a foothold in a new market. Often a branch can be established in a foreign country at minimal cost and inconvenience, because a separate legal entity is not required.

A major tax advantage of branch operations is that losses from a foreign branch can offset other income of the enterprise to reduce its current U.S. tax liability. Such losses may be recaptured as U.S.-source income in the computation of the foreign tax credit limitation when the taxpayer earns foreign-source income (section 904(f)) or as additional foreign-source income if the branch assets are transferred or the taxpayer incorporates the foreign branch (section 904(f)(3) and section 367(a)(3)). Although a branch offers the potential current benefit for branch losses, no tax deferral on branch profits is achieved.

A second major advantage is that if the operations abroad involve natural resources, the tax laws regarding depletion deductions, exploration and development expenses, and intangible drilling and development expenses may apply. When these operations are conducted through a branch rather than through a foreign subsidiary, the character of the income and expenses is preserved when applying U.S. tax law.

A third major advantage of branch operations is that most foreign countries levy withholding taxes on dividends paid by a local company to a foreign shareholder, which is often in addition to corporate income taxes levied on the company's earnings. In most countries, income repatriated from a branch is not subject to withholding tax. However, to achieve parity, certain countries (such as the United States, Canada, and Belgium) impose a second tax on branch profits in lieu of withholding on dividends applicable to local subsidiaries. The imposition of a branch tax usually removes the withholding tax savings by operating as a branch rather than a local subsidiary. Under some treaties, such as the United States-Belgium tax treaty, U.S. corporations are exempt from the branch tax.[1]

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[1]See Treas. Reg. Sec. 1.884-1(g)(3) for a list of treaties that prohibit a branch tax. An updated list is provided in chapter 21, Branch Profits Tax.

A fourth major advantage of branch operations is that property can be transferred by the U.S. taxpayer to a branch without tax on the appreciation in value under section 367.

The major tax disadvantage of branch operations is that there is no U.S. tax deferral on earnings. Income of the branch is taxed by the United States as earned because the branch is not a separate entity. In addition, as pointed out above, some foreign countries have branch taxes that may increase or accelerate the effect of the tax in lieu of the withholding on dividends. Some jurisdictions may also require financial or other disclosure to the taxing authorities of the total operations, including those in the United States. In addition, the legal liability of branch operations is not limited to the assets physically located in that foreign country.

Before a determination can be made about the advantages or disadvantages of operating as a branch, several tax factors must be considered. The first factor is that most foreign countries tax branches and corporations differently. The overall tax rates may vary, depending on the particular country and on whether that country has a tax treaty with the United States. The effective rate of tax on an entity's profits may also vary depending on whether a corporation repatriates all, some, or none of its profits to its U.S. parent in the form of dividends.

A second factor to consider is that the availability of loss carryforwards between a branch and a subsidiary may differ in a foreign country. A subsidiary incorporated in a foreign jurisdiction will typically receive a carryforward for net operating losses. Therefore, although a loss incurred by a foreign subsidiary will not result in any U.S. tax benefit in the year it is incurred, the loss will serve to offset profits in that foreign country (if any) in future years, thereby ultimately decreasing foreign taxes paid on those profits. Net operating loss carryovers are not available in all countries. Some countries allow a one-year carryforward, some a combination of carrybacks and carryforwards, and some an indefinite carryforward of start-up losses. It is therefore essential to determine the availability of carryovers if losses are expected.

A third factor to consider (although not as common for branches as for subsidiaries) is that some foreign countries allow losses to be carried forward in a branch doing business in that country. For example, in Austria a branch is not allowed any carryforward of net operating losses. Other countries, such as Belgium, allow a branch to carry forward its losses only while the branch retains its original form. An incorporation of

a branch with unexpired net operating loss carryforwards will cause forfeiture of those carryforwards.

The deductibility of management fees and other expenses paid to the home office is another important consideration. Some countries (for example, Switzerland) may allow a subsidiary to deduct management fees paid, but they do not grant this deduction to a branch. However, management fees or other expenses may be deductible by the foreign branch if paid to a separate company (such as a sister company) rather than the head office. Deductibility of management fees by a branch must be determined on a country-by-country basis.

Partnership

For partners who are U.S. citizens, corporations, or resident aliens, the U.S. tax laws do not generally distinguish between partnerships formed and operating in the United States and those formed and operating in foreign countries. U.S. tax law does not treat partnerships as separate taxable entities. The partnership is a conduit through which partnership income is passed to the partners. The income and expenses of the partnership retain the same character and source in the hands of the partners. The income is subject to current taxation whether or not distributed. From a foreign perspective, the tax advantages and disadvantages of operating in a foreign country through a partnership are similar to those of a foreign branch.

Domestic Subsidiary

Another alternative for developing foreign markets is to create a separate domestic (U.S.) corporation to handle international business. An important nontax advantage of channeling operations through a separate domestic subsidiary is that legal liability on the foreign operations is limited.

The domestic subsidiary is taxed currently on its income earned abroad. It can generally be included in a consolidated tax return with its parent corporation (section 1501). Consolidations can be especially advantageous in situations in which a subsidiary has incurred a loss or has excess foreign tax credits (Treas. Reg. Sec. 1.1502-4) or when profits are to be repatriated on a regular basis. The parent corporation will incur no additional U.S. taxes when profits are remitted up the U.S. chain because of the elimination of dividend income on the consolidated return.

A domestic (U.S.) corporation is especially useful when operations are conducted in a U.S. possession. The United States provides special tax concessions (possessions tax credit) for income earned from operations in a possession by an electing domestic corporation. Separate domestic subsidiaries are usually formed for these operations in the possession because of the strict percentage requirement that must be met to qualify for the possessions tax credit.

A domestic international sales corporation (DISC) is also a U.S. corporation. This is discussed in the section Domestic International Sales Corporation, below.

Potential Exclusion or Deferral of Taxation

Tax planning undertaken to achieve an exclusion or deferral from current U.S. taxation on foreign-source income can be a worthwhile objective because of the time value of money and its effect on a public corporation's accounting effective tax rate. Postponing tax payments may be tantamount to obtaining an interest-free loan that can be invested in projects that result in rates of return greater than the return on an investment made with after-tax amounts. In some situations, deferral may not be tantamount to obtaining an interest-free loan if the United States imposes an interest charge on the deferred tax, as in the case of taxes imposed on the income of a passive foreign investment company and an accumulation distribution from a foreign trust.

Another possible benefit from deferring recognition of foreign income is that the taxpayer usually elects when deferral is ended by controlling the timing of the repatriation. This may provide tax savings because income may be repatriated in a year in which U.S. tax rates are lower than in the year in which the income was earned, or such timing will maximize foreign tax credit use.

Deferral will accomplish little when effective foreign income tax rates on the foreign income equal or exceed those of the United States, either because of differences in statutory rates or differences in the measurement of the tax base. *Effective tax rate* as used here means the amount of foreign income taxes paid (including the present value of withholding taxes on the amounts ultimately repatriated) expressed as a percentage of earnings and profits computed according to U.S. tax laws. In the situation in which foreign effective tax rates equal or exceed the U.S. effective rates, nothing may be gained by postponing the repatriation of the for-

eign income because the foreign tax credit for the foreign income taxes associated with this foreign income may reduce U.S. income tax on this income to zero. However, even if the foreign earnings have an effective foreign tax rate equal to or greater than the U.S. tax, extenuating circumstances, such as a U.S. net operating loss or imposition of the foreign tax credit limitation, may influence the timing of the repatriation of foreign profits. For example, deferring repatriation of high-taxed foreign income can forestall the tolling of the foreign tax credit carryover period.

Domestic International Sales Corporation (DISC)

A *domestic international sales corporation* (DISC) (called an interest charge DISC or IC-DISC) is a domestic corporation whose activities are substantially derived from the sale of U.S. manufactured goods to foreign users, from the lease or rental of export property, or from the performance of technical services. An IC-DISC is designed as an export incentive. The principal tax features of an IC-DISC are that the IC-DISC is not taxed and shareholders of the IC-DISC are permitted a deferral from tax on most or all of the qualifying receipts until the income is distributed. The economic cost of the tax deferral on these profits is an interest charge (calculated on a base period Treasury bill rate) on the deferred taxes. To the extent that the income can be invested to achieve a return higher than the interest charge, the IC-DISC can provide a positive net economic benefit from the tax deferral.

Foreign Corporation

A *foreign corporation* is any corporation that is not "domestic" (section 7701(a)5)). A *"domestic" corporation* means a corporation created or organized in the United States or under the law of the United States or of any state (section 7701(a)(4)).

The principal tax advantage of a foreign corporation is that, in general, foreign-source income is not taxed currently by the federal government until the income is repatriated to U.S. shareholders owning the stock. Upon distribution, the dividends are included in the income of the U.S. shareholders. Foreign taxes paid on the income giving rise to the dividend may be taken as a deemed-paid foreign tax credit by qualifying corporate shareholders (section 902).

U.S. corporate shareholders usually do not receive a dividends-received deduction under section 243 (see section 245(a) for exceptions)

on dividends received from a foreign corporation. This disadvantage is not as significant as it might appear in that the foreign corporation paying the dividend has probably not paid any U.S. tax on the income.

A foreign corporation cannot be included in the consolidated return of its U.S. parent corporation unless it is a Mexican or Canadian corporation and is maintained solely for the purpose of complying with the laws of these countries regarding title and operation of property (section 1504(d)).

Certain hybrid entities, such as limited liability companies (LLC) or joint ventures (JV), can be treated by the United States as either a corporation or a flow-through entity (that is, a "disregarded entity" or partnership) under "check-the-box" regulations issued by the Treasury (Treas. Reg. Sec. 301.7701-3). Such a foreign entity enjoys the nontax benefits of limited liability protection, while also enjoying U.S. tax benefits, including the ability to use foreign entity losses currently. A more in-depth discussion of these regulations is provided in chapter 8.

Exceptions to Deferred Taxation

Controlled Foreign Corporation. When U.S. shareholders[2] own (directly, indirectly, or constructively) more than 50 percent of the combined voting power or value of a foreign corporation, the foreign corporation will be classified as a *controlled foreign corporation* (CFC). CFC classification causes several exceptions to tax deferral on the foreign earnings, which may have potentially disadvantageous consequences to the U.S. shareholders.

- Loss of tax deferral on certain types of "tainted" foreign income earned, called subpart F income.
- Loss of tax deferral on the CFC's earnings and profits regardless of how earned because of investments in nonqualifying U.S. property.
- Gain on the sale or redemption of stock or gain on liquidation is reported as ordinary income to the extent of prescribed earnings and profits rather than capital gains. This rule is usually advantageous for a corporation because of the availability of deemed-paid foreign tax credits related to the gain recharacterized as a dividend.

[2]For this purpose, *U.S. shareholder* is a term defined to mean only U.S. persons possessing stock constituting 10 percent or more of the corporation's voting power.

Foreign Personal Holding Companies. When a foreign corporation is more than 50-percent owned (directly, indirectly, or constructively) by five or fewer U.S. individuals and at least 50 percent (60 percent for the first year only) of its gross income is foreign personal holding company (FPHC) income, U.S. shareholders are currently taxed on the foreign corporation's current-year undistributed income. FPHC income is generally income received from portfolio investments, including gains on sales of stock or securities. FPHC status can be avoided by failing the 50-percent income test or the closely held ownership test. Avoiding FPHC status may not produce deferral because of the passive foreign investment company (PFIC) provisions discussed below in the Section "Passive Foreign Investment Company."

Current Taxation or Deferral Only With an Interest Charge

Passive Foreign Investment Company

A *passive foreign investment company* (PFIC) is defined as any foreign corporation with 75 percent or more of its gross income being passive income, or any foreign corporation 50 percent or more of whose assets produce or are held for the production of passive income. Unlike CFC or FPHC rules, the PFIC rules apply regardless of the level of U.S. ownership. If a foreign corporation is a PFIC, its shareholders may elect to treat the PFIC as a *qualified electing fund.* Every electing U.S. shareholder of a qualified electing fund will include in current income a pro rata share of the ordinary income and capital gains of the PFIC. Therefore, there is no deferral from U.S. tax for the U.S. shareholders of a qualified electing fund. If the shareholder of a PFIC does not elect qualified electing fund status, tax and interest on the tax will be levied if that shareholder receives an excess distribution (that is, more than 125 percent of the average amount received during the three preceding years). The interest charge on the deferral of tax on the profits reduces or eliminates the time value of the money benefit for the profits deferred.

Potential Tax Savings

Tax savings is used here to mean a direct reduction in tax liability rather than a deferral of taxes. Tax savings can be realized in the foreign busi-

ness area in such ways as qualification for certain exclusions of income from taxation, extra deductions, conversion of potential ordinary income into capital gain income when there is a rate differential between them, and tax treaty benefits.

Foreign Sales Corporation

A *foreign sales corporation* (FSC) is a foreign corporation that generates foreign trade income. *Foreign trade income* is income from sales of U.S.-manufactured property, leasing, and rendering technical and managerial services. Like the IC-DISC, a FSC is intended to provide an export incentive. A FSC is usually a subsidiary of a U.S. corporation. A percentage (depending on the intercompany pricing method used) of the FSC income is exempt from U.S. tax. The remaining income is either currently taxable or deferred depending again on the intercompany pricing method used. Through the use of a FSC, U.S. exporters may exempt from U.S. taxation up to 15 percent of the profit from the export sale. This permanent U.S. tax savings reduces the tax and accounting effective tax rates on export sale profits.

U.S. Possessions Income

An individual who is a bona fide resident of a specified U.S. possession during the entire taxable year may exclude income from sources within a U.S. possession and income effectively connected with the conduct of a trade or business within a possession. Section 931 contains the provisions relating to income from sources within Guam, American Samoa, or the Northern Mariana Islands. Section 933 deals with income from sources within Puerto Rico. A domestic corporation with (1) 80 percent of its gross income from sources within a U.S. possession and (2) at least 75 percent of its gross income from the active conduct of a trade or business within a U.S. possession may elect to receive a special tax credit under section 936, tantamount to an exclusion, which is related to the income from a business within a U.S. possession. In addition, a corporate shareholder of an electing possessions corporation is entitled to the usual dividends-received deduction on dividends paid to it from the U.S. possessions corporation. Because special lower tax rates are available in certain U.S. possessions to reduce the tax imposed by the U.S. possession, the use of the U.S. possessions tax credit results in an effective tax exemption on much of the income earned within the U.S. possession by

the electing possessions corporation. The Revenue Reconciliation Act of 1993 significantly reduced the amount of the U.S. possessions tax credit beginning in 1994.

U.S. Citizens and Residents Employed Abroad

A U.S. citizen who receives compensation for services performed in a foreign country can elect to exclude from gross income, for U.S. tax purposes, a specified amount of foreign-earned income ($76,000 in the year 2000) and foreign-earned income related to housing costs, provided he or she is a bona fide resident of the foreign country or countries for an uninterrupted period that includes an entire taxable year. In the case of a citizen or resident, a physical presence in a foreign country or countries for 330 full days during any twelve consecutive months may also qualify the individual for the foreign-earned income exclusion and the housing cost exclusion.

Conversion of Ordinary Income Into Capital Gain

Prior to the enactment of sections 1246 and 1248 in the Revenue Act of 1962, foreign income accumulated in a foreign corporation could easily be converted into capital gains by the liquidation of the foreign corporation or by the sale or redemption of its stock. This was so even though the foreign corporation's income was never subject to U.S. tax. Section 1246 provides that if stock of a foreign investment company that does not elect under section 1247 to distribute income currently is disposed of, any gain shall be treated as ordinary income to the extent of the taxpayer's share of earnings and profits accumulated after December 31, 1962. Section 1248 provides that gains from dispositions of stock in a controlled foreign corporation (CFC) by a 10-percent-or-more shareholder will be treated as ordinary income (a deemed dividend) to the extent of earnings and profits accumulated after December 31, 1962 and during the period the foreign corporation was a CFC. The following taxpayers are not subject to dividend treatment and may recognize capital gains from the disposition of stock of a foreign corporation.

Noncontrolled Foreign Corporations. A taxpayer who holds stock in a foreign corporation owned 50 percent or less by U.S. persons (a *noncontrolled foreign corporation*) at all times is not subject to the provisions of section 1246 or section 1248.

Shareholders Owning Less Than 10 Percent of Voting Power. Under section 1248(a)(2), any U.S. person that has at all times possessed less than 10 percent of the voting power of a CFC is not subject to the provisions of section 1248.

Domestic Corporations With Operations Abroad. Section 1248 usually applies to dispositions of stock of controlled foreign corporations; however, dispositions of stock of a domestic corporation formed or availed of principally for the holding of stock of a foreign corporation are also treated as section 1248 dispositions. Disposition of stock of a domestic corporation that conducts operations abroad (such as a possessions corporation) is not subject to section 1248.

Tax Treaties

Tax treaties are generally bilateral agreements between governments of different countries that secure certain reliefs for those persons and entities described in the treaty (treaty-country residents). A principal purpose of most tax treaties is to mitigate double taxation or to provide for a reduced tax rate on income earned by a resident of one contracting country in the other contracting country. For example, normal withholding taxes imposed on dividends or royalties paid to non-residents are often greatly reduced in a treaty (for example, from 30 percent to 0, 5, or 10 percent). The United States has entered into income tax and estate and gift tax treaties with more than fifty foreign countries and exchange-of-information agreements with many others. Many of the provisions of the individual treaties are similar; yet differences do exist depending on the specific country. Each U.S. taxpayer with economic contact in a foreign country should determine whether a treaty is in force and, if so, which specific treaty provisions might apply and what are the opportunities for tax savings.

Tax-Related Criteria for Selection of an Entity

Although operations abroad vary considerably, some of the common tax-related criteria a U.S. person should consider when selecting the form through which to conduct foreign activities are presented below.

Projection of Operating Results

If a taxpayer anticipates initial losses from foreign operations, a form of entity that will allow the current offset of foreign losses against domestic

income should be considered. A branch, partnership, or direct exporting and servicing operation will accomplish this, as would a domestic subsidiary (or contiguous-country corporation in either Canada or Mexico) that is part of a consolidated group. Such losses may be recaptured when the taxpayer earns foreign-source income, transfers assets outside the United States, or incorporates a foreign branch, but a timing benefit has been obtained. If profits are anticipated, a taxpayer should consider a foreign corporation that allows exemption, exclusion, or deferral of U.S. tax, such as a FSC or foreign subsidiary.

Use to Be Made of the Income

If the taxpayer expects to repatriate a sizable portion of the income from foreign operations within a short period of time after it is earned, from a tax perspective, little beyond the ability to control the exact timing of such repatriation can be gained by choosing an entity form that could otherwise provide tax deferral, because the income is taxed by the United States when it is repatriated.

If the taxpayer expects to reinvest its foreign income in foreign operations and does not intend to repatriate it, benefits may be derived from an entity that provides tax deferral as long as the foreign effective tax rate is lower than the domestic tax rate and the aftertax rate of return on the invested income is greater than it would have been had it been repatriated and invested by the U.S. owner of the foreign entity. Deferred income of a CFC cannot be invested in U.S. operations (for example, through a loan to the U.S. parent), because this will be treated as constructive repatriation and subject to U.S. tax (section 956).

Type of Income

Income From Natural Resources. If foreign income is derived from natural resources, it may be advisable to preserve the character of the income and related expenses to take advantage of (1) the percentage depletion deduction, if eligible to be taken on the taxpayer's U.S. tax return; (2) exploration deductions; and (3) deductions for intangible drilling costs. The character of the income and deductions can be preserved for U.S. tax purposes by using a flow-through entity and not realizing them in a foreign corporation.

Passive Income. No tax deferral will be achieved on the income of a foreign corporation that is classified as a foreign personal holding company (FPHC). Therefore, shareholders of a closely held foreign corporation

that realizes 50 percent or more of its income from passive sources (60 percent for the first year only) will be taxed on such income on a current basis.

Too much passive income or assets that produce passive income will also be disadvantageous if the foreign corporation is classified as a passive foreign investment company (PFIC). Electing shareholders of a PFIC are taxed on the income of the PFIC on a current basis. Nonelecting shareholders of a PFIC must pay interest on the deferred tax when excess distributions (that is, distributions of deferred income) are remitted to them.

Passive income can also affect the special tax advantages provided to U.S. possessions corporations. The provisions related to U.S. possessions corporations provide that no more than 25 percent of the gross income can be from passive sources.

Base Company Income. Companies that do business in several countries may choose to establish a base company in a foreign country. The *base company* directs the business activities in other countries. A base company may act solely as a holding company. The country chosen for the base is often one that has an attractive tax climate (such as zero tax, tax on income only from sources inside it, tax concessions for holding companies, tax concessions on certain activities, tax rates lower than competing jurisdictions, or a favorable tax treaty network with corresponding jurisdictions).

Consideration must be given to the effect of subpart F and FPHC provisions on base company operations because it is possible to lose the U.S. tax deferral on such income. Possible increased withholding taxes on dividend flows must also be considered when choosing to use a holding company. The extent to which these provisions apply depends on the type of income involved. However, by careful selection of entities through which various types of income are derived or by careful control of the types of income derived, the effect of these provisions can be minimized.

The subpart F and FPHC provisions contain de minimis rules relating to the amounts of income that will be considered tainted: The lesser of 5 percent of gross income or $1 million for subpart F income and 50 percent (60 percent for the first year only) for FPHC income. Consideration must also be given to the PFIC provisions for foreign corporations that are not CFCs. U.S. shareholders of a PFIC will lose the deferral on income earned if 75 percent or more of the foreign corporation's gross income is from passive sources or if 50 percent or more of the

foreign corporation's assets produce passive income or are held for the production of passive income. U.S. shareholders of a PFIC must either report the income currently or pay interest on tax, as well as tax on excess distributions from the PFIC. Exercising control over character of income or sufficient dilution of designated types of income to meet these de minimis rules can yield substantial benefits.

Foreign Tax Credit Considerations

Each country specifically legislates which economic events are subject to taxation and the rate of tax on each tax base. A country may rely on indirect taxes (such as property taxes), transactions taxes (such as value-added taxes), as well as taxes on income. Income taxes (or taxes in lieu of income taxes) are the only foreign taxes that are creditable in calculating U.S. tax liability. Other types of taxes are only deductible.

3

Choice of Country

U.S. taxpayers generally extend business activities because of some comparative advantages (technological, managerial, operational, and financial) from which they hope to benefit in foreign markets. However, different problems and risks may exist in the international environment that can materially affect the efficiency and effectiveness of operations, the risks to capital, the amount of income earned, and the total tax liability.

One of the most important decisions to be made in the international environment is the selection of the country or countries in which to extend business activities or make investments. Conditions (economic, political, legal, cultural, and tax) can vary considerably from country to country. The purpose of this chapter is to list, with brief comments, some of these salient factors, to alert readers to some of the opportunities and pitfalls (tax and nontax) that exist in the international environment, and to put tax considerations in perspective as one important variable among several.[1] The choice of a country in which to extend business

[1]For a more in-depth discussion of this topic see G. Peter Wilson, The Role of Taxes in Location and Sourcing Decisions, in *Studies in International Taxation*, edited by A. Giovannini, R. G. Hubbard, and J. B. Slemrod (Chicago, IL: University of Chicago Press, 1993): 195–231.

activities should be the culminating decision by a U.S. taxpayer after he or she has carefully studied business and other conditions in the country in question.

Political and Legal Climate

Among other concerns, governments are interested in economic well-being and initiate policies so that foreign business investments and operations will be consistent with this goal. The structures, priorities, and controls established by governments within their own countries can have significant influence on business conditions.

Political structures can range from totalitarian to democratic. A vast middle ground, which can be called democratic socialism, exists between the two. At one extreme, resources are generally allocated by central government fiat. At the other extreme, most resources are allocated based on market forces. In the middle ground, various policies exist that allow some market forces to guide economic activities but impose operating or ownership controls, or both types of controls, on private capital investments.

Political forces tend to vary, depending on whether the country is a developed or developing nation. Developing countries characteristically tend to rely more heavily on strong centralization and control and experience significant changes with each change of political leadership. Developed countries generally have less volatile political climates.

It is clear that some governments take more active roles than others in imposing controls to accomplish their goals. Controls can be placed on the movement of persons, goods, currency, capital, and profits. They can take the form of customs, licenses, quotas, embargoes, passports, visas, and currency controls. A particular country's political structure can indicate the control that can be expected, as well as the degree of ownership of certain industries that will be allowed. Sometimes the controls can be so unfavorable that they obviate serious consideration of investing in that country. Some other related factors to consider regarding political climate are—

- Risk of expropriation
- Risk of devaluation of currency
- Exchange controls
- Import restrictions and quotas

- Regulatory agencies
- Political relationships with other countries
- Restriction of participation in certain activities or restriction of property ownership by foreigners
- Required local participation in equity
- Restrictions on the future sale, joint venture, or transfer of the now-established business entity

Extension of business activities to foreign countries brings U.S. taxpayers into contact with several bodies of law: laws of the United States, laws of each host country, and international law. International law deals with the rights of nations in their relations with each other. It encompasses treaties (for example, those regulating tax, navigation, commerce, and defense), treaty-based agencies (such as the United Nations, the World Bank, and the International Monetary Fund), general agreements [for example, the General Agreement on Tariffs and Trade (GATT) and the North American Free Trade Agreement (NAFTA)], and the rights of foreign nationals in relation to a given country. In some cases, international law may supersede domestic laws. Investors must contend with overlapping or conflicting laws. Operating a successful business may well depend in good part on adequately assessing and coping with the distinctive legal environment in the country in question.

Some important laws of foreign countries to be cognizant of are—

- Laws concerning the rights of foreigners to own land and to participate in ownership or management of local enterprises
- Laws regarding monopolies, price-fixing, boycotting, or other forms of restraint of trade
- Laws governing labor legislation and the restrictions placed on alien personnel
- Laws regarding trade secrets, holding of property, and contractual obligations
- Laws restricting the rights of foreign majority shareholders in protection of local interests

The effectiveness of legal systems varies among countries. In some countries legal systems can be effective in protecting property rights and other personal rights. In others, there may be a lack of independent judiciary or clearly established precedents, or there may be ill-defined regulations or laws may be inadequately enforced.

Cultural and Economic Climate

Foreign business operations and investments involve dealings and transactions with foreign persons. Good human relations are important to business success. Such relations often depend on understanding and adapting to the special characteristics of people, which vary by country. Attitudes, customs, religion, institutions, interests, and values can be so important that unawareness of them can block or retard success in a foreign country.

The economic climate of a country also affects business operations. Economic factors that might influence investment include the following:

- Transportation and distribution systems (including airport capacity)
- Communications
- The development of the banking, legal, and accounting professions
- Level of education; skill and costs of labor in the workforce
- Government attitudes toward the environment

The economic climates tend to differ according to their stages of economic development. Some countries are basically agrarian and may not have adequate transportation, communications, public services, levels of skill in the workforce, and other elements in the economic infrastructure that may be necessary for an investment. Countries more advanced in development tend to have more efficient markets, keener competition, better public services, better sources of supply, and greater labor productivity and availability of financial capital.

Tax Climate

No international laws limit the prerogative of a country to tax its nationals, residents, income from sources within the country, or property located within the country. Limitations on taxation exist only by virtue of voluntary actions taken by a country to accomplish economic, social, or political goals. The varying objectives among countries have resulted in a diversity of tax structures. Because tax payments may be one of the largest expenses of operations or investments, investors usually review the tax structures of each country carefully prior to investment. The following sections contain a general discussion of how foreign tax structures vary.

Tax Entities or Events

In assessing taxes, each country must select the entities or events on which to impose taxes. Some common tax bases are wages, income and profits, consumption, property, excise, and gift and death transfers. Tax revenues are distributed across different tax bases in different countries, and in the majority of countries tax burdens are generally heavier than in the United States.

For U.S. taxpayers, how a country distributes taxes across different tax bases may be important. The United States allows a foreign tax credit only on foreign income taxes paid or accrued and for taxes paid or accrued in lieu of income taxes. The only treatment allowed for the payment or accrual of taxes that are not directly levied on income is a deduction in computing taxable income and earnings and profits. Because a tax credit is generally more beneficial than a deduction (that is, the value of a deduction depends on the taxpayer's marginal tax rate), taxes levied on income are more beneficial than equal amounts of tax levied on bases other than income.

Chapter 4 contains statistics for the countries that belong to the Organization for Economic Cooperation and Development (OECD). The composition of tax revenues differs significantly between these countries (see chapter 4, table 4.1). The United States relies more heavily on income and profits taxes than do most of the other OECD countries.

OECD countries rely more heavily on consumption taxes than does the United States. The consumption tax revenue in Europe is derived primarily from value-added taxes and gasoline taxes. Consumption-type taxes imposed in the United States are primarily in the form of general sales taxes and are levied by state and local governments rather than the federal government.

Social security taxes also comprise a significant percentage of tax revenues raised in the United States and most European OECD countries. Tax revenues collected through Social Security taxes in the United States during 1998 amounted to approximately 32 percent, which is about the average for European OECD members and Japan.

The United States tends to rely more on property taxes, including estate and gift taxes, than do other OECD members. The United States collected a higher percentage of tax revenues through property taxes in 1998 than any other OECD member.

Tax Havens

The location of offshore operations is important from a tax perspective. Many factors determine where an investment is to be made, including legal requirements (such as types of entities available, the level of foreign ownership permitted in these entities, currency exchange rates and controls, import and export controls, and the legal and administrative system), business climate (such as laws controlling pollution, laws controlling noise, and the existence of tax treaties), and the economic and political infrastructure (such as economic stability; political stability; access to qualified accountants, lawyers, bankers, and administrative staff; communications and transportation; labor supply; and language).

Categorizing countries as tax havens is difficult because the term tax haven can be used to describe a country that levies virtually no taxes, exempts certain activities from tax, or exempts income sourced outside that country. The term is also used to describe a country that levies significant taxes but at rates lower than those in jurisdictions competing for the same investment.

Many nontax factors can influence the location of investments in tax havens. Surveys of international companies indicate that there are more than thirty factors that influence the selection of a tax haven for investment activities (usually in the form of a holding company). Among these factors are guarantees against expropriation or nationalization of assets, fair treatment, low taxes, bank secrecy, avoidance of currency restrictions, free remittance of profits and capital, double-taxation treaties, political and economic stability, and minimum government controls. For example, if bank secrecy or secrecy of ownership of a holding company is an important factor, then a trade-off of this factor against higher taxes may be necessary.

Some business activities and tax-haven countries applicable to each are: investments (Bahamas, Cayman Islands, Netherlands Antilles), shipping (Liberia, Panama), holding companies (Liechtenstein, Luxembourg, Netherlands, Netherlands Antilles, Switzerland, United Kingdom), trading companies (Hong Kong, Cayman Islands), manufacturing (Ireland, Puerto Rico, Mexico, Singapore), artists and athletes (Monaco, Ireland), offshore treasury centers (Netherlands, Switzerland, Belgium, Ireland, Singapore), and management companies (Switzerland, Luxembourg, Belgium).

Foreign Investment Into the United States Using Tax Treaties

From a U.S. tax perspective, a foreign investor eligible for treaty benefits under a U.S. income tax treaty may fare better than an investor without such benefits. For example, under the United States-Swiss Income Tax Treaty, dividends from U.S. corporations in general are taxed at a rate of 15 percent, whereas dividends from a U.S. corporation to a Swiss company owning 10 percent or more of the U.S. corporation are taxed at a rate of 5 percent. There is no provision for exemption from tax on capital gains. The United States-Netherlands Income Tax Treaty and the United States-United Kingdom Income Tax Treaty also provide a 5-percent tax rate on dividends paid to 10-percent-or-more corporate shareholders and a 15-percent tax rate on all other dividends. Capital gains on non-real-estate property have a zero tax rate under the United States-Netherlands Income Tax Treaty and a tax rate of up to 30 percent under the United States-United Kingdom Income Tax Treaty.

The tax levied by the United States on remittances of income is only one of the foreign investor's considerations. Where an entity making an investment is formed or operates is another important consideration. There are many choices of jurisdictions — from the classic tax haven jurisdictions such as the Bahamas, the Channel Islands, and the Isle of Man to countries such as the Netherlands, the United Kingdom, or Switzerland that provide favorable tax treatment to holding companies and have extensive treaty networks.

Offshore Holding Companies

For a U.S. investor the use of a foreign holding company as a vehicle for offshore investment has limited usefulness because such income is likely to be tainted under subpart F, in which case it must be included in the income of a U.S. shareholder on a current basis. This results if the foreign company meets the definition of a controlled foreign corporations or foreign personal holding companies. It is often beneficial for a foreign investor to use an offshore holding company in an international business structure.

A holding company can be in a treaty or nontreaty country. It could be located in a country such as the Netherlands, the United Kingdom, or

Switzerland, which grant special tax privileges to holding companies and have extensive treaty networks, or in a tax haven jurisdiction without treaty benefits. One important point to make here is that a more complex organizational structure will be required for an offshore holding company. In addition to the tax relief a tax haven offers or the tax reduction a treaty offers, there are accompanying tax risks.

There are three levels of holding company taxes. The first is the tax on dividends remitted to the holding company from the operating subsidiaries; the second is the tax on such dividend income in the jurisdiction of the holding company; and the third is the withholding taxes imposed by the holding country jurisdiction when dividends are remitted from the holding company to the shareholders of the company.

Locating an offshore holding company in a treaty country usually provides the advantage of a reduction of taxes at all three levels, but some risks are involved. Some of the advantages are (1) reduced withholding taxes on dividends in the country where the subsidiary is located, (2) tax privileges afforded holding companies on dividends received from subsidiaries or on capital gains from selling a foreign subsidiary, and (3) exchange control freedom.

These potential benefits may be counteracted by antiavoidance rules in certain circumstances. The country in which the foreign subsidiary is located may have entered into tax treaties containing certain "treaty shopping" provisions that deny the reduced rate of withholding tax on dividends and other items of income. The United States generally insists that an anti-treaty-shopping provision be included in each new tax treaty. As an example, Article 26 of the 1992 U.S.-Netherlands tax treaty denies reduced withholding rates on dividends, interest, royalties, and branch profits remitted to non-Dutch residents. Regulations under the branch profits tax rules also contain anti-treaty-shopping provisions.

U.S. tax authorities are concerned with holding companies that are formed by nonresidents not eligible for treaty relief in treaty countries solely to gain a treaty advantage on income flowing from the United States. The tests that the United States applies in anti-treaty-shopping provisions state that the treaty benefits of reduced withholding on dividends, interest, or royalties will not be available unless certain conditions are satisfied. In general, these conditions are as follows: (1) more than a certain percentage of a corporation is owned by residents of the treaty country, (2) the income of such corporation is not used to meet liabilities for interest or royalties of persons who are nonresidents of that country or

the United States, or (3) the dividends derived are from an active business (not portfolio investments) in the United States. Under Article 26 of the U.S.-Netherlands treaty, treaty benefits are available only to Dutch corporations that are (1) publicly traded, (2) 50-percent Dutch-owned and have 50 percent of their gross income taxed in the Netherlands, (3) meet certain European Community (EC) criteria (for example, 70-percent EC-owned and 70 percent of their income is subject to EC taxation), (4) headquarters of internationally operating companies, or (5) corporations operating a substantial business in the Netherlands.

Older income tax treaties may not have anti-treaty-shopping provision. Nevertheless, the tax exposure in the treaty-shopping area in future years for nonresidents using holding companies in treaty countries must be considered.

A holding company in a jurisdiction with a limited treaty network may also be advantageous if the holding company is located in a tax haven such as the Bahamas, Bermuda, the Channel Islands, or the Isle of Man. These are among a number of tax havens that levy minimal taxes on interest or dividends that are paid from holding companies. Of course, dividends and other types of passive income paid by a U.S. person or entity to a nontreaty holding company will be subject to a 30-percent withholding tax by the United States.

Whether a holding company should be located in a tax haven jurisdiction or a jurisdiction with some treaty relief depends on the ultimate amount of tax that is paid on the profits that are repatriated to the ultimate owner of the enterprise. For example, dividends repatriated from a U.S. subsidiary to a Netherlands holding company are subject to a 5-percent withholding tax under the United States-Netherlands Income Tax Treaty. Such dividends will not be taxed by the Netherlands when they are repatriated to the holding company (the participation exemption). The Dutch do levy a withholding tax of 25 percent on dividends repatriated to nontreaty shareholders of the holding company. Therefore, comparing treaty and nontreaty treatment yields roughly the following: A 5-percent withholding tax is levied on the first remittance (no tax in the Netherlands if the holding company qualifies for tax relief), and a 25-percent tax is levied on remittances from the Netherlands holding company, compared with a total tax equal to the 30 percent on the first remittance to a tax haven holding company in a nontreaty situation. Of course, if the funds can be reinvested by the holding company, there is a time value to the money factor because of the deferral of the second tax.

There are other structures available, since to date few Dutch treaties include antitreaty shopping provisions. For example, a Netherlands Antilles holding company can hold the stock of the Dutch holding company to significantly reduce overall taxes. The Netherlands imposes a 5-percent or 7.5-percent withholding tax on dividends paid to Netherlands Antilles companies. The Netherlands Antilles imposes minimal taxes on such income and may not impose any tax on remittances to the owner of the Netherlands Antilles company. A plan that uses treaty networks can be successful in reducing overall taxes. Again, whether the expense of setting up and maintaining such a structure is beneficial will depend on the level of investment and income of the enterprise. The total costs involved may actually be less with a structure that does not involve holding companies in treaty countries.

The tax residence of a company may not be determined by its place of incorporation. A company incorporated in the Netherlands or Luxembourg could, by holding its board meetings in London, have its "management and control" in the United Kingdom and accordingly be fully liable for a corporation tax on its income and capital gains. In the United Kingdom, among other countries, a company is treated as resident if it is "managed and controlled" there. In the ordinary case, this means that the members of the board hold their meetings in the United Kingdom. If by this test a company is resident in the United Kingdom, it is liable for tax on its worldwide income; if it is not resident, its liability to tax is limited to income that has its source in the United Kingdom. As a nonresident, such company is usually exempt from U.K. capital gains tax.

Holding Companies in Countries With Treaty Networks

Of the countries suitable for holding companies, Luxembourg, the Netherlands, the United Kingdom, and Switzerland are perhaps the best known. For example, a holding company in Luxembourg is permitted certain limited activities. It may acquire, hold, and sell or otherwise exploit certain investments such as stocks, currency, and bullion. It may administer and control its investments from Luxembourg. It may not, if it is to keep its tax-exempt status, run a commercial business open to the public.

It may not own property or real estate, except to provide itself with offices. It may not act as a broker or commission agent. Holding companies in Luxembourg are subject to minimal taxes. Luxembourg holding companies are not entitled to the benefit of tax treaties to which Luxembourg is a party, but dividends paid from holding companies are not subject to withholding in Luxembourg. Therefore, passive income earned on U.S. portfolio investments does not receive treaty relief.

Perhaps the most common use of the Netherlands in international transactions is as a location for a holding company. The fundamental concept here is what the Dutch call a qualifying participation. A *qualifying participation*, in general terms, is a holding in a company that is subject to tax in some country, so that the holding involves some active participation in the affairs of the company and is not a mere passive investment. The requisite holding is, in law, a mere 5 percent, but it is understood in practice that the Dutch tax authorities may be unwilling to treat a holding of less than 50 percent as involving active participation. No Dutch tax is charged on dividends or capital gains arising from qualifying participation. Conversely, no tax benefit is derived from capital loss transactions. Therefore, the Dutch holding company is beneficial for some types of holding (that is, qualifying participation) but not as beneficial in the situations of investments in mere passive investments or where significant losses on disposition are anticipated. In situations in which the qualifying participation criteria are not satisfied, the taxable income of the Dutch company will be subject to tax at the regular tax rate on income.

Switzerland offers an exemption at the federal level for holding companies. This exemption applies to a Swiss company that holds a participation in other Swiss or foreign companies of not less than 20 percent of their capital. When this exemption applies, if all of the company's income is derived from qualifying participations, no federal tax on net profits is payable. Cantonal and communal taxes are levied, however, and basic rates and concessions vary significantly between each of the twenty-five separate cantonal taxing authorities. Switzerland has an extensive network of tax treaties. A Swiss holding company is therefore beneficial for some types of holdings (that is, a minimum of 20-percent ownership in operating companies) but not for investments in passive investments. But note that Swiss treaty-shopping domestic law requires a certain payout of treaty-benefited income of the Swiss holding company.

Holding Companies in Countries With Limited Treaty Networks

In jurisdictions with limited treaty networks (such as the Bahamas, the Channel Islands, and the Isle of Man), there are minimal taxes on holding company activities. In addition, there is no withholding tax on dividends and term payments arising from assets held in these countries. The Bahamas and Bermuda have not concluded any double-taxation agreements with any other countries, while the Isle of Man, Jersey, and Guernsey have limited tax agreements with the United Kingdom. To receive the tax-haven benefits in a Channel Islands company or Isle of Man company, the company must be a nonresident company; that is, management and control cannot be in the Channel Islands or Isle of Man.

The United States will levy a 30-percent withholding tax on dividends and certain other passive income paid to holding companies in nontreaty countries. There are many investments in portfolio assets that are not taxed, such as capital gains on non-real estate assets and certain portfolio interest.

4

Comparative Tax Systems

Taxes are the primary means through which most of the more than 200 countries in the world raise revenues. These taxes may be imposed on income, wages, property, or goods and services. An individual or entity investing or taking up residence abroad should consider the tax aspects of such a decision from both the U.S. perspective and the host country perspective. In particular, the interaction between the U.S. and host country tax systems should be investigated. This would include any treaty provisions and the elimination of double taxation through a tax credit or exemption.

The objective of this chapter is to present a broad overview of the tax systems of selected foreign countries. The countries discussed are Brazil, Canada, France, Germany, Italy, Japan, Mexico, the Netherlands, and the United Kingdom. These countries are those that have attracted the majority of U.S. investment abroad.[1] A detailed analysis of each country's

[1]Sarah E. Nutter, "Statistics of Income Studies of International Income and Taxes," *Statistics of Income Bulletin Winter 1998-1999* (Washington, DC: Internal Revenue Service): 151–174.

tax system is beyond the scope of this study.[2] Due to the dynamic nature of tax systems, the information presented with respect to each country's tax structure may have changed since this study's publication date.

Overview of Foreign Tax Systems

The great majority of developed countries raise revenues through a combination of tax regimes. Almost every country imposes a tax on income earned by individuals and corporations. Differences between countries arise with respect to (1) the rates applied to such income, (2) the types of income exempt from tax, (3) the deductions allowed to reduce gross income subject to tax, (4) the tax credits allowed to reduce the gross tax liability, (5) the treatment of the family for filing and reporting purposes, and (6) the extent to which corporate income is subject to an individual-level tax when earned or distributed. Income taxes are the primary source of tax revenues for most developed countries.

In addition to income taxes, governments collect revenues through the imposition of social security taxes, property taxes (including a tax on the transfer of property through bequest or gift), payroll taxes, and taxes on goods and services (primarily excise taxes and value-added taxes). Value-added taxes raise a significant portion of federal revenues in many countries, most notably in Europe, Canada, and Japan. The United States does not currently have a value-added tax, although it continues to be discussed as an alternative source of revenue along with other consumption taxes.[3]

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[2]For more detailed analyses, see Ernst & Young LLP, *Personal Taxation: A Worldwide Guide*, rev. ed. (Ernst & Young LLP, 1999); Ernst & Young LLP, *Corporate Taxation: A Worldwide Guide*, rev. ed. (Ernst & Young LLP, 1999); PricewaterhouseCoopers, *Corporate Taxes 1999: Worldwide Summaries* (New York: John Wiley & Sons, 1999); PricewaterhouseCoopers, *Individual Taxes 1999: Worldwide Summaries* (New York: John Wiley & Sons, 1999).

[3]American Institute of Certified Public Accountants, *Flat Taxes and Consumption Taxes: A Guide to the Debate* (New York: AICPA, 1995); U.S. Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth, Vol. 3, Value-Added Tax* (Washington, DC: U.S. Government Printing Office, 1984); Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS-6-91), May 30, 1991, 269–341; Tax Executives Institute, *Value-Added Taxes: A Comparative Analysis* (Washington, DC: Tax Executives Institute, 1992).

The relative tax revenues raised through the imposition of the various taxes for countries belonging to the Organization for Economic Cooperation and Development (OECD) are presented in table 4.1.

Table 4.1

Distribution of Tax Revenues as a Percentage of Total Tax Revenues Select Countries, 1996

Country	*Individual Income*	*Corporate Income*	*Social Security*	*Payroll*	*Property**	*Goods and Services*†	*Other*
Australia	41.2	15.0	—	6.7	9.0	28.0	—
Austria	23.1	4.7	34.8	6.3	1.4	28.6	1.1
Belgium	31.3	6.8	32.3	—	2.6	27.0	—
Canada	38.4	8.9	16.3	—	10.4	24.9	1.2
Denmark	55.6	4.6	3.1	0.4	3.3	32.7	0.2
Finland	35.0	6.7	25.8	—	2.2	30.1	0.2
France	14.2	3.8	43.1	2.3	5.1	27.3	4.3
Germany	24.6	3.8	40.6	—	3.0	27.9	0.0
Greece	16.1	6.3	30.6	0.8	3.4	42.8	0.0
Ireland	31.3	9.6	13.5	1.1	4.8	39.7	—
Italy	25.2	9.2	34.2	0.2	5.4	25.9	—
Japan	20.2	16.4	36.5	—	11.3	15.4	0.2
Luxembourg	22.1	16.0	26.6	—	7.6	27.7	—
Mexico	25.1	—	15.6	—	—	57.4	1.9
Netherlands	17.5	9.5	39.6	—	4.4	28.6	0.4
New Zealand	49.1	9.8	—	1.0	5.7	34.5	0.0
Norway	26.0	10.5	23.3	—	2.1	38.1	0.0
Portugal	19.0	9.5	25.7	—	2.5	42.6	0.7
Spain	23.1	5.9	35.9	—	5.5	29.2	0.4
Sweden	35.4	5.6	29.8	2.5	3.8	22.8	0.1
Switzerland	32.0	5.6	37.4	—	7.0	17.9	—
Turkey	20.5	5.7	15.8	—	1.8	38.3	18.0
United Kingdom	26.3	10.5	17.3	—	10.6	35.2	0.1
United States	37.6	9.6	24.7	—	11.0	17.2	—

*Includes estate and gift taxes.

†Includes excise taxes and value-added taxes.

Source: *Revenue Statistics 1965–1997* (Organisation for Economic Co-operation and Development, 1998).

Income Tax Systems

Residence

U.S. persons (individuals and corporations) investing or taking up residence abroad will, in almost every case, be subject to tax by the foreign country on income earned in the foreign country and income earned while the person is a resident of the foreign country. The extent to which income is taxed depends on the foreign country's system of taxation (worldwide or territorial), the source and type of the income, and the U.S. person's tax status (resident or nonresident) with respect to the foreign country.

Under a worldwide system of taxation, residents are subject to taxation on their income from all sources. The United States uses a worldwide system of taxation, as do most developed countries. Under a territorial system, a tax is imposed only on income sourced in (earned within) the country. Nonresidents are generally only taxed on income sourced in the country.

The definition of a resident differs from country to country. For U.S. tax purposes, a resident includes an alien individual who is lawfully admitted for permanent residence (green card test) or who is present in the United States for a prescribed number of days over a three-year period (*substantial presence test*) (section 7701(b)).[4] In the case of a corporation, the United States looks to the country of incorporation to determine its tax status.

Brazil. Brazil taxes its residents on their worldwide income. Nonresidents are taxable only on their Brazilian-source income. Individuals are deemed to be residents if they meet any of the following criteria: (1) they are Brazilian citizens living in the country; (2) they are foreign individuals who entered the country under a permanent work visa; (3) they are temporary resident visa holders and are authorized to work in Brazil; (4) they are temporary visa holders without authorization to work in Brazil and have been in the country for a total of 183 days during any 12-month period; or (5) they are former resident taxpayers who have left the country permanently without obtaining their tax clearance certificate prior to leaving (such persons are considered residents for the 12-month period following their departure). A corporation is considered a resident if it is

[4] See chapter 19 for details.

incorporated in Brazil and has its head office (principal seat of administration) located there.

Canada. Canada taxes its residents on their worldwide income. Provincial taxes may also be imposed on income earned in a province or earned by a resident of such province. Nonresidents are subject to tax only on income derived from Canada. *Residence* is not defined in the Canadian Income Tax Act, but it is generally based on common law principles. Individuals who regularly, normally, or customarily live in Canada are treated as residents for tax purposes. Individuals present in Canada for 183 days or more in a calendar year are treated as residents for the entire year and subject to tax on their worldwide income for that year. A corporation formed in Canada is considered a resident. Corporations formed outside Canada may be treated as residents if their central management and control are exercised in Canada. Non-resident entities are subject to Canadian income tax on income earned from "carrying on a business" in Canada, which includes certain activities, use of agents, and dispositions of specific types of property.

France. France taxes resident individuals on their worldwide income. Nonresidents, individuals and corporations, are taxed only on income sourced within France. Resident corporations are taxed on net profits earned in France or its territories (for example, Corsica). Nonresident corporations are taxed on business income from a permanent establishment in France, rental income from French real estate, and capital gains on property located in France. Individuals are considered residents if their habitual residence or domicile is in France. Individuals are treated as having their domicile in France if they have one of the following in France: (1) family home, (2) principal place of abode; (3) principal business or professional activity, or (4) center of economic interests. This definition applies to individuals regardless of citizenship. A corporation is considered a resident if it has its registered address (legal seat) or center of management there.

Germany. Germany taxes its residents on their worldwide income. Nonresidents are taxed only on their German-source income. Individuals are residents if they have their domicile or customary place of abode in Germany or are physically present in Germany for an uninterrupted period of six months over two calendar years. Nonresident individuals can elect to be treated as residents for tax purposes if all of their income

is subject to German taxation or a de minimis amount is not subject to German taxation. A corporation is considered resident in Germany if it has its legal seat (registered address) in Germany or if its central management is located there.

Italy. Italy taxes its residents on their worldwide income. Nonresidents are taxed only on their Italian-source income. Individuals are considered residents if they are registered with the General Registry Office of the resident population (*Anagrafe*), have a habitual abode within Italy for the greater part of the taxable year, or establish their domicile (seat of affairs and interest) in Italy. A corporation is resident in Italy if it is incorporated in Italy, has its legal or administrative headquarters in Italy, or conducts its principal business activity in Italy.

Japan. Japanese residents are subject to a national income tax on their worldwide income and an inhabitant's tax. Nonresidents are taxed only on their Japanese-source compensation at a flat rate of 20 percent. Individuals are considered permanent residents if they have been present in Japan for at least 5 years or intend to reside in Japan permanently. Permanent residents are taxed on their worldwide income. Nonpermanent residents are individuals who have not been present in Japan for at least 5 years and do not intend to become permanent residents. Nonpermanent residents are taxed on income earned in Japan and non-Japanese source income paid in or remitted into Japan. Nonresidents are individuals who do not meet the requirements to be a resident. A corporation is a resident of Japan only if it is incorporated in Japan. Resident corporations are subject to tax on their worldwide income; nonresident corporations with a fixed place of business (for example, a branch) are taxed on their Japanese-source income.

Mexico. Mexico employs a worldwide system of taxation for its residents. Nonresidents are taxed only on Mexican-source income. Individuals are considered residents if they establish a tax home in Mexico and live there for 183 days or more during the year. A corporation is considered a resident of Mexico if it is incorporated under Mexican law or if its principal seat of management is in Mexico.

Netherlands. The Netherlands employs a worldwide system of taxation in principle. Resident individuals are taxed on their worldwide income. Nonresident individuals are taxed on Dutch-sourced wages, business and real estate profits, interest, dividends, and social insurance payments.

Residence is a facts and circumstances determination. The courts have looked to physical presence, family residence, the location of the individual's permanent home, the individual's relationship to the Netherlands, the residence of the individual's family, registration in the population registry, where the individual's economic interests are, and the individual's intentions to work or reside in the Netherlands. Certain expatriate individuals temporarily employed in the Netherlands may qualify for a "35 percent ruling" that entitles them to be taxed as nonresidents.

Resident corporations are subject to tax on their worldwide income. Residency is a facts and circumstances determination (for example, center of management), although companies established under Dutch law are generally treated as residents. All Dutch corporations except "qualified investment companies" (including a holding company) are exempt from taxation on dividends and capital gains derived from a participation in the share capital of another company. To be eligible for this *participation exemption*, the shareholder must hold 5 percent or more of the par value of the stock for each day of the corporation's book year. With respect to a foreign subsidiary, the exemption only applies if the company is subject to a profits tax levied by a government in the country in which the subsidiary is located and the shares must not be held as a portfolio investment and the foreign corporation must be subject to a profits tax in its country of residence. This exemption results in a de facto territorial system with respect to corporations. Nonresident corporations are taxed only on certain income (business and real estate profits) sourced within the Netherlands.

United Kingdom. The United Kingdom taxes its residents and those individuals who are "ordinarily resident" or domiciled in the United Kingdom on their worldwide income. Nonresidents and U.K. citizens not domiciled in the United Kingdom are taxed only on their U.K.-sourced income. Individuals can be treated as residents under several physical presence tests: (1) they expect to live in the United Kingdom for a period exceeding 2 years; (2) they expect to be in the United Kingdom for less than 2 years but spend 183 days or more in the United Kingdom during the year; or (3) their visits to the United Kingdom over 4 consecutive years average 91 days or more a year. In the latter case, the individual is treated as a resident from the beginning of the fifth year unless their visits were intended from the outset. Employees intending to live in the United Kingdom for at least three years are considered "ordinarily resi-

dent" from the outset. A corporation is a U.K. resident if it is incorporated in the United Kingdom or its central management and control (usually determined by where it holds its directors' meetings) is located in the United Kingdom.

Dividends and Interest

Under the U.S. system of taxation, corporate income is subject to a two-tier tax. Income is taxed when it is earned by the corporation, and any net profits distributed as a *dividend* to the shareholders are taxed as income at the shareholder level. When the shareholder is another corporation, this system of double taxation is mitigated by allowing the shareholder corporation a *dividends-received deduction*. The United States is one of the few developed countries that uses a two-tier tax system with respect to corporate income. The two-tier system has been subject to criticism, most notably because it favors debt financing over equity financing and it encourages the retention of corporate earnings.[5]

Most developed countries use an *imputation system*, under which shareholders are provided a credit for all or a part of the corporate-level tax paid on distributed earnings. Under this shareholder-credit system, the shareholder grosses up the actual dividend received by the amount of the credit and includes the grossed-up amount in income. Alternatives to the shareholder-credit system would be to exempt dividend income from shareholder-level taxation or to allow the distributing corporation a deduction for dividends paid.

U.S.-source dividends and interest paid to nonresidents are subject to withholding tax. The withholding rates currently in effect are listed in table 4.2.

Brazil. Interest paid to resident and nonresident individuals is subject to a 15 percent withholding tax, subject to treaty provisions. The withholding tax represents the total tax liability on the income. Dividends paid to residents and nonresidents are not subject to tax.

Canada. Dividends paid by a Canadian corporation to another Canadian corporation are tax exempt. Dividends paid to nonresidents are subject to a 25-percent withholding tax, subject to treaty modification. Individuals

[5]Joint Committee on Taxation, *Tax Reform Proposals: Corporate Taxation* (JCS-40-85) (Washington, DC: U.S. Government Printing Office, 1985), 6-32; U.S. Treasury Department, *Integration of the Individual and Corporate Tax Systems* (Washington, DC: U.S. Government Printing Office, 1991).

Table 4.2

Withholding Tax Rate on U.S.-Source Dividends and Interest Paid by U.S. Persons to Nonresident Persons

Country	*Dividends (%)*	*Interest (%)*
Brazil	30	30
Canada	5/10/15*	0/10
France	5/15*	0/15
Germany	5/15*	0
Italy	5/10/15*	0/15
Japan	10/15*	10
Mexico	5/10*	4.9/10/15
Netherlands	5/15*	0
United Kingdom	5/15*	0

*The lower rates are for dividends paid to a corporate shareholder meeting minimum stock ownership requirements (usually 5, 10, or 25 percent).

include dividends from a Canadian corporation in gross income in an amount equal to 125 percent of the amount actually received. The individual then receives a federal tax credit of 13.33 percent of the total amount included in income (16.67 percent of the actual dividends received). The provincial taxes are generally computed in a similar manner and provincial tax credits are also provided (for example, Quebec provides a tax credit of 8.87 percent of total dividend income). Interest income is reported using the accrual method, and dividends are generally reported using the cash method.

France. Cash dividends from resident companies received by resident individual shareholders and certain nonresident shareholders are eligible for a 50-percent tax credit (*avoir fiscal*), computed as follows:

Taxable income of distributing corporation	$100.00
Corporate income tax (at 37.8 percent)	37.80
Dividend paid to shareholder	$ 62.20
Gross-up for 50 percent of corporate-level tax (*avoir fiscal*)	31.10
Dividend included in income	$ 93.30
Personal income tax (assumes a 40-percent rate)	37.32
Less: tax credit	31.10
Net personal income tax due	$ 6.22

An excess of tax credit over individual income tax payable is refunded.

If the income distributed does not bear a tax in France (for example, foreign-source income, capital gains, or dividends received from a 10-percent owned subsidiary) or is paid out of profits earned more than five years before the distribution, an equalization tax (*précompte mobilier*) of 50 percent of the dividend paid is imposed on the distributing corporation. This equalization tax is eligible for the shareholder credit (*avoir fiscal*). Generally French holding companies are exempt from the *précompte mobilier* but do not qualify for the *avoir fiscal*.

French parent corporations (corporations incorporated in France that own at least 10 percent of the issued share capital of the distributing corporation or own shares with a minimum value of FF 150 million) are exempt from tax on dividends received from a French or foreign subsidiary if such corporations commit to holding the stock for at least 2 years. Dividends paid to nonresidents are subject to a 25 percent withholding tax, subject to treaty provisions. Dividends paid to parent companies located in other European Community countries are exempt from withholding tax if the parent company commits to holding at least 25 percent of the distributing company for an uninterrupted period of at least 2 years.

Germany. Germany imposes a 25-percent withholding tax on dividends. In addition, dividend recipients pay a 5.5 percent solidarity surcharge on the withholding tax. These taxes are fully refundable to resident shareholders. Resident corporate and individual shareholders also receive a shareholder credit equal to 3/7 of the dividend received before withholding taxes, computed as follows:

Taxable income of distributing corporation	$100.00
Less corporate income tax (at 30 percent)	30.00
Less solidarity surcharge (at 5.5 percent)	1.65
Dividend paid to shareholder	$ 68.35
Less withholding tax at 25 percent	17.09
Dividend distributed	$ 68.35
Gross-up for 3/7 of the net dividend distributed	29.29
Dividend included in income	$ 97.64
Personal income tax (assume a 53-percent rate)	51.75
Less corporate income tax credit	29.29
Less solidarity surcharge	1.65
Net personal income tax due	$ 20.81

A corporate rate of 40 percent is applied to undistributed profits beginning in 1999. Dividends paid to parent companies located in other

European Community countries are exempt from withholding tax if the parent company commits to holding at least 25 percent of the distributing company for an uninterrupted period of at least 2 years.

Italy. Resident corporate and individual shareholders receive a shareholder credit for corporate taxes paid on distributed profits. For IRPEG (*imposta sul reddito delle persone giuridiche*) purposes, the imputed tax credit equals 58/73 percent of the dividend. The tax credit is included in taxable income. Dividends paid to resident individuals with small ownership percentages are subject to a 12.5 percent withholding tax. Nonresidents are subject to a final 27 percent withholding tax, subject to treaty modification. If an Italian company holds at least 25 percent of the stock of a European Union subsidiary for at least one year, 95 percent of any dividend received from the subsidiary is exempt from taxation. The remaining 5 percent is subject only to the IRPEG. In cases where a resident company owns at least 20 percent (10 percent in the case of a listed company) of a nonresident company not in the European Union, only 40 percent of the dividend is included in income. Residents and nonresidents are generally subject to a final 12.5 percent withholding tax on interest received, although interest from bank accounts is subject to a final 27 percent withholding tax.

Japan. One hundred percent of dividends received by a resident corporate shareholder, net of any related interest expense to acquire the shares, are deducted from income if the recipient corporation owns 25 percent or more of the distributing Japanese corporation. The deduction is limited to 80 percent of dividends received from less than 25-percent-owned Japanese corporations. Dividends distributed by a resident corporation are subject to a 20-percent withholding tax, subject to treaty modification. Resident individual shareholders may apply the withholding tax along with a partial shareholder credit (10 percent of the dividend received) against tax due on the dividend received. Resident individuals and nonresidents with a permanent establishment in Japan can elect to pay tax on dividends from a Japanese company at a fixed rate of 35 percent rather than including the dividend in taxable income and having it taxed at the graduated rates. This election applies if the shareholder owns less than 5 percent of the distributing corporation or the amount of dividends received from the company for the year is ¥500,000 or more. Interest that is Japanese-sourced received by residents is taxed at a 20 percent withholding tax rate (15 percent national and 5 percent local inhabitant's tax) and is not included in taxable income.

Mexico. Resident corporations are subject to a tax rate of 35 percent on distributed current earnings but are permitted to defer a portion of the tax on reinvested earnings. A reinvested earnings account (CUFIN) must be maintained for undistributed earnings. When such earnings are distributed, the distributing corporation must pay the deferred portion of the tax, computed as 5 percent (3 percent in 1999) times the declared dividend times a factor of 1.5385. A withholding tax is applied to dividends paid to nonresident and Mexican resident individuals. The withholding tax is 5 percent times the dividend grossed-up by 1.5385. The effective withholding tax rate is 7.7 percent, which may be limited to 5 percent or eliminated by treaty.

Netherlands. Resident individual shareholders include dividends in their taxable income. Dividends received from Netherlands companies are exempt up to a specified amount (Dfl 1,000 per year, or Dfl 2,000 if only one of the spouses is subject to tax on the dividend income). Resident corporations that qualify for a participation exemption with respect to a corporate shareholding (this requires a 5-percent-or-more ownership in a corporation's paid-up capital) are exempt from taxation on dividends received from such qualifying shareholdings. Dividends paid to parent companies (10 percent ownership if in Germany, Greece, and the United Kingdom; 25 percent ownership for other companies) located in other European Community countries are exempt from withholding tax if the parent company commits to holding at least 10 or 25 percent of the distributing company for an uninterrupted period of at least 1 year. Interest income in excess of interest expense is exempt up to Dfl 1,000 per year, or Dfl 2,000 if only one of the spouses is subject to tax on the interest income. This exemption reduces the dividend exemption allowed.

United Kingdom. Distributions from a resident U.K. corporation received by a resident corporate shareholder (referred to as *franked investment income*) are excluded from corporate taxable income. For distributions to resident individual shareholders after April 5, 1999, a tax credit of 10/90 of the net dividend is allowed. For distributions prior to April 6, 1999, the distributing corporation was required to pay an advance corporate tax (ACT) of 25 percent of the distribution. The ACT offset the corporate tax liability for the period in which the distribution was made. The individual shareholder added the ACT back to the dividend received and received a shareholder credit for the ACT amount. The treaty between the United States and the United Kingdom provides a full ACT refund

to U.S. shareholders of a U.K. corporation who are individuals and less-than-10-percent corporate shareholders. Corporate shareholders that owned 10 percent or more of the U.K. corporation received an ACT refund of one-half of the ACT amount. Companies with surplus ACT as of April 6, 1999 can carry the ACT forward and offset it against profits, limited by a "shadow ACT" system.

Capital Gains and Losses

Most developed countries provide some type of preferential tax treatment on capital gains. This treatment may take the form of reduced tax rates, an exemption from income, or indexation of the basis of the asset sold. The definition of a capital asset differs between countries, as do the required holding periods. A summary of the tax treatment provided capital gains by the selected countries follows.

Brazil. Capital gains are included in gross income and taxed at the regular income tax rates. Residents and nonresidents are subject to a 15 percent withholding tax on most capital gains, which may be offset against the normal tax liability. A 10 percent withholding tax is applied to gains from sales of stock on the stock exchange. Gain on sales of a personal residence is exempt from tax. Losses must be segregated into a *nonoperational loss* "basket" and can be offset against operational and nonoperational gains. Excess losses can be carried forward to offset nonoperational gains.

Canada. Three-fourths of capital gains are included in taxable income and taxed at the normal rates. Three-fourths of the excess of capital losses over capital gains can be carried back three years and forward indefinitely to offset net capital gains in those years. Gain from the sale of a personal residence is exempt from taxation. In addition, resident individuals are allowed a lifetime capital gain deduction of $Cdn 500,000 on gains realized from the sale of stock of a "qualifying small business corporation" or Canadian farm property.

France. In general, long-term capital gains are taxed at the standard tax rate (currently 33 1/3 percent) plus surtax. A reduced rate of 19 percent is applied to gains from qualifying sales of subsidiary stock and certain licensing arrangements. For individuals, gains from sales of assets, other than securities, held for less than one year (two years for real estate) are

subject to full taxation. Gains on assets held for more than 2 years are indexed for inflation. After December 31, 1999, gain from the sale of stock is exempt from individual income tax if the annual proceeds do not exceed FF 50,000 (an overall 26 percent tax is levied on all gains if the threshold is exceeded). Gain on the sale of a personal residence is exempt.

Germany. Capital gains from the disposal of a company's assets are included in gross income and taxed at the normal rates. Fifty percent of gain realized on the sale of fixed assets can be deducted against the cost of a replacement asset acquired in the current or previous year. Capital gains derived by individuals are exempt from taxation unless they are deemed to be speculative and exceed DM 1,000. A gain is considered speculative if it is derived from the sale of real estate held for less than 10 years or stock held for less than 1 year. Gain from the sale of stock is taxable if the individual owns 10 percent of more of the company within five years of the sale. Gain from the sale of an entire business or of substantial holdings in a corporation (25 percent or more) is spread over five years.

Italy. Corporations treat capital gain and loss as ordinary business income, although gains on the sale of assets held for more than 3 years may be spread over five years. Companies can elect to have "extraordinary" gains such as gain from sales or contributions of a going concern held for more than 3 years taxed at 27 percent and paid in five equal installments. Individuals may qualify for a specific capital gain tax of 12.5 or 27 percent on sales of securities. Capital losses may be carried forward for five years and offset against capital gains.

Japan. Corporate capital gains and losses are treated as ordinary income and losses. Individuals are subject to a separate capital gain tax of 26 percent on gains from sales of securities. Gain from the sale of realty held for more than 5 years is taxed at rates of 26 percent until March 31, 2000. Long-term capital gain on other property held for more than five years qualifies for a 50 percent long-term capital gain deduction. Individuals are permitted a special deduction of ¥500,000 per year for long-term gains (¥30 million for residential property).

Mexico. Capital gains and losses are included in taxable income. In determining the amount of gain or loss, the cost basis is indexed for inflation. Capital losses are divided by the number of years in the asset's holding

period, and that amount is deducted in the current year. Any excess loss can be carried forward for 3 years and offset capital gains.

Netherlands. Corporations generally include capital gains and losses in taxable income as ordinary gains and losses. Gains and losses from the sale of stock that qualifies for the participation exemption are not included in taxable income. Individuals are not taxed on capital gains unless they constitute business income or the investment represents a substantial interest in the company.

United Kingdom. Corporate capital gains and losses are included in the computation of taxable income. Capital losses can only offset capital gains; any excess can be carried forward indefinitely. In the case of gains, an index allowance is applied to the asset's basis to adjust it for inflation. Individuals do not index capital assets but instead are eligible for "taper relief" under which a proportion of the gain that is taxable is reduced over time, ultimately reaching an effective tax rate of 10 percent after 10 years.

Depreciation

Almost all developed countries allow as a deduction in the computation of taxable income an allowance for the depreciation of capital assets used in the production of income. Differences between countries arise with respect to the method of depreciation allowed (for example, straight-line or declining-balance), the useful life of the assets, and the depreciation base.

Brazil. Depreciation of fixed assets is based on the useful life of various classes of assets. General rates of depreciation are as follows: 4 percent for buildings, 10 percent for machinery and equipment, 10 to 20 percent for tools, and 20 percent for computers and vehicles. A full write-off is allowed for assets with a useful life of less than one year. Depreciation at 1.5 times the normal rate is allowed for machinery and equipment used in two shifts per working day and 2 times the normal rate if used in three shifts per working day. Certain new assets used in an industrial process are eligible for double the normal depreciation rate.

Canada. A capital cost allowance (CCA) is permitted with respect to broad classes of assets using a declining-balance method. General rates of depreciation are as follows: 4 percent for buildings, 20 percent for furni-

ture and fixtures, 30 percent for manufacturing and processing equipment, and 30 percent for automobiles and computer software. Special allowances are made for specific industries.

France. Depreciation using either a straight-line or declining-balance method is allowed over the asset's useful life. General rates of depreciation are as follows: 2 to 5 percent for commercial buildings, 5 percent for industrial buildings, 10 to 20 percent for machinery and office equipment, and 20 percent for automobiles (subject to special limitations). Under the declining-balance method, the straight-line rate is multiplied by a coefficient that corresponds to the asset's useful life (1.5 if 3 or 4 years, 2 if 5 or 6 years, and 2.5 if more than 6 years). The declining-balance method is not allowed if the asset's useful life is less than three years.

Germany. Depreciation is allowed using either a straight-line or declining-balance method. Declining-balance rates are limited to the lower of 30 percent or 300 percent of straight-line. Depreciation rates are not fixed by law, although the Federal Ministry of Finance publishes guidelines on useful lives. Straight-line rates are as follows: 2 to 4 percent for buildings, 10 to 20 years. Full write-offs are allowed for some assets, and additional allowances are provided for assets that protect the environment.

Italy. Depreciation is generally allowed using the straight-line method only. Additional depreciation may be claimed during the first three years of an asset's useful life. Accelerated depreciation is allowed for high-use assets. Depreciation may be deferred by newly formed corporations until the first year in which revenues are received. Intangibles may be amortized at rates up to 20 percent; goodwill is generally amortized at 10 percent. Acceptable straight-line rates include: 2 to 5 percent for commercial buildings, 5 percent for industrial buildings, 10 to 20 percent for office equipment, 20 to 25 percent for vehicles, and 5 to 20 percent for plant and machinery. Plant and machinery can also be depreciated using the declining-balance method at rates between 17.5 to 60 percent.

Japan. Depreciation is allowed using a straight-line or declining-balance method and is applied to 95 percent of the asset's cost. Buildings acquired after April 1998 must be depreciated using a straight-line method. Intangible assets must be amortized using a straight-line method. Depreciation rates are published by the Minister of Finance. A corporation can forgo depreciation in a loss year and can claim additional depreciation in the acquisition year. Straight-line rates for specific asset cate-

gories are as follows: buildings at 14.2 to 2 percent, building improvements at 33.3 to 5.5 percent, machinery and equipment at 33.3 to 4 percent, and motor vehicles at 50 to 5 percent. Depreciation for tax purposes may not exceed depreciation for accounting purposes.

Mexico. Assets must be depreciated using a straight-line method. For assets placed in service after 1987, the historical acquisition cost of each asset is indexed for inflation. General rates of depreciation are as follows: 5 percent for buildings, 10 percent for manufacturing and processing equipment, 10 percent for office equipment, 100 percent for environmental machinery and equipment, 25 percent for automobiles, and 30 percent for computers. Taxpayers can elect to deduct the present value of the entire allowable depreciation in the year of acquisition. This rule applies only to new fixed assets.

Netherlands. Depreciation is allowed using either a straight-line or declining-balance method over the asset's useful life. Useful life is determined based on industry experience (that is, facts and circumstances). Depreciable basis is computed taking into account residual value. General depreciable lives are as follows: 33 to 50 years for buildings, 5 to 10 years for plant and machinery, 3 to 10 years for office equipment, and 3 to 5 years for vehicles. Goodwill and other intangibles can be amortized over 5 years.

United Kingdom. Capital allowances (depreciation) are provided for tangible and intangible assets. First-year allowances are allowed for certain assets, up to 100 percent of cost. A writing-down allowance of 25 percent of the remaining balance is allowed for most capital expenditures (applied on a declining-balance basis). A writing-down allowance of 4 percent is allowed for industrial buildings. Assets purchased after November 25, 1996 with a useful life of 25 years or more are depreciated using the declining-balance method at an annual rate of 6 percent. A first-year allowance of 100 percent is allowed for industrial buildings in designated Enterprise Zones.

Net Operating Losses

Almost all developed countries provide for the carry forward and, in some cases, the carry back of a net operating loss. Differences arise with respect to the length of the carryover period and the types of losses that may be carried over. A summary of the net operating loss tax treatment provided by selected countries is provided in table 4.3.

Table 4.3

Treatment of Corporate Net Operating Losses

Country	*NOL Treatment*
Brazil	Indefinite carryforward; loss allowed is limited to 30 percent of profits
Canada	3-year carryback; 7-year carryforward
France	3-year carryback; 5-year carryforward; indefinite carryforward if the NOL is due to depreciation
Germany	1-year carryback, limited to DM 1 million; indefinite carryforward
Italy	5-year carryforward; losses incurred in the first 3 years have an indefinite carryforward
Japan	5-year carryforward; 1-year carryback suspended through March 31, 2000
Mexico	10-year carryforward; losses are adjusted for inflation
Netherlands	3-year carryback; indefinite carryforward
United Kingdom	1-year carryback; indefinite carryforward to offset profit from the same trade

Other Tax Incentives

The following summarizes other tax incentives for each of the selected countries.

Brazil. The Brazilian government, through its industrial developments council (CDI), offers exemptions and tax reductions for the importation of plant and equipment for specific industrial projects. In addition, special tax incentives are provided to encourage capital investment in the Sudene (northeast) and Sudam (Amazon) regions. Incentives consist of accelerated depreciation, import tax relief, employee welfare programs, loans at favorable interest rates, and the opportunity to invest a portion of Brazilian taxes in approved projects.

Canada. An investment credit is allowed with respect to purchases of certain property. Scientific research corporations may deduct 100 percent of current expenses and capital expenditures for scientific research. The Canadian government provides grants, loans, and technical assistance for

industries that foster new-product development, technological advancement, and the creation of jobs. Tax rate reductions are provided to Canadian-controlled private corporations (CCPC) with Canadian-source active business income.

France. Research and development credits are allowed in an amount equal to 50 percent of the increase in inflation-adjusted research and development spending. Several tax holidays are available for investments in certain depressed areas. The French government provides loans and grants for various projects, including investment in underindustrialized areas. An income tax credit is provided for each job created. Accelerated depreciation is available for anti-pollution equipment.

Germany. Tax incentives in the form of subsidized loans, grants, and special depreciation allowances are provided for the establishment of new plants or the modernization of existing plants. Many investment incentives and financing options are provided for investment in the eastern states of Germany.

Italy. A tax credit is available for a portion of research and development costs. Tax incentives are provided to small- and medium-sized companies located in southern Italy (*Mezzogiorno* area).

Japan. Tax incentives are provided primarily to Japanese majority-owned companies. These incentives are generally limited to specific industries and take the form of low-interest long-term loans and tax reductions. Additional depreciation and extended loss carryforwards are provided to branches and subsidiaries of foreign corporations that are involved in the manufacture or development of software. Tax rates are reduced for companies operating within the Okinawa free trade zone.

Mexico. Tax credits are available for investment in buildings, machinery, and equipment in counties located outside the major metropolitan areas. Free-trade zones have been established in certain areas (for example, Baja California), which allow free import duties on machinery, equipment, and spare parts. This exemption also applies to inbound assembly and processing plants (for example, clothing and electronics) that are established in various areas. Import tax relief is provided to *maquiladoras*, which import raw materials, parts, and machinery and equipment and then assemble such materials into exportable goods.

Netherlands. An investment deduction is allowed on certain new investments. The Dutch government offers numerous grants and assistance to finance new industrial buildings and the expansion of existing facilities. Additional deductions are allowed for investments that promote energy efficiency and employee training. The Netherlands also has an extensive network of treaties that reduces withholding taxes on repatriations of profits.

United Kingdom. The British government offers many grant and loan programs to attract investment to high-unemployment areas. Enterprise zones have been established in England, Northern Ireland, Wales, and Scotland to encourage economic investment in urban areas. Depreciation allowances of 100 percent are provided for investments in enterprise zones.

Tax Rates

The most significant changes in the tax systems of developed countries in recent years have been made in the individual and corporate rate structures. Many of the changes resulted from the reduction in rates made by the United States in the Tax Reform Act of 1986. Most developed countries apply a progressive tax rate structure to individuals (that is, the rate of tax increases as income increases) and a flat-rate tax to corporate income.

Brazil. Brazil imposes rates from 15 percent to 27.5 percent on individual taxable income. Corporate taxable income of nonfinancial corporations is taxed at a statutory rate of 15 percent plus an additional 8 percent for social contribution. An additional tax at 10 percent is levied on income exceeding a specified threshold (R$240,000).

Canada. Individual taxable income is taxed at rates of 17, 26, and 29 percent, plus a surtax that ranges from 3 to 5 percent. Provincial taxes ranging from 40.5 percent (Ontario) to 69 percent (Newfoundland) of the federal tax are added to the individual tax liability. Corporate taxable income is taxed at a rate of 38 percent (less abatements that reduce the maximum rate to 28 percent), plus a surtax of 4 percent. Provincial taxes ranging from 5 percent to 17 percent are added to the federal income tax.

France. France imposes a very progressive tax rate structure on individual taxable income. Income is segregated into seven brackets (including

a zero-rate bracket), with the marginal tax rates ranging from 10.5 percent to 54 percent. Corporations are taxed at a rate of 33 1/3 percent, with a 10 percent surtax imposed on the corporate income tax. (The surtax does not apply to certain small corporations.) A reduced rate of 19 percent is applied to certain capital gain and licensing transactions.

Germany. Individual taxpayers are taxed at rates ranging from 15.5 percent to 53 percent (there are eleven brackets of income). A church tax of 8 to 9 percent of the individual's income tax liability is levied on persons belonging to a church. All taxpayers are assessed a solidarity tax of 5.5 percent on their income. Corporations are taxed at 40 percent on undistributed income and 30 percent on distributed income, with a 5.5 percent solidarity tax added.

Italy. Italy taxes individuals by using a progressive rate structure ranging from 19 percent to 46 percent. Taxable income is divided into five rate brackets. Corporate income is taxed at 37 percent (*imposta sul reddito delle persone giuridiche*, or IRPEG). A regional tax (*imposta regionale sulle attivitá produttive*, or IRAP) is imposed on the net value of production derived by a business. The rate is generally 4.25 percent, with lower rates imposed in the agricultural sector.

Japan. Individual income is divided into four rate brackets and subject to tax at rates of 10 percent to 37 percent. Individuals are also subject to a local inhabitant tax, which range from 5 percent to 13 percent. Corporations with paid-in capital in excess of ¥100 million are taxed at a flat rate of 30 percent. A reduced rate of 22 percent is applied to the first ¥8 million of taxable income for smaller corporations. Corporations are also subject to inhabitants taxes imposed by the prefectural and municipal governments. The standard rate is 17.3 percent times the corporate tax liability.

Mexico. Mexico taxes individual taxable income using progressive rates of 3 percent to 40 percent. There are 10 brackets of income. Corporate income is taxed at a flat rate of 34 percent. Reduced corporate rates are granted to book publishers, agriculture, cattle, forestry, and fishing. A minimum tax of 1.8 percent is levied on the net assets of resident companies and permanent establishments of nonresidents. The income tax can be credited against the net assets tax.

Netherlands. Resident individual taxpayers are subject to rates of 7.1 percent, 50 percent, and 60 percent. National insurance taxes of 29.25 per-

cent are added to income in the first two rate brackets, increasing the lowest marginal tax rate to 36.35 percent (under age 65). Corporate income is taxed at 35 percent.

United Kingdom. Individuals are taxed at rates of 20 percent, 23 percent, and 40 percent. National insurance taxes of 3 percent to 10 percent of earnings are added Corporate income is taxed at a flat rate of 30 percent (20 percent for corporations with profits not exceeding UK£300,000).

Treatment of the Family

The establishment of different filing statuses (for example, single, married filing jointly, married filing separately, head of household, and qualifying widow or widower) for individual taxpayers is rather unique to the United States. Most developed countries require each individual to file a separate tax return and use a uniform rate structure.

Brazil. Income tax is computed and paid on a monthly basis and on an individual basis. A standard deduction of R$90 is allowed for each dependent.

Canada. The taxpaying unit in Canada is the individual. Personal tax credits can be claimed for the taxpayer and his or her dependent spouse and dependents age 18 and over who are infirm.

France. The incomes of a married couple and unmarried children under age 18 are aggregated for tax computation purposes. The income total is divided by a specific income splitting coefficient (depending on marital status and number of dependents), and the income tax table is applied to the resulting number. The tax is then multiplied by the coefficient to determine the total tax due. Unmarried children age 18 or older are taxed separately unless they meet certain criteria (for example, a student under age 25), in which case they may continue to file with their parent(s).

Germany. Married couples may elect to be taxed on their separate incomes or combine their incomes and split the total between them. A tax is then computed on the split income and multiplied by two to determine the total tax due. An income allowance is provided for each child, and a household exemption for each child is provided to unmarried persons. A child's income is taxed separately.

Italy. Individual income tax is determined on a separate-taxpayer basis. Income splitting is not permitted for married couples except in the case of a family business. Married couples may file a joint tax return or separate returns, although the filing of a joint tax return is for convenience and does not change the amount of tax due. A child must file a separate income tax.

Japan. The taxable unit in Japan is the individual. However, the total property income of the family (for example, interest, dividends, and rents) is combined and subject to the progressive rate structure. A personal basic deduction can be subtracted from income for the taxpayer and each dependent family member.

Mexico. The individual income tax is applied on a separate-person basis. No allowances or exemptions are provided for family members.

Netherlands. Individuals are taxed on their own separate income from personal labor. Other income and deductions are allocated to the spouse with the higher income from personal labor. The investment income of minors is included in the income of the parent with the higher income from personal labor. A child is taxed separately on income from personal labor. Additional exemptions are provided depending on personal circumstances (for example, a one-earner exemption, a one-parent exemption, and a labor exemption).

United Kingdom. A married couple is taxed as separate individuals. Each person is given a separate tax allowance. In addition, the couple is given a married couple's allowance of UK£ 190, which can be transferred between spouses. Allowances are not given for dependent children. Children under age 18 are taxed separately on their income.

Value-Added Taxes

The majority of developed countries raise additional tax revenues through the imposition of a value-added tax (VAT). In its most basic form, a VAT has been defined as a "multistage sales tax that is collected at each stage or point in the production and distribution process."[6] In the case of a manufactured product, the value added is the difference between

[6]U.S. Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth*, *Vol. 3*, *Value-Added Tax*, 5.

the retail price of the product and the nonlabor costs of production. One important issue in the development of a VAT is the treatment of capital expenditures. Under the consumption-type VAT, which is used in Europe, capital expenditures are fully deductible in computing a firm's value added.[7]

Alternative Methods of VAT Calculation

Tax-Credit Method. Under the tax-credit method of VAT calculation, which is the method most frequently used, a tax is computed on every transaction. The VAT rate is applied to the sale or service price charged by the firm, and the tax is printed on the sales or purchase invoice. At the end of each reporting period, the firm computes its tax liability by adding up the VAT collected on its sales and subtracting the total tax paid on its purchases from other firms. This method requires the firm to calculate the tax on every transaction and to keep a record (invoice) of each item sold. The tax-credit method has the advantage of flexibility; that is, specific items can be exempted from VAT or multiple rates (including a zero rate) can be imposed on different stages in the process.

> *Example 4.1*. A tree farmer harvests ash trees and sells them to a bat maker. The sales price is $18, to which a VAT of $2 is added. The bat maker makes a baseball bat and sells it to a retailer for $63, to which is added a VAT of $7 on the value added of $45 ($63 1 $18). The bat maker's net VAT is $5, after subtraction of a $2 credit paid on the purchase of the tree. The retailer sells the bat to the final consumer for $72 and pays a VAT of $8 on the value added of $9 ($72 1 $63). The retailer's net VAT is $1 after subtracting a credit of $7 paid on the purchase of the bat. The consumer's final cost is $80, which is the $72 retail price plus the VAT of $8.[8]

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[7]For more detailed studies on the VAT, see U.S. Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth, Vol. 3, Value-Added Tax;* U.S. General Accounting Office, *Tax-Credit and Subtraction Methods of Calculating a Value-Added Tax* (Washington, DC: General Accounting Office, 1989); American Institute of Certified Public Accountants, *Design Issues in a Credit Method Value-Added Tax for the United States* (New York: AICPA, 1990); Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS-6-91), May 30, 1991, 269-341; Tax Executives Institute, *Value-Added Taxes: A Comparative Analysis* (Washington, DC: Tax Executives Institute, 1992).

[8]This example is taken from U.S. General Accounting Office, *Tax-Credit and Subtraction Methods of Calculating a Value-Added Tax* (Washington, DC: General Accounting Office, 1989): 13-16.

Subtraction Method. Under the subtraction method, a firm computes its VAT liability by subtracting from its sales its purchases from other firms and applying the tax rate to the difference.

Example 4.2. Assume in example 4.1 that a VAT of 10 percent is applied to each firm and the subtraction method is used. The VAT paid by each firm is as follows:

Tree Farmer	
Sales	$20
Purchases	0
Net receipts	$20
VAT	$ 2
Bat Maker	
Sales	$70
Purchases	20
Net receipts	$50
VAT	$ 5
Retailer	
Sales	$80
Purchases	70
Net receipts	$10
VAT	$ 1

The total VAT paid by the consumer is $8.

Summary of Different VAT Systems

Brazil. A VAT-like "tax on the circulation of merchandise and interstate and intermunicipal transportation and communication services (ICMS) is imposed by each state. The basic state rate for Rio De Janeiro, São Paulo, and Minas Gerais is 18 percent and is imposed on imports and goods shipped to a final consumer. The most common rate for the other states is 17 percent. A 25-percent rate is applied to superfluous items such as arms, ammunition, and perfume. Exports of manufactured goods are exempt. The federal VAT (IPI) is imposed on imports or when products physically leave an industrial plant. The federal rate generally ranges from 0 percent to 25 percent, with the average rate being 15 percent.

Canada. Canada imposes a 7-percent Goods and Services Tax (GST). The GST is imposed on services provided in Canada and goods delivered

or made available in Canada. Tax-exempt supplies include supplies delivered outside Canada, rights to explore or exploit natural resources, proceeds from the sale of a business, sports and gambling winnings, and government grants. Tax-exempt supplies also include long-term residential rents, health and dental services, day care, legal aid, education, and domestic financial services. Exports of goods and services, basic foodstuffs, prescription drugs, and medical services are zero-rated.

France. France applies a standard rate of 20.6 percent times the retail price of goods and services subject to a VAT. A reduced rate of 5.5 percent is imposed on most foodstuffs, medicines, and books. Several transactions are exempt from VAT, including transactions with social objectives, financial transactions, and activities of the liberal professions (for example, medical and legal services, education, and the arts).

Germany. The general VAT rate (turnover tax) is 16 percent times the retail sales price. A reduced rate of 7 percent is applied to food, books, journals, newspapers, and works of art. The following are exempt from VAT: medical services, private schools, orchestras, museums, loan administration, and all exports.

Italy. A VAT (IVA) is imposed on every transaction of goods and services and is chargeable on the net invoice price. The standard rate is 20 percent. A rate of 4 percent is imposed on agriculture, fishery and food products, books, and magazines. A rate of 9 percent is imposed on soap, restaurant meals, hotel services, records, musical instruments, telephone services, livestock, various foodstuffs, and broadcasting. Exports are not subject to VAT, nor are renting and leasing real estate, banking and insurance, hospitals, or schools.

Japan. Japan imposes a consumption tax (similar to a subtraction-method VAT) of 5 percent on a broad range of goods and services. Transactions exempt from the tax include tuition fees, transfers of securities, transfers and leases of land, medical treatment, and exports. Food is taxable.

Mexico. Mexico imposes a general rate of 15 percent on most goods and services and imports. A 10 percent rate is applied to border residents. Exempt transactions include sales of land, residential construction, banking services, medical services, and some forms of public entertainment.

A zero-percent VAT applies to certain agricultural products, listed basic foodstuffs, medicines, food products, and exports of goods and listed services.

Netherlands. A VAT of 17.5 percent is imposed on the deliveries of goods and services within the Netherlands and on imports of goods. A lower rate of 6 percent applies to certain goods and services (for example, foodstuffs, works of art, books, medicines, hotel lodgings, and restaurant meals). A zero rate applies to exports and the purchase of seagoing vessels and aircraft used for international transportation.

United Kingdom. The United Kingdom imposes a standard rate of 17.5 percent on any supply of goods and services in the United Kingdom. Certain items are zero-rated, including food, water, books, fuel and power, construction, exports, and children's clothing. Other items are exempt from VAT, including land, insurance, postal services, betting, finance, education, health services, and burial services. In addition, small traders are exempt from VAT.

5

Source-of-Income Rules

The geographic source of a taxpayer's gross income, as derived either from within or outside the United States, may determine the extent to which he or she is subject to U.S. taxation on such income. In many cases, income that is sourced outside the United States must be further separated and identified as to specific categories ("baskets") or to specific foreign countries or U.S. possessions. Sections 861-865 and the accompanying regulations contain the U.S. rules for identifying the source of gross income and also for allocating and apportioning related expenses to such gross income to compute taxable income figures. The statutory source rules can be overridden by specific treaty provisions between the United States and a foreign country.

The sourcing rules are important to non-U.S. persons (that is, foreign corporations and nonresident aliens) because they limit the scope of U.S. taxation on their income. In general, nonresident aliens (sections 871-879) and foreign corporations (sections 881-884) are subject to U.S. taxation on fixed or periodic income they derive from U.S. sources and on income generated from an activity that is "effectively connected" with the conduct of a U.S. trade or business. In addition, these persons may be subject to tax under section 897 on the disposition of investments in U.S. property.

U.S. taxpayers (that is, U.S. citizens, resident aliens, U.S. corporations, and fiduciaries) are subject to U.S. taxation on their worldwide income, regardless of where it is earned. On first reflection, one might conclude that the rules governing U.S.-source income are unimportant to this group. However, sections 861 through 865 are relevant to U.S. taxpayers because they determine the amount of foreign tax credit allowed as a reduction against any U.S. tax imposed on foreign-source income. These rules also determine whether certain foreign income is exempt from U.S. tax (section 911) or eligible for a credit (section 936). U.S.-source income, if paid by a U.S. person to a foreign person, may be subject to U.S. withholding tax (sections 1441, 1442, 1444, 1445, and 1446). Situations in which the source rules affect the U.S. tax liability of a U.S. taxpayer are discussed more fully below.

Relevance of U.S. Source-of-Income Rules to U.S. Taxpayers

Foreign Tax Credit

Foreign income taxes paid or accrued may be taken as credits against U.S. tax liabilities, subject to limitation. The United States cedes primary jurisdiction to foreign governments to tax U.S. persons on income earned outside the United States, while retaining the residual right to tax foreign-source income to the extent it has not been "fully taxed" by the foreign government. The United States limits the amount of foreign tax that is creditable in a taxable year to the precredit U.S. tax liability for the year times the ratio of foreign-source taxable income to total taxable income (section 904(d)). Separate foreign tax credit limitation calculations must be made for different categories ("baskets") of foreign-source income. The higher the ratio of foreign-source taxable income to total taxable income, the larger the maximum credit allowable. The rules governing U.S.-source income determine whether specific items of gross income are included in the numerator of the foreign tax credit limitation ratio and determine what deductions must be allocated and apportioned to the gross income to compute foreign-source taxable income. Taxpayers in an "excess foreign tax credit" position often seek ways to characterize additional gross income as foreign source or deductions as U.S. source, thereby increasing the limitation. In the case of gross income, this strat-

egy only makes sense if the gross income reclassified as foreign source does not attract a foreign tax rate in excess of the U.S. tax rate.

Tax Concessions Allowed to Income From U.S. Possessions and the Commonwealth of Puerto Rico

The United States allows tax concessions to income derived from U.S. possessions (Guam, American Samoa, the Northern Mariana Islands, and the Virgin Islands) and the Commonwealth of Puerto Rico. These concessions take the form of either tax-reduction, tax-deferral, or tax-credit privileges (sections 30A, 931, 932, and 936). The income must be properly identified with these countries using U.S. source rules to receive these tax concessions.

Citizens or Residents Earning Income Outside the United States

Section 911 allows U.S. citizens or residents who earn income from services performed outside the United States to exclude such income (up to certain limits) from U.S. taxable income. Section 912 permits exemptions for certain overseas allowances for civilian officers and employees of the U.S. government.

Employees of Domestic Subsidiaries Engaged in Business Outside the United States

Section 407 allows employees (U.S. citizens) of domestic corporate subsidiaries that derive at least 95 percent of their gross income from sources outside the United States (section 407(a)(2)(A)(ii)) and that meet other prescribed requirements to be treated as employees of the domestic parent corporation for purposes of the tax aspects of pension, profit-sharing, stock bonus, annuity, or bond purchase plans.

Dividends-Received Deduction

Section 245 provides that a domestic corporation receiving dividends from a 10-percent-owned foreign corporation may take a dividends-received deduction (as allowed by section 243) on the U.S.-source portion of the dividends. The U.S.-source portion of the dividend is computed using the ratio of post-1986 undistributed U.S. earnings over total post-1986 undistributed earnings.

Withholding Tax Requirements

Persons paying U.S.-source interest, dividends, rents, and royalties are required to withhold a flat 30-percent tax on the gross amount paid to a foreign person (sections 1441 and 1442). The withholding tax rate can be reduced or eliminated by a specific treaty provision. A 10-percent withholding tax is generally imposed on the sale by a foreign person of a U.S. real property interest (section 1445). No withholding tax is required if the income is effectively connected with the conduct of a U.S. trade or business (sections 871(a) and 881).

Basic Statutory Framework of the Source Rules

Sections 861 through 863, section 864(e), section 865, and the related regulations provide the U.S. rules for allocating income and deductions from U.S. and foreign sources as well as from activities on continental shelf areas as described in section 638.

Section 861—Income From Sources Within the United States

Section 861(a) provides the rules for identifying eight classes of gross income from within the United States. The classes of income are interest, dividends, personal services, rents and royalties, sale of real property, sale of personal property, underwriting income, and Social Security benefits. Each class has individual criteria for source determination. Section 861(b) requires allocation of expenses, losses, and other deductions to these items to convert gross income to a taxable income figure.

Section 862—Income From Sources Without the United States

Section 862(a) provides the rules for identifying those same classes of gross income from sources outside the United States as well as an additional class from gains, profits, and income from the disposition of a U.S. real property interest located in the Virgin Islands. Section 862(b) requires allocation of expenses, losses, and other deductions to the above items to convert them to taxable income figures.

Section 863—Special Rules for Determining Source

Section 863(a) states that the criteria for allocating the source of other classes of income (not covered by sections 861 and 862) are to be pro-

vided by regulations. Some income (for example, services, manufacturing, and sale of inventory) may be derived by a taxpayer as the result of activities that occur both within and outside the United States. Section 863(b) provides special rules for the manner of allocating such income. Sections 863(c), (d), and (e) provide special source rules for transportation income, income from space and ocean activities, and international communications income, respectively.

Section 864(e)—Rules for Allocating Interest and Certain Other Expenses

Section 864(e) requires that interest expense and any other expense that is not directly allocable and apportioned to a specific income-producing activity must be allocated and apportioned on the basis of assets. In addition, such expenses must be allocated among members of an affiliated group as if all members of the group were a single corporation (the *one taxpayer* rule).

Section 865—Source Rules for Personal Property Sales

Section 865 provides a residence-based source rule for sales of personal property. Exceptions to this source rule are provided for sales of inventory, depreciable personal property, and intangibles, sales through an office or fixed place of business, and sales of stock of certain foreign affiliated corporations.

Principles That Underlie the Source Rules

Although the source rules are strictly definitional in nature (that is, they do not impose a tax liability), U.S. and foreign taxpayers can effectively defer or avoid U.S. taxation on income by structuring transactions to have gross income treated as foreign source and expenses treated as U.S. source. If the foreign taxing jurisdiction imposes a tax rate higher than the U.S. rate, the reverse strategy may be more appropriate.

Before enacting the Tax Reform Act of 1986, Congress became concerned that U.S. taxpayers were aggressively using the existing source rules to "create" foreign-source income to maximize the foreign tax credit limitation. In some cases, Congress determined that income treated as foreign-source was not subject to taxation by a foreign government. As a result, Congress significantly changed some of the source rules in the Tax Reform Act of 1986 to restrict taxpayers' abilities to manipulate the source of income and expenses to avoid taxation by the United States.

In making changes to the source rules, Congress was guided by the following principles:

1. Income should be allocated to the place where the economic activity generating the income occurs. If the income is derived from the use of capital or property, it should have its source where the property or capital is used.
2. The source rules should be neutral. The United States should not object if other countries applied the same rules (that is, the U.S. source rules could serve as an international norm).
3. The source rules should not allow erosion of the legitimate U.S. tax base through taxpayer manipulation of the source rules or of the foreign tax credit limitation.
4. The source rules should be clear and readily applied.
5. Income that is not likely to be taxed by foreign governments should not be treated as foreign source by U.S. taxpayers.[1]

Source Rules for Gross Income

The term *gross income* is used frequently in sections 861–865 and in related regulations. Although gross income is the basis for allocating most of the different types of income, its meaning is not defined within these sections. Instead, gross income must be determined by referring to section 61.[2] Gross income generally is not synonymous with gross receipts. When property or inventory is sold, gross receipts are reduced for the basis or cost of the goods sold to arrive at a gross income figure. When services are involved, gross receipts are tantamount to gross income.

The criteria for determining source of income vary, depending on the class of income. Taxpayers must carefully characterize their income to decide which criteria are applicable (for example, royalty income versus gain from sale of personal property). In addition, taxpayers must determine whether the item is gross income according to U.S. tax laws. If the income is excludable, the source rules are irrelevant for U.S. tax purposes.

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[1]See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 99th Cong., 2d Sess., 1987, Committee Print, 918–919.

[2]See also Rev. Rul. 56-514, 1956-2 C.B. 499.

Interest Income

In general, the source of interest income is determined by the residence of the obligor (sections 861(a)(1) and 862(a)(1)). If the obligor (borrower) resides in the United States, the interest is U.S. source regardless of whether the payee (lender) resides within or outside the United States. If the obligor resides outside the United States, the interest income is foreign source.

The term *interest* includes any payment for the use of borrowed funds, including unstated interest that is part of a deferred payment on the sale of property (section 483) and original issue discount (section 1273(a)(1)). Any payment of interest by the U.S. government, a U.S. territory, or any subdivision of a U.S. territory (except from a U.S. possession) is U.S.-source income. Note that the source of interest does not depend on such factors as where funds are borrowed or spent, the place where principal is paid, or the place where a debt obligation is issued.

> *Example 5.1*. A U.S. corporation pays interest on its bonds to a resident of the United Kingdom. The interest is U.S.-source income. A U.S. citizen residing in Wisconsin receives interest from a German corporation. The interest is foreign-source income.

The key word in the above general rule is residence. Some special rules and exceptions exist depending on the type of obligor.

Interest Received From an Individual

For an obligor who is an individual, residence is determined generally by where the obligor lives at the time of payment. However, if the obligor has not lived in one country for prescribed periods of time or has not shown an intention to remain indefinitely, then it is likely the individual is a transient rather than a resident. The difference between a transient and a resident depends on the individual's intention with regard to the nature and length of stay (Treas. Reg. Sec. 1.871-2(b)). As to nature, the courts have looked to various factors to determine the true intent of an individual, such as (1) the location of the individual's family; (2) whether the person buys a home, pays foreign taxes, and becomes involved in social and community affairs; and (3) the length of time spent in a country.[3] An individual who intends to stay in a country for an indefinite time

[3]See *Howard J. Sochurek v. Comm.*, 300 F.2d 34 (CA-7, 1962).

is considered a resident, whereas a person who comes to a country for a definite purpose that can be accomplished in a short time is considered a transient. An individual may become a resident if he or she makes an extended stay.

Interest Received From a Resident Alien or a Domestic Corporation

In general, interest received from a resident alien or a domestic corporation is U.S.-source income. An exception to this rule applies to interest received from resident aliens or domestic corporations that meet the "foreign business requirements" of section 861(c)(1). If 80 percent or more of the obligor's aggregate gross income is *active foreign business income* over the three-year period ending with the close of the taxable year preceding the payment of the interest (the *testing period*), then special source rules apply depending on whether the recipient is an "unrelated" person or a "related" person. *Active foreign business income* is defined in section 861(c)(1)(B) as income attributable to the active conduct of a trade or business in a foreign country or U.S. possession. A domestic corporation meeting this test is often referred to as an *80/20 company*.

Interest payments made by 80/20 companies or resident aliens to unrelated persons are sourced entirely outside the United States. Interest payments made to related persons are subject to *look-through* rules under section 861(c)(2). Under these rules, the portion of the interest payment that is treated as foreign source is determined using the ratio of the obligor's foreign-source gross income for the testing period over the obligor's total gross income for the testing period. Note that whereas the determination of whether a domestic corporation or resident alien meets the foreign business requirements to be an 80/20 obligor depends on active foreign business income, the look-through rules use foreign income from all sources in computing the amount of interest that is treated as foreign source. A *related person* is defined in section 861(c)(2)(B) as one who owns stock possessing at least 10 percent of the total voting power or total value of the obligor. This definition is a modification of the term defined in section 954(d)(3).

Example 5.2. During 19X9, U.S. Corporation (USCo) paid $10,000 interest to Bonds, a holder of one of its notes. For the three years prior to 19X8 USCo reported gross income from the following sources:

	U.S.-Source	*Foreign Active*	*Foreign Passive*	*Total*
19X8	$10,000	$ 80,000	$10,000	$100,000
19X7	20,000	60,000	20,000	100,000
19X6	0	100,000	0	100,000
Total	$30,000	$240,000	$30,000	$300,000

USCo's active foreign business income during the testing period is 80 percent of total gross income ($240,000/$300,000). Therefore the corporation meets the active foreign business income requirements and qualifies as an 80/20 company. If Bonds is unrelated to USCo (as defined in section 861(c)(2)(B)), the entire $10,000 interest payment is treated as U.S.-source income. If Bonds is related to USCo (she owns stock possessing at least 10 percent of USCo's voting power or value), the amount of the interest payment treated as foreign source is $9,000 ($270,000/$300,000 × $10,000). Note that the 80-percent active foreign business income requirement is determined on an aggregate basis and does not have to be met in each separate year in the testing period.

Interest Received From a Foreign Corporation

Interest income received from a foreign corporation is sourced entirely outside the United States, regardless of the source of funds used to pay the interest.

Interest Received on Deposits With a Foreign Branch of a Domestic Bank

Section 861(a)(1)(B)(i) treats interest income from deposits with a foreign branch of a domestic corporation or a domestic partnership engaged in the commercial banking business as income from sources outside the United States.

Interest Received by a Nonresident Alien or Foreign Corporation From Deposits in a U.S. Bank

Interest income received by a nonresident alien or a foreign corporation from deposits in domestic banks, savings and loans, or insurance companies is treated as U.S.-source income. However, section 871(i)(2)(A) and section 881(d) exempt such interest from U.S. withholding tax unless the interest is effectively connected with the conduct of a trade or business within the United States. An explicit exemption from U.S. withholding tax also applies to income derived from a foreign central bank of issue from bankers' acceptances (section 871(i)(2)(C)).

This exemption is designed to encourage foreign flows of capital into the United States. By treating such interest as U.S.-source income, this rule excludes such interest from the numerator of the foreign tax credit limitation ratio in the case of a U.S. owner of a foreign corporation that has deposits in U.S. banks.

Portfolio Interest

Section 871(h) exempts U.S.-source portfolio interest paid to a nonresident alien or foreign corporation from U.S. withholding tax. Portfolio interest is generally any U.S.-source interest (including original issue discount) that is not effectively connected with the conduct of a trade or business and is paid on an obligation that satisfies certain registration requirements. Interest paid to 10-percent shareholders of the issuer of the obligation does not qualify for the withholding exemption. This provision was enacted in 1984 to give U.S. businesses direct access to the Eurobond market.

As part of the 1993 Tax Act, Congress excluded *contingent interest* from qualifying as portfolio interest (section 871(h)(4)). Contingent interest includes interest determined by reference to the debtor's receipts, sales or other cash flow, income or profits, or changes in the value of property. Contingent interest also includes interest determined by reference to any dividend, partnership distribution, or similar payment made by the debtor. This provision was enacted in response to the growth in hybrid securities that were debt in form but provided equity participation rights.

Dividend Income

In general, the source of dividend income is determined by the residence (country of incorporation) of the corporation paying the dividend. The term *dividend* is defined as a distribution of money or property out of a corporation's current or accumulated earnings and profits (section 316). The amount of dividend sourced within the United States is prorated in certain cases in which a foreign corporation derives income from the conduct of a U.S. trade or business. A portion of the dividends paid to a foreign shareholder is exempt from U.S. withholding tax when the domestic corporation qualifies as an 80/20 company. The rules for determining the source of dividend income are summarized in table 5.1.

Table 5.1

Rules for Determining the Source of Dividend Income

Type of Corporation	*Source of Dividend Income*	*Internal Revenue Code Section*
Domestic corporation	Entirely within United States*	861(a)(2)(A)
U.S. possessions corporation	Entirely outside United States	861(a)(2)(A)
Foreign corporation		
Ratio of effectively connected income to total gross income:		
Less than 25% for three-year period	Entirely outside United States	861(a)(2)(B)
25% or more for the three-year period	Prorate within United States and outside United States	861(a)(2)(B)
Dividends treated by section 243(e) as out of earnings and profits of a domestic corporation	Entirely within United States	861(a)(2)(B)
Domestic International Sales Corporation (DISC)		
To extent of qualified export receipts	Entirely outside United States	861(a)(2)(D)
To excess of qualified export receipts	Entirely within United States	

*If the domestic corporation has 80 percent of its total gross income from active foreign business income over the prior three years and the dividend is paid to foreign shareholders, then a prorated portion of the dividend is exempt from U.S. withholding tax (section 871(i)(2)(B)).

Dividends Paid by Domestic Corporations

Domestic corporations are corporations created or organized in the United States (section 7701(a)(4)). Dividends paid by a domestic corporation are sourced entirely within the United States (section 861(a)(2)(A)). If a domestic corporation meets the requirements of an 80/20 company, a portion of the dividend payments to foreign shareholders will not be subject to U.S. withholding tax under section 871(i)(2)(B). The portion not subject to withholding is determined by

multiplying the dividend by the ratio of foreign-source gross income for the three-year period ending with the close of the taxable year in which the dividend was declared over total gross income for the same time period.

In determining whether a domestic corporation meets the active foreign business income test to be an 80/20 company, look-through rules are applied to dividends paid from a lower-tier corporation to an upper-tier corporation for purposes of attributing the lower-tier corporation's active foreign business income to the upper-tier U.S. corporation. Before the look-through rules apply, the U.S. corporation must own directly or indirectly at least 50 percent of both the voting power and value of the stock of the lower-tier corporation.

Example 5.3. U.S. corporation X and foreign corporation F jointly incorporate U.S. corporation Y to operate a mining operation in a foreign country. During its first year of operations, Y earned $900 of foreign-source income from its mining operations and $100 of U.S.-source income from investments in the United States. At the end of the year, Y distributed a $100 dividend to both X and F. This was the only income received by X and F for the year. X distributed $50 as a dividend to its shareholders, all of whom were foreign residents. The source rules, in conjunction with the look-through rules, operate to source the dividends as follows:

1. The $100 dividend to X Corporation is entirely U.S.-source income.
2. The $100 dividend to F Corporation is entirely U.S.-source income. Because Y Corporation meets the 80-percent active foreign business income requirement, a portion of the dividend is exempt from U.S. withholding tax. The exempt amount is $90, determined by multiplying $900/$1,000 × $100. In this case, the current year's gross income is used because the company has no prior business history (see section 861(c)(1)(C)).
3. The $50 dividend by X Corporation to its foreign shareholders is entirely U.S.-source income. Because X Corporation has no other gross income, it also will be treated as an 80/20 company. Under the look-through rules, the source of the income out of which the dividend was paid is attributed to the recipient for purposes of determining the 80/20 designation. Therefore, 90 percent of the dividend ($45) paid to the foreign shareholders is exempt from U.S. withholding tax because the dividend is deemed to be paid from an 80/20 company that earned 90 percent of its gross income from foreign sources. If X Corporation had $13 of additional nonactive foreign gross income for the year, it would not have been an

80/20 company, and all of the dividend payment to its foreign shareholders would have been subject to U.S. withholding tax.[4]

A second exception to the sourcing rules for dividends paid by domestic corporations applies to possessions corporations making an election under section 936. Dividends paid from such corporations are sourced entirely outside the United States (section 861(a)(2)(A)).

Dividends Paid by Foreign Corporations

Section 7701(a)(5) defines a *foreign corporation* as a corporation that does not meet the definition of a domestic corporation (that is, it is created or organized outside the United States). Dividends from a foreign corporation are generally treated as entirely from sources outside the United States.

An exception applies to a foreign corporation that derived 25 percent or more of its aggregate gross income over the three-year period ending prior to the year in which the dividend was declared from sources effectively connected with the conduct of a trade or business within the United States (section 861(a)(2)(B)). If the foreign corporation paying the dividend meets this 25-percent gross income test, the dividends are allocated between income from sources within and outside the United States using the ratio of gross income effectively connected with a trade or business within the United States for the prior three-year period over total gross income for the same period.

The U.S.-source portion of dividends paid by a foreign corporation meeting the 25-percent test is subject to a 30-percent withholding tax under section 871 if paid to foreign shareholders. This second-tier dividend tax may be reduced by treaty. The withholding tax is not imposed if the foreign corporation is subject to the branch profits tax imposed by section 884 (section 861(a)(2)(B)). The second-tier dividend tax is imposed on dividends from pre-1987 earnings and profits and also applies to foreign corporations exempt from the branch profits tax under a treaty.

The term *effectively connected income*, when referring to activities of nonresident aliens and foreign corporations, is generally characterized as income connected with a trade or business within the United States

[4]This example is taken from Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 939–940.

attributable to a fixed place of business located in the United States. In the case of periodic income, if income is derived from assets used in the conduct of a U.S. business, or if the activities in the United States are a material factor in the realization of income, then such income is effectively connected with a U.S. trade or business (section 864(c)(2)).

Section 864(c)(4) states that four classes of income from sources outside the United States shall be treated as effectively connected with a U.S. trade or business, provided the nonresident alien or foreign corporation has an office or other fixed place of business within the United States to which the income is attributable. These four classes include (1) certain rents and royalties from intangible property, (2) dividends or interest derived from the active conduct of a banking or financing business, or from trading in stocks or securities for its own account, (3) gain or loss from the sale of inventory outside the United States, provided a foreign office did not participate materially in the sale, and (4) income from life insurance companies attributable to a U.S. business. Two exceptions to these four classes of foreign income that are not treated as U.S.-source income are (1) dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns more than 50 percent of the voting power of all classes of voting stock and (2) subpart F income (within the meaning of section 952(a)) of a controlled foreign corporation (CFC).

> *Example 5.4*. Hill Company, a domestic corporation, owns 70 percent of Dale, Ltd., a foreign corporation. Dale, Ltd. pays a dividend of $100,000 to Hill Company in 19X9. In the three-year period preceding 19X9, 60 percent of the income earned by Dale, Ltd. was effectively connected with a U.S. trade or business. In 19X9, $60,000 of the dividend is treated as U.S.-source income. Hill is entitled to an 80-percent dividends received deduction ($48,000) under section 245(a). The remaining $40,000 is treated as foreign-source income.

Dividends paid by a foreign corporation that are deemed to be paid out of the earnings and profits of a predecessor domestic corporation are treated as dividends paid by a domestic corporation (section 243(e)). This rule prevents the conversion of U.S.-source income to foreign-source income through an acquisition of a U.S. corporation by a foreign corporation, in cases in which the foreign corporation succeeds to the U.S. corporation's earnings and profits (for example, a tax-deferred asset or stock acquisition).

Compensation for Services Rendered

The source of compensation received for personal services rendered is generally determined by the place where the services are performed (sections 861(a)(3) and 862(a)(3)). The United States provides a statutory exception to the general rule for compensation for labor or personal services performed in the United States by a nonresident alien. Such income is not considered U.S.-source income if the nonresident alien was not in the United States for more than ninety days, did not earn more than $3,000, and was employed either by a foreign entity not engaged in a trade or business in the United States or by a U.S. entity in a foreign country or U.S. possession (section 861(a)(3)). This is often referred to as the *commercial traveler's exception*. Income tax treaties frequently alter this rule, most often by extending the allowed length of stay (to 183 days) and eliminating the limitation on earnings. In 1997, Congress modified the compensation source rules to treat compensation earned by nonresident alien crew members of foreign vessels as foreign source even if it was earned while the vessel was in U.S. waters (section 861(c)(3)). This rule applies to services rendered on a foreign vessel engaged in transportation between the United States and a foreign country or possession of the United States.

Personal services are not limited to services performed by individuals. A corporation can perform personal services by means of its employees, in which case the previously discussed source rules apply to the corporation.[5]

A problem can arise when distinguishing compensation for personal services from gross income from the sale of property rights. This may occur in the creation and sale of artistic endeavors, such as music recordings, artworks, and sculptures.[6] If gross income received from the creation and sale of these works is treated as compensation for personal services, the place where the service is performed (where the work is created) determines the source of the gross income. If the gross income is treated as a royalty or sale of personal property, different sourcing rules apply.

[5]Rev. Rul. 60-55, 1960-1 C.B. 270.

[6]See *Boulez*, 83 T.C. 584 (1984); *Cook v. United States*, 599 F.2d 400 (Ct. Cl. 1979).

Retirement Plans and Deferred Compensation

Retirement plans and deferred compensation are unique in that these payments are generally received years after the time when the services related to such payments were performed. In addition, the payments may be out of a fund located in a country other than the country in which the services were performed. Nevertheless, the source of such income is still the country where the services generating these deferred payments were originally performed.[7] Neither the residence of the individual nor the location of the fund at the time the proceeds are received is relevant. Pension income related to compensation earned by nonresident alien crew members of foreign vessels related to service within the United States is considered U.S.-source income even though the compensation itself is treated as foreign income (section 861(c)(3)).

Commissions

The source of gross income from commissions is the place at which the service that earned the income was rendered and not the place where the goods were sold or the destination of the goods.[8]

Continental Shelf

Section 638 states that personal services performed in connection with exploiting natural resources on a continental shelf are to be considered derived from sources within the country that has exclusive rights over the continental shelf according to international law.

Coastwise Travel

Treas. Reg. Sec. 1.861-4(c) states that wages earned inside the territorial limits of the United States and wages of alien seamen on vessels engaged in coastwise travel are to be regarded as derived from sources within the United States. *Coastwise travel* is defined as a voyage from one U.S. port to another U.S. port, regardless of whether the ship travels outside the territorial limits en route.

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[7]I.T. 3804, 1946-1 C.B. 151; I.T. 3199, 1938-1 C.B. 209.

[8]Rev. Rul. 60-55, 1960-1 C.B. 270.

Community Property

Under community property laws, one-half of the income derived by one spouse is considered to have been derived by the other spouse. The source of the income to the latter spouse is the same as the source of the income to the spouse who actually derived the income.[9] Special rules are provided for situations in which U.S. citizens or residents are married to nonresident aliens and elect to file joint returns (section 6013(g)).

Allocation Between Countries

When compensation for services rendered both within and outside the United States is paid in a lump sum, the amount must be apportioned between the countries in which the services were performed. Treas. Reg. Sec. 1.861-4(b) states that the apportionment shall be determined on the basis that most clearly reflects income under the facts and circumstances of the particular case. The regulations also state that, in many cases, the facts and circumstances will be such that an apportionment on a time basis will be acceptable. The dollar amount allocated to U.S. sources for which a time-basis allocation is appropriate is the amount that bears the same relation to the total compensation as the number of days of performance of services within the United States bears to the total number of days of performance.[10] Deciding what consideration is provided by the taxpayer in return for compensation can be complicated.[11]

> *Example 5.5.* Blair, a nonresident alien, was employed by Downing Company from March 1, 1999, to June 12, 1999, a total of 104 days, for which he received compensation of $15,600. During that period, Blair was in the United States for fifty-nine days. Under the employment contract, he was subject to call at all times by his employer and was in a payment status on a seven-day-week basis. There was no specific agreement as to the amount of pay for services performed within the United States; moreover, Blair received his stipulated salary payments regardless of the number of days per week he actually performed services. Under these circumstances the

[9] Rev. Rul. 54-16, 1954-1 C.B. 157.

[10] Rev. Rul. 69-238, 1969-1 C.B. 157.

[11] *Stemkowski*, 76 T.C. 252 (1981), *aff'd. in part & remanded*, 690 F.2d 40 (CA-2, 1982); *Hanna*, 76 T.C. 252 (1981), *aff'd. in part & remanded*, 763 F.2d 171 (CA-4, 1985); Rev. Rul. 87-38, 1987-1 C.B. 176; and *Favell v. United States*, 16 Cl. Ct. 700 (1989).

amount of compensation Blair treats as from sources within the United States is $8,850 ($15,600 × 59/104).[12]

Rents and Royalties

Sections 861(a)(4) and 862(a)(4) provide that the income from the use of tangible property has its source in the country in which the tangible property is located. Income from the use of intangible properties or rights has its source in the country in which the intangible properties or rights are used. The country of use of intangible property is the country that protects the owner of the property against unauthorized use of such property.[13]

These rules cover income from the use of every kind of real and personal property. Sections 861(a)(4) and 862(a)(4) specifically list patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, and franchises. Also included would be royalty fees from natural resources. Whether or not a property or right is legally patented does not affect the sourcing rules.[14]

Furthermore, the source rules based on location of tangible property and place of usage for intangible property hold true regardless of where the products, as a result of the use of the property or rights, are produced or sold.[15] That is, gross income attributable to the actual production or sale of the property (versus the fees for the use of the property or rights) is sourced according to rules for personal property, which will be discussed below (section 865).

When fees are received for property or rights used within more than one country, the apportionment of such income between countries is acceptable if the taxpayer presents evidence to justify a basis for apportionment. If no evidence is presented, then all the income will be treated as from within the United States (if one of the countries of use is the United States).[16]

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[12]Adapted from Treas. Reg. Sec. 1.861-4(b)(1)(ii), example 1.

[13]Rev. Rul. 68-443, 1968-2 C.B. 304.

[14]Rev. Rul. 55-17, 1955-1 C.B. 388.

[15]Rev. Rul. 68-443, 1968-2 C.B. 304; *Ingram, Admx (Caruso Estate)*, 57 F.2d 65 (CA-2, 1932).

[16]*Misbourne Pictures Ltd. v. Johnson*, 189 F.2d 774 (CA-2, 1951), *aff'g*. 90 F. Supp. 978 (S.D.N.Y. 1950).

When property or rights are used in more than one country, the type of evidence that should prove most helpful to support apportionment of income is a provision in the contracts for separate allocations of fees by country or separate contracts or agreements for each country. However, the allocations in the contracts should have some reasonable basis. For example, if the fees paid are a function of time, then the allocation of the fees between countries should also have some basis with respect to time.

Some care must be taken to distinguish between a sale and a use or license of property or property rights. Income from a sale of personal property (subject to exceptions) generally has its source in the country of residence of the seller. Income from a license has its source in the country in which the tangible property is located or intangible property is used. The granting of an exclusive license has been construed as a sale.[17] However, sections 865(d), 871(a)(1)(D) (applicable to nonresident aliens), and 881(a)(4) (applicable to foreign corporations) provide that when intangible property is sold for a contingency price (for example, contingent upon productivity, use, disposition of property, or interest), the source of the gain on the sale is to be determined by the rules for rents and royalties. Section 865(d)(3) provides an exception for sale of goodwill, which is treated as having its source in the country in which the goodwill was generated.

Sale of Real Property

The location of the real property generally determines the source of income derived from the sale of such property (sections 861(a)(5) and 862(a)(5)). For example, if real property sold is located within the United States, gross income from the sale is treated as U.S.-source income. What constitutes real property for U.S. tax purposes in general is determined by legal principles under local U.S. laws (but see Treas. Reg. Sec. 1.897-1(b)(1) for an exception related to foreign investment in U.S. real property interests). Gain from sale of a U.S. real property interest (for example, stock in a U.S. real property holding company) also will be considered U.S.-source income, regardless of where title passes.

Because real property is generally immobile in nature, the problem of apportionment of income between countries does not arise.

[17]Rev. Rul. 60-226, 1960-1 C.B. 26; Rev. Rul. 58-353, 1958-2 C.B. 408.

Sale of Personal Property

The rules for determining the source of income from the sale of personal property can be divided into two groups: (1) those rules applicable to purchased personal property and (2) those applicable to produced personal property.

Purchased Personal Property

The rules for determining the source of income from the sale of purchased personal property are found in sections 861(a)(6), 862(a)(6), and 865. The general rule of section 865(a) states that gross income from sales of personal property is sourced based on the seller's residence. Thus, gain from the sale of personal property by a U.S. resident will be U.S. source, regardless of where title passes.

The determination of residency is based on whether the seller has a tax home (as defined in section 911(d)(3)) within the United States (section 865(g)(1)(A)). A U.S. citizen or resident alien is deemed to be a U.S. resident for purposes of this source rule if he or she does not have a tax home outside the United States. A nonresident alien will be deemed to be a U.S. resident if he or she has a tax home within the United States. An exception to the residence rule applies to U.S. citizens and resident aliens who have a tax home in a foreign country. Such persons will not be considered nonresidents of the United States on sales of personal property if the gain on such sale is subject to a tax of less than 10 percent by the foreign country (section 865(g)(2)). In that case, the gain will be treated as U.S.-source income. This 10-percent rule is waived in the case of a bona fide resident of Puerto Rico who sells stock in a corporation that is actively engaged in a trade or business in Puerto Rico and derives more than 50 percent of its gross income from such active trade or business, as measured over the three taxable years prior to the sale of the stock (section 865(g)(3)).[18]

Entities are considered to be residents of the United States if they are U.S. persons as defined in section 7701(a)(30). In the case of a sale by a partnership, the source of the gain that is allocated to the partners is generally determined by the residence of each partner to whom the gain is allocated. Congress has provided regulatory authority to the Secretary of

[18]House Committee on Ways and Means, *Report on the Miscellaneous Revenue Act of 1988* (H.R. 4333), 100th Cong., 2d Sess., 225.

the Treasury to provide for exceptions to this rule in cases in which it is not administratively possible to apply the rules at the partner level. For example, it may be appropriate to determine source at the partnership level in the case of a publicly traded partnership with hundreds of partners.[19]

There are several significant exceptions to this residence-of-the-seller rule. These exceptions apply to sales of inventory, depreciable property, intangibles, stock of an 80-percent-owned foreign corporation, and sales through foreign offices or a fixed place of business. A summary of the sourcing rules applicable to sales of purchased personal property is contained in table 5.2.

Table 5.2

Source of Income From the Sale of Purchased Personal Property

Type of Property	*Source Rule*	*Internal Revenue Code Section*
Inventory	Source where title passes	865(b), 861(a)(6)
Depreciable	Gain that represents depreciation is sourced in the country in which the depreciation deductions reduced income.	865(c)
Intangible	If the sale is at a fixed price, source using the seller's residence.	865(d)
Goodwill	Source in the country in which generated.	865(d)(3)
Stock of 80-percent-owned foreign corporation	Source in the place of sale if the sale takes place in the foreign country in which the foreign affiliate derived more than 50 percent of its gross income for the prior three years. Otherwise, source using the seller's residence.	865(f)
Other property	Source using the seller's residence.	865(a)

Note: If the sale of property is not sourced using one of the exceptions to section 865(a), the gain may still be sourced outside the United States if the sale is attributable to an office or fixed place of business outside the United States (section 865(e)).

[19]*Ibid.*

Sales of Inventory. Gross income from sales of inventory is sourced based on the place where title passage occurred (section 865(b) refers the reader to sections 861(a)(6), 862(a)(6), and 863(b)). Although the key determination is the place where title passage occurred, sections 861(a)(6) and 862(a)(6) state that the source of income from purchased personal property is to be based on the place where the sale occurs. After years of litigation regarding when and where a sale occurs, the Treasury issued Treas. Reg. Sec. 1.861-7(c), which states the general rule that a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Treas. Reg. Sec. 1.861-7(c) further states that when bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. In other words, where the rights and interest to the property have been transferred, but not the title, legal technicalities can be overlooked and the sale can be deemed to have been made. It is therefore possible to have had a sale for purposes of this source-of-income determination without passage of title.

Fixing the source of income to the country to which title passes has been criticized as an arbitrary criterion in that it is based on legal technicalities rather than economic realities. In addition, where title passes may have little relation to activities that earn the income, and the rule allocates all the income to one country. Although these arguments led Congress to enact a general residence-of-the-seller rule in the Tax Reform Act of 1986, Congress chose to retain the title passage rule for inventory because it believed that a residence-of-the-seller rule would reduce the competitiveness of U.S. businesses abroad and thereby exacerbate the U.S. trade deficit.

Where title passes is largely under the control of the contracting parties. Taxpayers can either control the substance of the contract or agreement, the place the substance of the sale occurs, or the governing jurisdiction under which the contract falls. Considerable freedom exists for taxpayers to pass title where they desire. The only limit to manipulation of title passage is the situation in which title passage is used as a sham to avoid taxes (Treas. Reg. Sec. 1.861-7(c)). As a safety precaution to ensure that income has a source in the country desired, a taxpayer should consider placing in that country as many activities as possible regarding the sale transaction, such as accepting the order, executing the contract

or agreement, shifting the risk of loss, or paying for the property.[20] Of course, when title passes in a foreign country, exposure to taxation by that country can be a substantial risk.

Depreciable Personal Property. A second exception to the residence-of-the-seller rule applies to the sale of depreciable personal property. Section 865(c)(1) requires that the portion of the gain that represents depreciation recapture is sourced within the country in which the depreciation deductions reduced income. Gain in excess of previous depreciation deductions is sourced using the title passage rule (section 865(c)(2)). The gain apportioned as having its source in the United States is computed by multiplying the gain (not to exceed the total depreciation adjustments) by the ratio of *U.S. depreciation adjustments* to total depreciation adjustments. *U.S. depreciation adjustments* are those deductions allowed in computing taxable income from sources within the United States. If depreciable property is used predominantly in (outside) the United States for a taxable year, all of the allowable depreciation deductions for that year are treated as having been allocated to sources of income in (outside) the United States for purposes of this sourcing rule (section 865(c)(3)(B)).

> *Example* 5.6. U.S. Corporation (USCo) used a machine in its U.S. operations during its taxable years 1995–1997. On January 1, 1998, USCo transferred the machine to Canada, where it was used in its Canadian operations. On July 1, 1999, USCo sold the machine to a Canadian corporation for $100,000. Title passed in Canada. The $100,000 gain included recovery of depreciation deducted against U.S.-source income of $40,000 and depreciation deducted against foreign-source income of $30,000. USCo will have $40,000 of U.S.-source gain and $60,000 of foreign-source gain ($30,000 using the depreciation recapture rule and $30,000 using the title-passage-rule).

Intangibles. Section 865(d) imposes a residence-of-the-seller rule on the sale of intangibles, but only if the sale is at a fixed price. If a portion of the sales price is contingent on the productivity, use, or disposition of the intangible, the source of gain is determined using the royalty source rules of section 861(a)(4). Under these rules, the source of gain is determined

[20]Court cases involving factual issues related to title passage include *Liggett Group, Inc.*, 58 T.C.M. 1167 (1990), *Barber-Greene Americas, Inc.*, 35 T.C. 365 (1960), and *A.P. Green Export Co. v. United States*, 284 F.2d 383 (Ct. Cl. 1960).

based on where the property is used. If gain from the sale of the intangible includes the recovery of previously allowed amortization deductions, such gain, to the extent of the amortization deductions, is sourced using the depreciation recapture rules of section 865(c)(1) regardless of whether the payments are contingent on productivity, use, or disposition (section 865(d)(4)). In the case of contingent payments, the entire gain is sourced using the depreciation recapture rule until the total amortization deductions are recaptured. Excess gain is sourced using a residence-of-the-seller rule in the case of noncontingent payments.

An *intangible* is defined as a patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property (section 865(d)(2)).

An exception to the residence-of-the-seller rule applies in the case of the sale of goodwill. Gain from the sale of goodwill is sourced in the country in which the goodwill was generated (section 865(d)(3)).

Stock of Affiliates. A U.S. resident selling stock in an affiliate (an 80-percent-owned corporation) will treat gain from the sale as foreign source if the following three criteria are met: (1) the affiliate is a foreign corporation, (2) the sale occurs in a foreign country in which the affiliate is engaged in the active conduct of a trade or business, and (3) more than 50 percent of the affiliate's gross income for the three years preceding the year in which the sale occurred was derived from the active conduct of a trade or business in the foreign country in which the stock was sold (section 865(f)).

If the affiliate has wholly owned foreign subsidiaries, the U.S. resident may elect to treat the affiliate and its wholly owned subsidiaries as one corporation for purposes of computing the more-than-50-percent-of-gross-income test and for meeting the country-of-sale requirement.

Sales Through Offices or Fixed Places of Business. Gross income from the sale of personal property that is not sourced outside the United States because of one of the previous exceptions may still be sourced outside the United States if the sale is attributable to an office or other fixed place of business in a foreign country (section 865(e)). In the case of a U.S. resident, this rule will apply only if the foreign taxing jurisdiction imposes a tax rate of at least 10 percent on the income from the sale. The tax must meet the definition of an income tax as it is used in determining the foreign tax credit limitation. This 10-percent rule also applies to the sale of

an intangible when the sales price is not contingent on productivity, use, or disposition.

If a nonresident maintains a fixed place of business in the United States, the income from sales of all personal property attributable to that office will be sourced within the United States. In the case of sales of inventory from that office outside the United States, the title-passage rule applies, provided an office or fixed place of business outside the United States materially participated in the sale.

Whether a taxpayer has an office or a fixed place of business and whether a sale is attributable to such an office or fixed place of business are determined under the principles of section 864(c)(5). In general, the nonresident alien or foreign corporation must empower its agents with the authority to solicit orders or negotiate contracts in its name, and such agents either regularly exercise that authority or sell inventory from stock on hand on behalf of the nonresident alien or foreign corporation. In addition, the office or fixed place of business must be a material factor in the production of income and regularly carry on the activities from which the income was derived.

Gains From Sale of Certain Stock or Intangibles. Under general rules, if gain from the sale of stock of a foreign corporation or of an intangible would be treated as foreign source under a treaty provision and U.S. source under a statutory provision, the provision that is later in time prevails. Under an exception provided in section 865(h), a taxpayer may elect to have the treaty provisions apply to the transaction (that is, the gain will be foreign source). However, if the election is made, foreign taxes on that gain may only offset the U.S. tax imposed on such gain. In addition, no other foreign taxes can be used to offset any U.S. tax on that gain.

Gains From Liquidation of a Possessions Corporation. Gain recognized as a result of the liquidation of a possessions corporation will be sourced outside the United States if the corporation derived more than 50 percent of its gross income for the three years prior to the year in which the liquidating distribution is received from the active conduct of a trade or business in the possession (section 865(h)(2)(B)). Any foreign taxes paid on such gain may only offset the U.S. tax imposed on that gain. No other foreign taxes can be used to offset any U.S. tax on that gain.

Inventory Produced Within (Outside) the United States and Sold Outside (Within) the United States

Section 863(b) provides a special source rule for income from the sale of inventory property (as defined in section 865(i)(1)) that is produced (in whole or in part) within (outside) the United States and is sold outside (within) the United States (*Section 863 Sale*). Such income is treated as derived partly from sources within and outside the United States. The allocation made under section 863(b) is generally applied to *gross income* from such sales (sales minus cost of goods sold).

Treas. Reg. Sec. 1.863-3(c)(1)(i)(A) defines *production activity* as an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. This definition is similar to the meaning given the word *produced* in section 864(a). Section 863(b) applies to inventory that is produced either "in whole or in part." Generally, the only production activities taken into account for purposes of this source rule are those conducted directly by the taxpayer (Treas. Reg. Sec. 1.863-3(c)(1)(i)(A)).

Treas. Reg. Sec. 1.863-3(a)(1) provides the taxpayer with three elective methods for apportioning gross income from Section 863 Sales between U.S. and foreign sources. Each of these methods bifurcates gross income from section 863 sales between production activity and sales activity. The methods are described in Treas. Reg. Sec. 1.863-3(b). The default apportionment method is the "50/50 method" described in Treas. Reg. Sec. 1.863-3(b)(1).

50/50 Method

Under this method, one-half of the taxpayer's gross income from Section 863 Sales is considered income attributable to production activity and one-half is considered attributable to sales activity. Gross income apportioned to each activity is sourced based on criteria described in Treas. Reg. Sec. 1.863-3(c)(1) and (c)(2).

Gross Income Attributable to Production Activity. Gross income apportioned to production activity is sourced based on criteria described in Treas. Reg. Sec. 1.863-3(c)(1). In general, such gross income is apportioned between U.S. and foreign sources based on where the "production assets" that produced the inventory are physically located (within or out-

side the United States). Intangible assets are treated as located where the tangible production assets owned by the taxpayer to which the intangible relates are located (Treas. Reg. Sec. 1.863-3(c)(1)(i)(C)).

As discussed above, *production activity* means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory (Treas. Reg. Sec. 1.863-3(c)(1)(i)(A)). Further, production assets for purposes of this computation include only tangible and intangible assets owned directly by the taxpayer that are directly used by the taxpayer to produce inventory sold in a Section 863 Sale (Treas. Reg. Sec. 1.863-3(c)(1)(i)(B)). Production assets owned by a contract manufacturer hired by the taxpayer to produce inventory are not included in the computation. Production assets do not include accounts receivable, marketing intangibles such as trademarks or customer lists, transportation assets, warehouses, the inventory itself, raw materials, work-in-process, cash or other liquid assets (including working capital), investment assets, prepaid expenses, or stock of a subsidiary (Treas. Reg. Sec. 1.863-3(c)(1)(i)(B)). Special rules apply when the taxpayer is a partner is a partnership that manufactures inventory sold in a Section 863 Sale (Treas. Reg. Sec. 1.863-3(g)).

Where all of the taxpayer's production assets are located either within or outside the United States, all of the gross income apportioned to production activity (50 percent) is treated as either all U.S. or all foreign source income. Where the production assets are located both within and outside the United States, the taxpayer must apportion a part of the gross income as foreign source using an apportionment ratio that has as its numerator the *average adjusted basis* of production assets located outside the United States and as its denominator the average adjusted basis of all production assets (Treas. Reg. Sec. 1.863-3(c)(1)(ii)(A)). The remaining gross income is treated as U.S.-source income. The average adjusted basis of an asset is computed by averaging the adjusted basis of the asset at the beginning and ending of the taxable year, unless the asset was subject to material changes such that the average does not fairly represent the average for the year (Treas. Reg. Sec. 1.863-3(c)(1)(ii)(B)).

Where production assets are used to produce inventory sold in Section 863 Sales and other sales (for example, sales of inventory within the United States), the regulations state that the portion of the assets allocated to the Section 863 Sales is to be made using "any method that reasonably reflects the portion of the assets that produces inventory sold in Section 863(b) sales" (Treas. Reg. Sec. 1.863-3(c)(1)(ii)(B)). The reg-

ulations further state that gross receipts could be reasonable basis for making the allocation.

Example 5.7. U.S. Corporation (USCo) manufactures goods for sale in the United States and Europe. The initial manufacture of the goods takes place in the United States. A second stage of production for goods sold outside the United States takes place in Europe. U.S. plant and equipment used to manufacture the goods has an average adjusted basis for the year of $200. The average adjusted basis of the foreign equipment was $25. USCo's gross receipts from all sales of goods was $100, and its gross receipts from its export sales was $20. Gross income from sales of goods in Europe was $13. Using the 50/50 method, USCo apportions gross income from production activity as follows:

1. Only gross income from sales of goods manufactured in the United States and sold outside the United States is subject to apportionment under section 863(b). Gross income from Section 863 Sales is $13. One-half of the $13 ($6.50) is apportioned to production activity.
2. Production activity assets include the U.S. plant and equipment and the foreign equipment. Because the U.S. plant and equipment was used to manufacture goods sold within and outside the United States, its average adjusted basis must be apportioned between U.S. sales and section 863 sales using a reasonable method, such as gross receipts. Assuming gross receipts is a reasonable method, 20 percent ($20/$100) of the average adjusted basis of the U.S.-based production activity assets ($200), or $40, is treated as production activity assets used in the Section 863 Sales. Total production activity assets related to Section 863 Sales is $65 ($25 plus $40).
3. The portion of the $6.50 treated as foreign-source income is $2.50, computed by multiplying $6.50 times a ratio, the numerator of which is foreign-based production activity assets ($25) and the denominator of which is total production activity assets ($65).[21]

The regulations contain an antiabuse rule that provides that the District Director may make appropriate adjustments to more clearly reflect the source of the gross income from production activity if the taxpayer has entered into or structured one or more transactions with a principal purpose of reducing its U.S. tax liability by manipulating the production activity formula (Treas. Reg. Sec. 1.863-3(c)(1)(iii)). An example provided in the regulations relates to a U.S. taxpayer selling its

[21]Adapted from Treas. Reg. Sec. 1.863-3(c)(1)(iv), example 1.

U.S. production assets to an unrelated U.S. corporation and then leasing them back with the express purpose of treating its gross income related to production activities as foreign-source income (Treas. Reg. Sec. 1.863-3(c)(1)(iv), example 3). This provision counteracts a Tax Court decision that held that leased property was to be excluded from the definition of production activity property for purposes of the 50/50 method.[22]

Gross Income Attributable to Sales Activity. The remaining one-half of the gross income from section 863 sales is apportioned based on the taxpayer's gross sales of the relevant product within or outside the United States for the taxable year (Treas. Reg. Sec. 1.863-3(c)(2)). The source of such gross income is determined using the title passage rules described in Treas. Reg. Sec. 1.861-7(c). The regulations caution that gross income from sales of inventory wholly produced in the United States and sold for use or consumption in the United States will be treated as U.S. source income regardless of where title passes. Inventory will be treated as wholly produced in the United States if it is subject to no more than packaging, repackaging, labeling, or other minor assembly operations outside the United States (Treas. Reg. Sec. 1.863-3(c)(2)).

Independent Factory Price (IFP) Method

In lieu of the 50/50 method, taxpayers can elect to allocate gross income between production and sales activities using the independent factory price (IFP) method (Treas. Reg. Sec. 1.863-3(b)(2)(i)). Before this election can be made, the IFP must be fairly established. An IFP is fairly established only if the taxpayer *regularly sells* part of its output to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income earned from production activity (Treas. Reg. Sec. 1.863-3(b)(2)(i)). These regulations further state that a sale will not be deemed to fairly establish an IFP if the taxpayer's sales activity related to the sale is significant in relation to all of the activities with respect to the product.

Under the IFP method, the *gross sales price* equal to the IFP is treated as attributable to production activity (Treas. Reg. Sec. 1.863-3(b)(2)(ii)). The excess of the gross sales price over the IFP is treated as attributable to sales activity. Gross income from production and sales activities is

[22]*Phillips Petroleum*, 101 T.C. 78 (1993).

determined by reducing the amount of gross receipts allocating to each activity by the cost of goods sold properly attributable to each activity (Treas. Reg. Sec. 1.863-3(b)(2)(iii)). In most cases, cost of goods sold will be allocated to production activity. The *source* of the gross income (U.S. or foreign) allocated to production and sales activities is determined using the same source rules that apply to the 50/50 method (Treas. Reg. Sec. 1.863-3(c)(1) and (2)).

> *Example* 5.8. U.S. Corporation (USCo) manufactures goods for sale in the United States and Europe. The manufacture of the goods takes place in the United States. U.S. plant and equipment used to manufacture the goods has an average adjusted basis for the year of $200. USCo sells the goods in Germany to GP, an unrelated purchaser for $20, with title passing outside the United States. Cost of goods sold is $13, entirely attributable to production activity. USCo does not engage in significant sales activity in relation to its other activities in the sales to GP. The sale to GP establishes an IFP of $20. As a result, $20 of the gross sales price is treated as attributable to production activity, and no amount of income from this sale is attributable to sales activity. After reducing the gross sales price by the $13 cost of goods sold, $7 of the gross income is treated as attributable to production activity. The gross income is entirely U.S.-source income because USCo's production activity assets are located entirely within the United States.[23]

The IFP method must be applied to all Section 863 Sales of inventory that are substantially similar in physical characteristics and function, and which are sold at a similar level of distribution as the inventory sold in the sale that fairly established the IFP (Treas. Reg. Sec. 1.863-3(b)(2)(ii)). In addition, only the IFP method can be applied to sales that are "reasonably contemporaneous" with the sale that fairly established the IFP. An IFP cannot be applied to sales in other geographic markets that are substantially different. Once elected, the IFP method must be used for all years in which an IFP can be established for any product sold in a Section 863 Sale. Gross income from sales for which an IFP cannot be established is sourced using either the 50/50 method or the books and records method.

The final regulations issued with respect to the IFP method are effective for taxable years beginning after 1996 and supersede Notice 89-10.[24]

[23]Adapted from Treas. Reg. Sec. 1.863-3(b)(2)(iv), example 1.

[24]1989-1 C.B. 631. See also the preamble to the proposed regulations under Treas. Reg. Sec. 1.863-3 issued on December 7, 1995.

Books and Records Method

Treas. Reg. Sec. 1.863-3(b)(3) allows the taxpayer to elect to bifurcate its gross income from Section 863 Sales between production and sales activities using its books of account, provided the taxpayer has received advance permission of the district director having audit responsibility over its tax return. The taxpayer must establish to the satisfaction of the district director that the taxpayer, in good faith and unaffected by considerations of tax liability, will regularly employ in its books of account a detailed allocation of receipts and expenditures that *clearly reflects* the amount of the taxpayer's income from production and sales activities. (Under the prior regulations, the taxpayer had to establish that its books of account *more clearly* reflected the amount of income from production and sales activities.) The source of the gross income allocated to the production and sales activities is determined using the source rules under Treas. Reg. Sec. 1.863-3(c)(1) and (2). This method is so rarely used in practice that the Treasury Department considered eliminating it as an option when it issued proposed regulations in 1995.

Computing Taxable Income From Section 863 Sales

The final regulations under Treas. Reg. Sec. 1.863-3 direct the taxpayer to properly allocate and apportion expenses, losses, and other deductions to gross income from section 863 sales after determining its source using one of the three source methods (Treas. Reg. Sec. 1.863-3(d)). If the taxpayer uses the IFP method or the books and records method, expenses, losses, and other deductions are to be allocated and apportioned to gross income from within and outside the United States using the rules of Treas. Reg. Sec. 1.861-8 through 1.861-14. If the taxpayer uses the 50/50 method, expenses, losses, and other deductions allocated and apportioned to such gross income are to be apportioned between sources within and outside the United States pro rata based on the relative amounts of gross income sourced within and outside the United States determined under the 50/50 method.

Special rules apply if the taxpayer deducts research and experimental expenses under section 174. If the taxpayer elects the IFP method or the books and records method, all expenses, losses, and other deductions, must be further allocated to the respective amounts of gross income from each relevant product category that the taxpayer uses in apportioning the research and experimental expenses (see Research and Experimental

Expenditures, below). If the taxpayer uses the 50/50 method, the research and experimental expenses are allocated using the rules under Treas. Reg. Sec. 1.861-17 and are not allocated pro rata, as are the other expenses.

Election and Reporting Rules

The taxpayer must elect to use either the IFP method or the books and records method. The taxpayer elects the IFP method or the books and records method by using the method on a timely filed original return, including extensions (Treas. Reg. Sec. 1.863-3(e)(1)). The taxpayer must have received permission from its District Director to apply the books and records method. Once a method has been elected, the taxpayer must continue to use the method in future years unless the commissioner of internal revenue consents to a change. If the taxpayer wishes to change to or from the books and records method, such request must be made to its District Director and not the commissioner of internal revenue.

Treas. Reg. Sec. 1.863-3(e)(2) states that a taxpayer using one of the three source methods under Treas. Reg. Sec. 1.863-3(b) must fully explain in a statement attached to the tax return the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income allocated.

Policy Issues Related to Section 863 Sales

The source rules related to section 863 sales have been very controversial, particularly the 50/50 method. Section 863 sales are a critical tax planning strategy for U.S. corporations with excess foreign tax credits. The 50/50 method allows the taxpayer to create zero or low-taxed foreign source income on export sales by passing title outside the United States. (The extent to which gross income from export sales is subject to foreign tax often depends on whether the taxpayer has a permanent establishment in the country into which the goods are sold or whether the United States has a treaty with such country that exempts export sale income from taxation in the country in which the goods are sold.[25])

At issue is whether the 50/50 method reflects the "economics" of the transaction. Empirical studies seem to indicate that net income from manufacturing is generally higher than from sales (wholesaling). In response to a congressional mandate in the Tax Reform Act of 1986, the

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[25]See *Intel Corp.*, 100 T.C. 616 (1993), as an example.

U.S. Treasury issued a report on Section 863 Sales in 1993.[26] The Treasury estimated the U.S. government forgoes $1 in lost taxes in exchange for 63 cents in increased exports under the so-called *export source rule*. Subsequent economic studies have produced conflicting results on whether these rules are an efficient subsidy for U.S. exports and U.S.-based manufacturing (including employment).[27]

The Clinton administration has recommended replacing the current Section 863 Sales source rules with an "activity-based" rule that would source income from section 863 sales based on where the activity producing the income takes place. To date, U.S. multinational companies have been successful in lobbying Congress to retain the existing rules.

Other Applications of Section 863(b)

The rules of section 863(b) also apply to services rendered partly within and outside the United States and to purchases of inventory within a possession of the United States and its sale or exchange within the United States (Treas. Reg. Sec. 1.863-3(f)).

Underwriting Income

Section 861(a)(7) states the general rule that underwriting income is sourced based on the location of the risk incurred. Such income would be sourced within the United States if the property or activity insured is located within the United States or the income relates to the insurance of the lives or health of U.S. residents.

Transportation Income

Gross income attributable to transportation that begins and ends in the United States is treated as U.S.-source income (section 863(c)(1)). Income from transportation that begins or ends in the United States is

[26] U.S. Department of the Treasury, *Report to the Congress on the Sales Source Rules* (Washington, DC: National Technical Information Service, 1993).

[27] See Donald J. Rousslang, "The Sales Source Rules for U.S. Exports: How Much Do They Cost?", *Tax Notes International* (February 21, 1994): 527–538, and Gary C. Hufbauer and Dean A. DeRosa, "Costs and Benefits of the Export Source Rule," *Tax Notes* (June 9, 1997): 1401–1412.

sourced one-half within the United States. This rule applies to both U.S. and foreign persons.

Transportation income includes income from the use, hiring, or leasing of a vessel or aircraft, or the performance of services directly related to the use of a vessel or aircraft (section 863(c)(3)). Income derived from the lease of a vessel that is not used to transport cargo or persons for hire is not treated as transportation income, but rather as income derived from an ocean activity and sourced using the rules of section 863(d). Personal service income is considered transportation income only if the transportation begins (ends) in the United States and ends (begins) in a U.S. possession.

Example 5.9. A cargo vessel leaves from a port in Belgium with an ultimate destination of New York. During its journey, the vessel makes intermediate stops in France and Portugal. Under section 863(c), one-half of the gross income attributable to cargo carried from Belgium, France, and Portugal will be considered U.S.-source. Any income from cargo offloaded in France or Portugal before arrival in New York is sourced outside the United States.

Income derived from furnishing round-trip travel beginning or ending in the United States is treated as transportation income that begins (for the outbound portion) and ends (for the inbound portion) in the United States. Therefore, one-half of the gross income attributable to the outbound portion is sourced within the United States, and one-half of the gross income attributable to the inbound portion is sourced within the United States.

Example 5.10. Northeast Airlines makes a round-trip flight from Boston to London. Gross income attributable to the flight from Boston to London will be sourced one-half within the United States, as will one-half of the income attributable to the return flight from London to Boston.

The Internal Revenue Service has held that income earned from the transportation of crude oil from foreign countries to deep-water ports (in particular, the Louisiana Offshore Oil Port) should be sourced under section 863(c)(2) as being 50-percent U.S.-source income.[28] Most U.S. treaties exempt such income from U.S. taxation, however.

[28]Internal Revenue Service, *Coordinated Issue Paper on Section 863(c)(2) Source of Income from Transportation between Foreign Country Ports and U.S. Deep Water Ports*, Issued Sept. 18, 1996.

Ocean and Space Activities

Taxable income derived from a space or ocean activity is sourced as within the United States if it is realized by a U.S. person (section 863(d)). If such income is realized by a foreign person, it is sourced entirely outside the United States (that is, a country-of-residence test is applied). Space or ocean activities are defined to mean any activity conducted in space and any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States itself. Ocean activities include activities performed in Antarctica.

Examples of the types of activities covered by these rules are services performed or provided in space or on or beneath the ocean, the leasing of equipment for use on or beneath the ocean or in space (for example, spacecraft and satellites), the licensing of technology or other intangibles for use in space or on or beneath the ocean, and the manufacturing of property in space or on or beneath the ocean. Specifically excluded from the definition of space or ocean activities are activities giving rise to transportation income or international communications income and activities with respect to mines, oil and gas wells, or other natural deposits to the extent the mines or wells are located within the jurisdiction of any country (including the United States).

International Communications Income

International communications income derived by U.S. persons is sourced one-half within the United States and one-half outside the United States (section 863(e)). If such income is derived by foreign persons, it is sourced entirely outside the United States. However, if the foreign person derives international communications income from an office or fixed place of business in the United States, all such income attributable to such office is treated as sourced entirely within the United States.

International communications income includes all income derived from the transmission of communications or data from the United States to any foreign country (or possession of the United States) and vice versa. It includes income from the transmission of signals, images, and sounds or from data transmitted by buried or underwater cable or by satellite. Income derived from transmission of telephone calls between two countries would be international communications income. Communication

between two points within the United States is not international communications income even though it is routed through a satellite located in space. Such income also does not include income attributable to the communication between a U.S. source and a vessel at sea or an airborne plane outside the jurisdiction of any foreign country.

Natural Resources

Treas. Reg. Sec. 1.863-1(b) states that gross receipts from the sale outside (within) the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber located within (outside) the United States must be allocated between U.S. and foreign sources based on the product's fair market value at the export terminal. The source of gross receipts equal to the product's fair market value at the export terminal is treated as from sources where the farm, mine, well, deposit, or uncut timber is located. Any excess gross receipts are sourced based on the following criteria:

- If the taxpayer engages in additional production activities subsequent to shipment from the export terminal and outside the country of sale, the source of excess gross receipts is determined using the source rules under Treas. Reg. Sec. 1.863-3. Only those production activity assets used in the additional production activity subsequent to the export terminal are taken into account (Treas. Reg. Sec. 1.861-3(b)(1)(i)).
- In all other cases (that is, where the additional production takes place in the country of sale or the taxpayer does not engage in additional production), excess gross receipts are treated as from sources within the country of sale (Treas. Reg. Sec. 1.861-3(b)(1)(ii)).

Example 5.11. US Gold, a U.S. corporation, mines gold in Mexico, produces gold jewelry in the United States, and sells the jewelry in Europe. The fair market value of the gold at the export terminal in Mexico is $40, and US Gold ultimately sells the jewelry for $100. Costs of goods sold is $20, resulting in gross income of $80 on the sale. All of the production assets related to the subsequent production activity are located in the United States. Title to the jewelry passes outside the United States.

1. $40 of the gross receipts is treated as from sources outside the United States (that is, the fair market value of the gold at the export terminal).
2. The remaining $60 of gross receipts ($100 − $40) must be allocated using an apportionment method under Treas. Reg. Sec. 1.863-3(b).

3. If US Gold uses the 50/50 method, 50 percent ($20) of the remaining gross income of $40 ($60−$20) will be attributable to U.S. sources because all of the production assets used in the subsequent production are located within the United States. The remaining $20 of gross income is treated as from outside the United States because title to the jewelry passed outside the United States.[29]

Prior regulations under Treas. Reg. Sec. 1.863-3(b) held that the source of gross receipts from the sale of natural resources was determined using the location of the natural resource (that is, the mine, oil well, forest). This interpretation was overturned by the Tax Court in *Phillips Petroleum Co.*[30] In this case, the taxpayer successfully argued that the source rules under Treas. Reg. Sec. 1.863-3 should be applied to sales of natural resources (in this case, sales of natural gas extracted in Alaska and sold to Japan). The Tax Court subsequently also allowed the taxpayer to use the 50/50 method in making the source allocation.[31] The Treasury responded by issuing the current regulations under Treas. Reg. Sec. 1.861-1(b), which treat sales of natural resources as Section 863 Sales, but which reach essentially the same result as the previous regulations. Included in the current regulations is an example that replicates the facts in *Phillips* and reaches the same conclusion as under the prior regulations.[32]

In the 1993 Tax Act, Congress mandated that gross income from the sale of any unprocessed timber that is softwood and was cut within the United States is treated as U.S.-source income (section 865(b)). *Unprocessed timber* includes any log, cant, or similar form of timber. This provision was enacted because Congress was concerned that the prior source rules encouraged the cutting of old-growth forests and fostered the "export" of U.S. milling jobs outside the United States.

Partnership Income

There are no source-of-income rules under sections 861-865 specifically dealing with partnership income. However, sections 701 through 708, which deal with the taxation of partners and partnerships, provide guid-

[29]Adapted from Treas. Reg. Sec. 1.863-1(b)(7), example 3.

[30]101 T.C. 78 (1993).

[31]*Phillips Petroleum Co.*, 101 T.C. 78 (1993).

[32]Treas. Reg. Sec. 1.863-1(b)(7), example 2.

ance on this determination. Under these sections, the general principle is that a partnership is a conduit for the partners. Income, gains, expenses, and losses incurred by a partnership retain their same character when recognized by the partners (Treas. Reg. Sec. 1.702-1(b)).

By applying the same principle, the source of income in the hands of the partnership determines the source of income for the partners, calculated by dividing the partnership income into component parts and applying the source-of-income rules of sections 861–865 to the various parts. This general rule holds true regardless of whether a domestic or foreign partnership is involved.

An exception to this general rule exists for income received by a partner from a partnership under section 707(c), relating to guaranteed payments without regard to the income of the partnership, and under section 707(a), regarding transactions with the partnership by a partner in a capacity other than as partner. Such types of income from partnerships are different because the income is not a distributive share of partnership income. The source of such income is determined without regard to the income of the partnership. In the case of guaranteed payments, the income would be sourced based on where the partner performed the services related to such payments.

Income From S Corporations

Income or losses of a corporation making an election under subchapter S are treated in a similar manner to those items realized by a partnership. Section 1366(b) provides that the character of any item included in the shareholder's pro rata share of income has the same source as was realized by the S corporation. Therefore, if the S corporation has either a foreign-source loss and income from U.S. sources or foreign-source income and a U.S.-source loss, these items retain their separate sources and cannot be netted against one another before being passed through to the shareholder.

Trust and Estate Income

The conduit principle discussed previously for partnership income also should apply to determining the source of trust or estate income, because distributions to beneficiaries from trusts or estates retain the same character as they do in the hands of the trust or estate.

In the absence of a trust instrument specifically allocating classes of income to different beneficiaries, the Internal Revenue Code states that the classes of income for such trust and also for an estate shall be allocated pro rata to the beneficiaries based on the ratio of the total income of that class to total distributable net income (sections 652(b) and 662(b)). Presumably this method would apply for determining the sources of income for each beneficiary when the income of a trust or estate is from sources both within and outside the United States.

Income Attributable to Certain Notional Principal Contracts

Income from a notional principal contract is sourced by reference to the taxpayer's residence (Treas. Reg. Sec. 1.863-7(b)(1)). A notional principal contract is defined in Treas. Reg. Sec. 1.863-7(a)(1) as "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts." Both the notional principal amount and each of the payments under the agreement must be denominated in terms of the taxpayer's functional currency.

Two exceptions apply to this source rule. If a taxpayer who is a U.S. resident owns a foreign qualified business unit (as defined in section 989(a)) that is the only active and material participant in negotiating and acquiring the notional principal contract, the income from such contract will be sourced using the residence of the qualified business unit (Treas. Reg. Sec. 1.863-7(b)(2)). In addition, if the notional principal income arises from the conduct of a U.S. trade or business, such income will be sourced in the United States (Treas. Reg. Sec. 1.863-7(b)(3)).

Scholarships and Fellowship Grants

The source of a scholarship or fellowship grant is generally determined by the payor's residence (Treas. Reg. Sec. 1.863-1(d)). Under this general rule, scholarships awarded by a U.S. citizen or resident, a domestic corporation, the U.S. government, a state, or the District of Columbia are treated as U.S.-source income. This source rule reflects the opinion of the Internal Revenue Service that the payor's residence, and not the place

where the recipient studies, is the "principal economic nexus with the payments."[33]

The regulations treat targeted grants made by tax-exempt organizations and the U.S. or state governments to foreign persons who will conduct their activities outside the United States as from sources outside the United States (Treas. Reg. Sec. 1.863-1(d)(2)(iii)). A targeted grant is a grant for an activity undertaken in the public interest and not primarily for the private financial benefit of a specific person or persons or organization (Treas. Reg. Sec. 1.863-1(d)(3)(v)).

Sale and License of Software Programs

In November 1996, the Treasury Department issued long-awaited proposed regulations dealing with the sale and license of software programs, and final regulations were issued in September 1998 (Treas. Reg. Sec. 1.861-18). At issue were two questions: (1) How should software programs be classified; and (2) What distinguishes a "sale" from a "license" of software.

Under the Treas. Reg. Sec. 1.861-18(b), a transfer of software must be classified in one of four ways:

- A transfer of a copyright right in the computer program;,
- A transfer of a copy of the computer program (a copyrighted article);
- The provision of services for the development or modification of the computer program, or
- The provision of know-how relating to computer programming techniques.

The classification determines the source rule used. Transfers of a copyright right will be treated as a sale or license generating royalty income, whereas transfers of a copyrighted article will be treated as a sale or license generating rental income (Treas. Reg. Sec. 1.861-18(f)(1) and (2)).

A transfer will be of a copyright right if one of four copyright rights is transferred (otherwise the transfer is treated as a copyrighted article):

[33]Rev. Rul. 89-67, 1989-1 C.B. 233.

- The right to make copies of the computer program for distribution to the public;
- The right to prepare derivative computer programs based on the copyrighted computer programs;
- The right to make a public performance of the computer program; or
- The right to publicly display the computer program (Treas. Reg. Sec. 1.861-18(c)(2)).

The most common type of transaction, the transfer of "shrink-wrapped" computer programs, is treated as the transfer of a copyrighted article (such as the sale of a book) provided the transferee does not have the right to reproduce and sell the program or modify the program. The final regulations define a "shrink-wrapped" licensed program as one in which the "disks are placed in boxes covered with a wrapper on which is printed what is generally referred to as a shrink-wrap license. The license is stated to be perpetual." (Treas. Reg. Sec. 1.861-18(h), example 1).

Whether a transfer is treated as a sale or license has important implications for determining the source of income from the transaction. The Section 863 Sales rules apply to a sale (applying the 50/50 method, 50 percent of the gross income from the sale of a U.S.-manufactured software program can be treated as foreign source if title passes outside the United States). The royalty source rules apply to a license (the entire profit has its source based on where the intangible is used).

The regulations state that if the "benefits and burdens of ownership" are transferred (that is, the purchaser can use the program in perpetuity), the transaction is treated as a sale (Treas. Reg. Sec. 1.861-18(f)(2)). If use is restricted to a certain time period, the transfer is treated as a license.

Example 5.12. Macrosoft Corporation, a U.S. corporation, owns the copyright in a computer program, Doors2000. The company copies the program onto disks. The disks are placed in boxes covered with a wrapper on which is printed what is generally referred to as a shrink-wrap license. The license is stated to be perpetual. Under the license, the purchaser is not permitted to alter the program. In addition, the purchaser receives the right to use the program on two of its computers (for example, a laptop and desktop) provided that only one copy is in use at any time. According to the regulations (Reg. §1.861-18(h), example 1), a sale of this program to a purchaser outside the United States is treated as the sale of a copyrighted article. Therefore, gain from sale of the program has its source based on the rules under section 863(b).

Items of Gross Income Not Listed in Sections 861 and 862

Section 863(a) provides the Treasury Department with the authority to prescribe source rules for items of gross income not listed in sections 861 and 862. Such income includes alimony, prizes, fellowships, cancellation of debt income, recovery of deducted items, annuity payments, compensation for injuries or sickness, damages for breach of contract, windfalls, and gains on the surrender of life insurance contracts.

In Rev. Rul. 73-252 (1973-1 C.B. 337), the Internal Revenue Service announced that "in the absence of an overriding Code provision, the main factor in determining the source of income... is whether the location of the property to which the payment related or the situs of the activities that resulted in its being made was in the United States or abroad."

Under this general rule, alimony has been held to have its source based on where the payer resides. In *Housden*[34] a Canadian citizen who was a U.S. resident failed to withhold U.S. taxes on alimony payments to his two ex-wives living in Canada. Under the general rule, the alimony was U.S.-source and met the definition of fixed or determinable, annual or periodic income, which required the taxpayer to withhold U.S. taxes on such payments.

Treaties

Many tax treaties have provisions that modify some of the source-of-income rules stated in the Code. The specific source rules modified and the purposes for modification vary by treaty. Some treaties modify the source rules for purposes of the foreign tax credit calculations; others modify the rules to limit the taxation of foreign persons or permanent establishments on income from U.S. sources; still others modify source rules for specific classes of income or to provide lower tax rates for classes of income (such as royalties, interest, dividends, and wages).

The primary reason why some treaties modify the source-of-income rules for purposes of the foreign tax credit is to help alleviate double taxation. The source of income is important in calculating the limitation of the foreign tax credit and is determined strictly by U.S. laws. Situations may arise in which a U.S. taxpayer pays creditable foreign taxes on cer-

[34] 63 T.C.M. 2063 (1992).

tain income derived in a foreign jurisdiction but, for the treaty provision, would be denied a foreign tax credit against U.S. income tax imposed on that income because the income is not considered foreign-source income under U.S. laws (that is, the numerator of the foreign tax credit limitation formula would be zero). By treating such income as foreign-source income, the treaty permits the U.S. taxpayer to credit any foreign income tax paid on that income against his or her U.S. tax liability.

Allocation and Apportionment of Expenses, Losses, and Other Deductions to U.S.- and Foreign-Source Income

Once a taxpayer has determined gross income from sources within and outside the United States, the next task is to deduct the allowable expenses, losses, and other deductions allocated to such income to compute *taxable income* from sources within and outside the United States. The statutory authority for allocating expenses is found in sections 861(b), 862(b), and 863(a). The statutes, however, provide only very general statements, which are inadequate for application to specific situations. Section 861(b) states, for example, that "there shall be deducted the expenses, losses, and other deductions properly apportioned and allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income." Section 863(a) delegates power to the Secretary of the Treasury to prescribe specific regulations to implement this general allocation statement to fact-specific situations.

The first regulations dealing with the computation of taxable income from sources within and outside the United States were issued in 1957 under Treas. Reg. Sec. 1.861-8, but they did little more than restate the statute itself. For several years the Treasury Department attempted to revise Treas. Reg. Sec. 1.861-8. Proposed regulations were first issued in August 1966. They attracted considerable criticism and were withdrawn, and new regulations proposed in June 1973 were also subsequently withdrawn. New proposed regulations were issued in November 1976 and made final in January 1977. In September 1987 proposed and temporary regulations were issued to update the regulations for changes made in the Tax Reform Act of 1986 and to implement new sections 864(e)(1) and (e)(5). These rules were replaced by proposed and temporary regulations issued in September 1988.

The general objective of Treas. Reg. Sec. 1.861-8 is to allocate deductions based on the factual relation of an expenditure to, or its identification with, gross income rather than the specific purpose of the expenditure. Treas. Reg. Sec. 1.861-8(a)(2) states, as follows:

> A taxpayer to which this section applies is required to *allocate* deductions to a *class* of gross income and, then, if necessary to make the determination required by the *operative section* of the Code, to *apportion* deductions within the class of gross income between the *statutory groupings* of gross income (or among the statutory groupings) and the *residual grouping* of gross income [emphasis added].

All deductions must be allocated and apportioned using the rules of this regulation unless the deduction is "not definitely related" to a class of gross income, in which case the deduction is ratably apportioned to all gross income.

A deduction that is determined to be definitely related to a class of gross income must be allocated to and deducted from such income. A *class* of gross income is defined to be the gross income to which a specific deduction is *definitely related* and may consist of one or more *items* of gross income listed in section 61 (for example, compensation for services, gross income derived from business, gains derived from dealings in property, interest, rents, royalties, dividends, alimony, annuities, and distributive share of partnership gross income) (Treas. Reg. Sec. 1.861-8(a)(3)). Classes of gross income are not predetermined but must be determined on the basis of the deductions to be allocated.

A deduction is considered definitely related and therefore allocable to gross income if it is incurred as "a result of, or incident to, an activity or in connection with property from which the class of gross income is derived" (Treas. Reg. Sec. 1.861-8(b)(2)). Deductions must be allocated based on the factual relationship that exists between the deduction and the class of gross income. The allocation is made to a class of gross income whether or not there exists any income in such class for the current taxable year or whether the deduction allocated exceeds the gross income in such class.

Treas. Reg. Sec. 1.861-8(b)(1) states: "Although most deductions will be definitely related to some class of a taxpayer's total gross income, some deductions are related to all gross income." If a deduction is not definitely related to a specific class of gross income, all of the taxpayer's gross income will be considered a single class of gross income for purposes of apportioning the deduction between statutory and residual groupings of gross income. Examples of deductions that are not definitely related are

listed in Treas. Reg. Sec. 1.861-8(e)(9) and include medical expenses, alimony, and real estate taxes on a personal residence.

The allocation of expenses to different classes of income becomes important if the taxpayer is required by statute to determine taxable income from specific sources or activities. The gross income from a specific source or activity that must first be determined to arrive at taxable income from such specific source or activity is referred to as a *statutory grouping* of gross income (Treas. Reg. Sec. 1.861-8(a)(4)). The specific section of the Code that requires the determination of taxable income from specific sources or activities and that gives rise to the statutory grouping is referred to as the *operative section*. Gross income from sources or activities other than those relating to the statutory grouping or groupings is referred to as the *residual grouping*.

> *Example 5.13.* Section 904(d)(1)(A) requires the taxpayer to make a separate foreign tax credit limitation calculation for "passive income." The income within this separate limitation category constitutes a statutory grouping of income. All other income not within this separate limitation category (whether from U.S. sources or within a different separate limitation category) is the residual grouping in this calculation. In this example, section 904(d)(1)(A) is the operative section.

Deductions that have been allocated to a class of gross income must be apportioned between the statutory and residual groupings within that class of gross income (Temp. Treas. Reg. Sec. 1.861-8T(c)(1)). If the class of gross income to which a deduction has been allocated consists entirely of a single statutory grouping or the residual grouping, there is no need to apportion that deduction. Deductions that are definitely related to a class of gross income are to be apportioned using a method that reflects the factual relation between the deduction and the grouping of gross income. Treas. Reg. Sec. 1.861-8(c)(1) lists some of the relevant bases and factors for such apportionment:

- Comparison of units sold
- Comparison of the amount of gross sales or receipts
- Comparison of costs of goods sold
- Comparison of profit contribution
- Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent that are attributable to the activities or properties giving rise to the class of gross income
- Comparison of the amount of gross income

A taxpayer may be required to apportion interest expense on the basis of assets (Temp. Treas. Reg. Sec. 1.861-8T(c)(2)). A taxpayer may apportion other expenses on the basis of assets, provided the method reflects the factual relation between the deduction and the groupings of income. Apportionment based on assets may be made either on the basis of tax book value or fair market value. A taxpayer who elects the fair market value method must continue to use this method unless the commissioner expressly allows for a change.

If a deduction is not definitely related to any gross income, the deduction is apportioned ratably between the statutory grouping and the residual grouping. The apportionment is based on the proportion of gross income in the statutory grouping (residual grouping) to total gross income (Treas. Reg. Sec. 1.861-8(c)(3)).

Allocation and Apportionment of Certain Deductions

Treas. Reg. Sec. 1.861-8(e) provides special rules for allocating and apportioning the following deductions:

1. Interest
2. Research and experimental expenditures
3. Stewardship expenses attributable to dividends received
4. Legal and accounting fees and expenses
5. Income taxes
6. Losses on the sale, exchange, or other disposition of property
7. Net operating loss deduction
8. Deductions that are not definitely related
9. Special deductions
10. Charitable contributions

The deductions for personal and dependency exemptions are not taken into account for purposes of allocation and apportionment under Treas. Reg. Sec. 1.861-8.

Section 864(e)

Congress enacted section 864(e) in the Tax Reform Act of 1986 to provide additional rules for allocating interest and other deductions. The pri-

mary intent behind enactment of these rules was to treat affiliated groups of corporations as one taxpayer in apportioning non-definitely-related expenses (section 864(e)(1)) and to prohibit the use of the gross income method of allocating interest (section 864(e)(2)).

Section 864(e)(3) further provides that tax-exempt assets (and income from such assets) are not taken into account in allocating or apportioning any deductible expense. Stock that generates dividend income eligible for the dividends-received deduction under section 243 is treated as a tax-exempt asset to the extent of the dividends-received deduction (that is, 70 percent of the stock is considered a tax-exempt asset if the corporation owns less than 20 percent of the value or voting power of the stock, and 80 percent of the stock is considered tax-exempt if the corporation owns 20 percent but less than 80 percent of the value or voting power of the stock).

Section 864(e)(4) requires that if the "tax book value" method of apportionment is used, the basis in the stock of a 10-percent-owned (but less than 80-percent-owned) domestic corporation and in the stock of a 10-percent-or-more-owned foreign corporation must be increased by the amount of (or reduced by the deficit in) earnings and profits of the corporation attributable to that stock and accumulated during the period the taxpayer held it.

Finally, Section 864(e)(6) states that expenses other than interest that are not directly allocable and apportioned to any specific income-producing activity shall be allocated and apportioned as if all members of the affiliated group were a single corporation. This rule is commonly referred to as the one-taxpayer rule.

The Secretary of the Treasury is authorized to write regulations to carry out the purposes of section 864(e). Interestingly, the proposed and temporary regulations for these sections were issued under Treas. Reg. Sec. 1.861 because the Treasury Department believed that taxpayers looking for guidance on these issues would turn to this regulation first.

The proposed and temporary regulations issued to implement section 864(e) have been controversial, especially with respect to interest allocation. Compliance with these rules is administratively burdensome and requires significant record keeping by the taxpayer.

Interest Expense

Congress made significant changes to the allocation of interest expense in the Tax Reform Act of 1986, reflecting its concern that U.S. tax-

payers were manipulating the prior rules to apportion the maximum interest expense against U.S.-source income (thus maximizing the foreign tax credit limitation ratio). In addition to section 864(e), the allocation and apportionment of interest is subject to Temp. Treas. Reg. Sec. 1.861-8T(e)(2) and Temp. Treas. Reg. Secs. 1.861-9T through 1.861-13T. The principles on which these rules are based, as enunciated in the preamble to the proposed regulations, can be summarized as follows:

1. In general, money is fungible and interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which the interest is paid.
2. All activities and property require funds, and management has a great deal of flexibility as to the source and use of funds.
3. Creditors of a taxpayer normally subject money advanced to a taxpayer to the risk of the taxpayer's entire activities and look to the general credit of the taxpayer for payment of the debt.
4. Money borrowed for a specific purpose will free funds for other purposes, and it is reasonable to attribute part of the cost of borrowing to such other purposes.
5. In general, the aggregate of deductions for interest is considered related to all income-producing activities and properties of the taxpayer and, thus, is allocable to all the gross income that the activities and properties generate, have generated, or could reasonably have been expected to generate.

Allocation and Apportionment of Interest Expense

The general rules applying to the allocation and apportionment of interest expense are found in Temp. Treas. Reg. Sec. 1.861-9T. For purposes of these rules, interest expense includes any expense that is deductible under section 163 (including original issue discount). The term *interest* as it is used in this section refers to the gross amount of interest expense incurred by a taxpayer in a given taxable year. Temp. Treas. Reg. Sec. 1.861-9T(b) lists certain interest equivalents that are treated as interest expense for purposes of allocation and apportionment.

The apportionment of interest expense must, in most cases, be based on the *asset method* (Temp. Treas. Reg. Sec. 1.861-8T(c)(2)). Apportionment under the asset method may be based on either tax book value or fair market value (Temp. Treas. Reg. Sec. 1.861- 9T(g)(1)(ii)).

The fair market value method must be used by all related parties (as defined in section 267(d)) if one of the parties makes the election. The fair market value election cannot be revoked without the permission of the commissioner of internal revenue.

Under the asset method, assets are attributed to statutory groupings based on the source and type of income they generate, have generated, or may reasonably be expected to generate (Treas. Reg. Sec. 1.861-9(g)(3)). The physical location of the assets is irrelevant to the determination. Assets involved in the production of inventory must be categorized based on the source rules for each sale of inventory.

Assets are valued under either method by taking the average of tax book value or fair market value at the beginning and end of the tax year (Temp. Treas. Reg. Sec. 1.861-9T(g)(1)(i)). A qualified business unit of a domestic corporation may compute the average values in units of its functional currency and translate the values into dollars using the exchange rate on the last day of the taxpayer's taxable year (Temp. Treas. Reg. Sec. 1.861-9T(g)(2)(ii)). Special valuation rules apply to an affiliated group that elects to use the fair market value method of apportionment (Temp. Treas. Reg. Sec. 1.861-9T(h)).

Example 5.14. U.S. Corporation (USCo) reports interest expense of $150,000 for 1999. USCo uses the tax book value method to apportion interest. The average tax book value of its assets is $3.6 million. Assets with an average book value of $3 million generated domestic-source income during 1999, and assets with an average tax book value of $600,000 generated foreign-source general limitation income as defined by section 904(d)(1)(I). The $150,000 interest expense will be apportioned $125,000 to domestic-source income ($3,000,000/$3,600,000 × $150,000) and $25,000 to foreign-source general limitation income ($600,000/$3,600,000 × $150,000).[35]

Example 5.15. Assume the same facts as in example 5.13 except that USCo apportions interest expense using the fair market value method. USCo's total assets have a fair market value of $4 million, of which $3.2 million generates domestic-source income and $800,000 generates foreign-source general limitation income. The interest expense will be apportioned $120,000 to domestic-source income ($3,200,000/$4,000,000 × $150,000) and $30,000 to foreign-source general limitation income ($800,000/$4,000,000 × $150,000).[36]

[35] Temp. Treas. Reg. Sec. 1.861-9T(g)(1)(v), example 1.

[36] Temp. Treas. Reg. Sec. 1.861-9T(g)(1)(v), example 2.

Asset Classification for Purposes of Apportionment

For purposes of making the interest apportionment, assets are divided into the following three groups (Temp. Treas. Reg. Sec. 1.861-9T(g)(3)):

1. *Single-category assets*—assets that generate income that is exclusively within a single statutory grouping or residual grouping. These assets are directly attributable to the relevant statutory or residual grouping.
2. *Multiple-category assets*—assets that generate income within more than one grouping of income (statutory or residual). The value of each asset is prorated among the groupings of income based on the proportion of gross income generated by it within each relevant grouping.
3. *Assets without identifiable yield*—assets that produce no directly identifiable income yield or that contribute equally to the generation of all the income of the taxpayer (for example, assets used in general and administrative functions). Although the values of these assets must be determined, they are not taken into account in computing the ratio of assets within the groupings of income because prorating the value of these assets will not alter the ratio.

Assets Producing Exempt Income

Exempt income is taken into account in allocating deductions that are definitely related to separate classes of gross income (Temp. Treas. Reg. Sec. 1.861-8T(d)(2)(i)(A)). Assets producing exempt income are not taken into account in apportioning deductions for expenses that are definitely related and allocable to a class of gross income consisting of multiple groupings of income or to all gross income (Temp. Treas. Reg. Sec. 1.861-8T(d)(2)(i)(B)).

Exempt income is defined as income that is, in whole or in part, exempt, excluded, or eliminated for federal tax purposes (Temp. Treas. Reg. Sec. 1.861-8T(d)(2)(ii)(A)). *Exempt assets* are any assets producing such income. Exempt assets include stock that produces dividends eligible for the dividends-received deduction under section 243(a)(1) or (2) and section 245(a). Such stock is exempt to the extent of the amount of dividends deductible (70 percent or 80 percent). Exempt assets do not include assets producing income of a foreign person that is not effectively connected to a U.S. trade or business, income of a possessions cor-

poration for which a section 936 credit is taken, and gross income of a DISC or FSC used to compute combined taxable income with a related supplier. The application of these rules is illustrated in the following example:

Example 5.16. U.S. Corporation (USCo) owns 100 percent of Forco, a foreign corporation, and 49 percent of Americo, a domestic corporation. Neither Forco nor Americo has retained earnings and profits. In 1999, USCo reported interest expense of $60,000. USCo apportions its interest expense using the fair market value method. The fair market value of its assets was $1.5 million, which included $100,000 of tax-exempt municipal bonds and the stock of Americo, which had a value of $500,000. All of USCo's assets-generated domestic-source income. The stock investment in Forco had a fair market value of $2 million. The assets of Forco generated solely foreign-source general limitation income. No portion of USCo's interest expense was directly allocable solely to identified property within the meaning of Temp. Treas. Reg. Sec. 1.861-10T.

In the apportionment of interest using the asset method, USCo must exclude assets that generate exempt, eliminated, or excluded income. The municipal bonds are not taken into account because they generate exempt income. Because USCo is entitled to deduct 80 percent of any dividends received from Americo under section 243, 80 percent of the value of the Americo stock ($400,000) is not taken into account as an asset for purposes of apportioning the interest expense. The value of 20 percent of the Americo stock ($100,000) is included in the apportionment. The value of the remaining domestic source assets included in the computation is $900,000.

USCo apportions its interest expense to the statutory grouping of foreign-source general limitation income by multiplying the interest expense ($60,000) by the ratio of the fair market value of the assets that produce taxable foreign-source general limitation income ($2 million) over total worldwide assets that do not produce tax-exempt income ($2 million + $100,000 + $900,000 = $3 million). The interest expense apportioned to the foreign-source general limitation income is $40,000 ($60,000 × $2,000,000/$3,000,000). The remaining interest expense is apportioned to the residual grouping of domestic-source income ($60,000 × $1,000,000/$3,000,000).[37]

[37]Temp. Treas. Reg. Sec. 1.861-8T(g), example (ii).

Allowable Interest Deductions

The interest allocation and apportionment rules apply only to interest expense that is currently deductible (Temp. Treas. Reg. Sec. 1.861-9T(c)). The rules do not apply to interest that is disallowed, suspended, or capitalized. Disallowed interest is not allocated or apportioned. Examples of disallowed interest would be interest described in section 163(h) (disallowed personal interest) and section 265 (interest related to tax-exempt income). Interest required to be capitalized under section 263A is not deductible interest. Interest that is capitalized in inventory or depreciable property is not separately allocated and apportioned when the inventory is sold or the property is depreciated. Capitalized interest is effectively allocated and apportioned as part of the cost of goods sold or depreciation deduction itself.

Suspended interest would be interest treated under section 163(d) (investment interest) and section 469 (interest allocated to a passive activity loss). In the case of suspended interest for passive activity losses, the amount of interest expense suspended is computed by multiplying the suspended passive activity loss by the ratio of passive interest expense over total expenses related to the passive activity. The amount of suspended interest expense that is deductible in a subsequent year is computed by multiplying the portion of cumulative suspended passive activity loss by the ratio of the portion of the cumulative suspended passive activity loss that is deductible in the current year over the cumulative suspended passive activity loss for the prior taxable years.

> *Example 5.17.* On January 1, 1997, Anderson, a U.S. citizen, invested in a passive activity. In 1997, the activity generated a passive activity loss (PAL) of $100 and no passive income. The entire $100 of passive loss was suspended for 1997. Included in the PAL was $10 of interest expense. In 1998 the passive activity generated $50 in passive income and $150 in passive losses, which included $30 of interest expense. The entire $100 of PAL was suspended in 1998, including $20 of the interest expense ($100 × $30/$150). In 1999 the passive activity generated $100 of passive income and no passive losses. Anderson can now deduct $100 of the cumulative PAL of $200 in 1999. The deduction would include $15 of the cumulative suspended interest deduction of $30 ($30 × $100/$200). The $15 interest expense is apportioned as though it were incurred in 1999.[38]

[38]Temp. Treas. Reg. Sec. 1.861-9T(c)(4)(iii), example.

Apportionment Rules for Individuals, Estates, and Certain Trusts

Special apportionment rules apply to individuals, estates, and complex trusts that are beneficially owned by individuals (Temp. Treas. Reg. Sec. 1.861-9T(d)). All deductible interest is allocated to domestic-source income if an individual's foreign-source income (including income excluded under section 911) does not exceed $5,000. Interest that is separately characterized under section 163(h)(2) is subject to the following separate apportionment rules:

1. Interest incurred in the conduct of a trade or business (section 163(h)(2)(A)) is apportioned based on an asset method using the individual's business assets.
2. Investment interest (section 163(h)(2)(B)) is apportioned based on the individual's investment assets.
3. Passive activity interest (section 163(h)(2)(C)) is apportioned based on the individual's passive activity assets. Passive activity interest allocated to an individual from a partnership is subject to special rules applicable to partnerships.
4. Qualified residence interest (section 163(h)(2)(D)) and deductible personal interest are allocated based on a gross income method that includes business, passive activity, and investment income, but excludes income that is exempt under section 911.

Example 5.18. Ripken, a U.S. citizen, is engaged in the active conduct of a business as sole proprietor. Ripken's business generates only domestic-source income. Her stock portfolio generated both domestic-source and foreign-source general limitation income. Ripken's adjusted basis in the stock that generates domestic-source income was $40,000, and her adjusted basis in the stock that generates foreign-source income was $60,000. She incurred $10,000 of qualified residence interest and $4,000 of other interest, which was divided equally between her business and her investment portfolio. Ripken's gross income for the year before any interest apportionment was $50,000 from her business, $4,000 of domestic-source investment income, and $6,000 of foreign-source investment income. She would apportion the interest expense between domestic- and foreign-source income for purposes of computing the foreign tax credit limitations under section 904(d) as follows:

1. The $2,000 interest attributable to her business would be apportioned entirely to domestic-source income because the business assets generate only domestic-source income.

2. The $2,000 of interest expense attributable to investment income would be apportioned based on the tax-adjusted bases of the assets that produce domestic-source and foreign-source passive income. As a result, 40 percent of the $2,000 ($800) would be apportioned to domestic-source income and 60 percent of the $2,000 ($1,200) would be apportioned to foreign-source passive income.
3. The $10,000 of qualified residence interest is apportioned based on Ripken's gross income. She has a total gross income of $60,000, $54,000 of which is domestic-source and $6,000 of which is foreign-source passive income. She would apportion 54/60 of the $10,000 ($9,000) to domestic-source income and 6/60 of the $10,000 ($1,000) to foreign-source passive income.[39]

Interest expense incurred by a nonresident alien is considered connected with income effectively connected with a U.S. trade or business, but only to the extent the interest expense is incurred with respect to liabilities that are entered on the books and records of the U.S. trade or business when incurred or are secured by assets that generate such effectively connected income. Interest expense incurred by a nonresident alien will not be considered effectively connected with a U.S. trade or business to the extent the liabilities on which the interest is incurred exceed 80 percent of the gross assets of the U.S. trade or business.

Estates and complex trusts that are beneficially owned by an individual are treated in the same manner as individuals, except that $5,000 de minimis rule does not apply to trusts.

Special Apportionment Rules for Partnerships

Special apportionment rules also apply to partnerships (Temp. Treas. Reg. Sec. 1.861-9T(e)). A partner's distributive share of interest expense that is not directly allocated to identified property under Temp. Treas. Reg. Sec. 1.861-10T generally is subject to apportionment at the partner's level, after taking into account the partner's allocable share of partnership assets and income-producing activities. A partner's percentage interest in a partnership and a partner's pro rata share of partnership assets are determined by the partner's interest in partnership income for the year.

A corporate partner with a partnership interest of 10 percent or more apportions its distributive share of partnership interest expense by reference to its total assets, including its pro rata share of partnership assets.

[39]Temp. Treas. Reg. Sec. 1.861-9T(d)(1)(v), example.

The apportionment of its distributive share of partnership interest is subject to the special rules of Temp. Treas. Reg. Sec. 1.861-9T(f) relating to corporations.

Individual partners who are general partners or who are limited partners with a direct or indirect partnership interest of 10 percent or more are subject to the apportionment rules of Temp. Treas. Reg. Sec. 1.861-9T(d) on their distributive share of partnership interest. Such persons must classify their distributive share of partnership interest as interest incurred in an active trade or business, as passive activity interest, or as investment interest. In making the apportionment under Temp. Treas. Reg. Sec. 1.861-9T(d), individual partners must take into account their pro rata share of the partnership's assets or gross income. If the asset method is used, individual partners use the partnership's basis for the assets if the tax-adjusted basis method is used and use the fair market value of the assets if the fair market value method is used.

Less-than-10-percent limited partners and less-than-10-percent corporate partners allocate their share of partnership interest expense directly to their distributive share of partnership gross income. The interest expense must be apportioned in accordance with the partner's distributive share of partnership income that is classified into statutory and residual groupings (for example, foreign-source income in each foreign tax credit limitation category and domestic-source gross income). The partnership gross income will be considered passive income in most cases.

In allocating other interest expense, a partner using the asset method will use the basis or fair market value of the partnership interest, not the partner's pro rata share of the partnership assets.

Special Apportionment Rules for Corporations

Corporations are subject to special apportionment rules in Temp. Treas. Reg. Sec. 1.861-9T(f). Domestic corporations must apportion interest expense using the asset method. If a domestic corporation has a foreign branch, the domestic corporation must take the assets of the foreign branch into account and combine its own interest expense with any deductible interest expense incurred by the branch. The branch will continue to compute its currency gain or loss under section 987 by taking into account only its separate income.

> *Example 5.19.* Orchid Inc., a domestic corporation, operates a branch in a foreign country. The corporation has domestic-source gross income of $1,000 and gross foreign-source general limitation income of $500, without

regard to the branch. Orchid Inc. incurred $200 of interest expense. It has a tax-adjusted basis of $6,000 in its assets generating domestic-source income and a tax-adjusted basis of $1,000 in its assets generating foreign-source general limitation income. The branch earned $500 of gross foreign-source general limitation income and incurred $100 of interest expense. The tax-adjusted basis of its assets was $3,000. The interest expense of Orchid Inc. and its branch is combined ($300) and is apportioned between domestic- and foreign-source general limitation income based on the combined tax-adjusted bases of the assets of Orchid Inc. and its branch. Therefore, 60 percent of the interest expense ($180) is apportioned to domestic-source income ($300 × $6,000/$10,000), and 40 percent ($120) is apportioned to foreign-source general limitation income ($300 × $4,000/$10,000).[40]

Special Allocations of Interest Expense

Reference has been made to special rules that allow a taxpayer to deduct interest expense directly against income generated by the assets that were acquired with certain types of debt instruments. These direct allocation rules are described in Temp. Treas. Reg. Sec. 1.861-10T and are exceptions to the complete fungibility-of-money concept. In general, interest expense on "qualified nonrecourse indebtedness" is allocable solely to the gross income generated by the assets acquired, constructed, or improved with the proceeds of such indebtedness.

Qualified nonrecourse indebtedness is defined to be debt that meets the following criteria:

1. The indebtedness on which the interest was paid was specifically incurred for the purpose of purchasing, constructing, or improving identified property that is either depreciable tangible personal property or real property with a useful life of more than one year, or for the purpose of purchasing amortizable personal property with a useful life of more than one year.
2. The proceeds of the borrowing were actually applied to purchase, construct, or improve the identified property.
3. The creditor can look only to the specific property (or any lease or other interest therein) as security for the payment of the principal and interest on the loan.

[40]Temp. Treas. Reg. Sec. 1.861-9T(f)(2), example.

4. It may be reasonably assumed that the cash flow on or from the property will be sufficient in each year of ownership to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payment of principal and interest. Cash flow does not include revenue derived from activities such as sales, labor, services, or the use of other property or the performance of services that are not ancillary and subsidiary to the use of the property. Ancillary and subsidiary expenses would include security, maintenance, and utilities provided to tenants of a building.
5. There are restrictions in the loan agreement on the disposal or use of the property consistent with the assumptions described in 3 and 4.

Qualified nonrecourse indebtedness does not include a transaction that lacks economic significance or involves cross-collateralization, credit enhancement, the purchase of inventory, or the purchase of any financial asset, or constitutes qualified residence interest. These exceptions are more fully explained in the regulations under Temp. Treas. Reg. Sec. 1.861-10T.

The direct allocation rules of Temp. Treas. Reg. Sec. 1.861-10T also do not apply to debt incurred between related persons or debt incurred from an unrelated person for the purpose of purchasing property from a related person. A *related person* is defined as in section 267(b) with the modifications prescribed by Temp. Treas. Reg. Sec. 1.861-8T(c)(2). Interest on identified property that is leased to a related person is not subject to the qualified nonrecourse indebtedness rules to the extent of the proportion of the property leased to the related person.

Special interest allocation rules apply when there is debt between a U.S. shareholder and its controlled foreign corporation. These rules, which are described in Treas. Reg. Sec. 1.861-10(e), are discussed in chapter 8.

Special Rules for Allocating and Apportioning Interest Expense of an Affiliated Group of Corporations

Temp. Treas. Reg. Sec. 1.861-11T implements sections 864(e)(1) and (5), which require an affiliated group of corporations to allocate and apportion expenses on a single-taxpayer basis. Sections 864(e)(1) and (5) apply to the computations required under the following sections:

1. Section 904 (computation of the foreign tax credit limitation)

2. Section 907 (computation of the foreign tax credit limitation for certain oil and gas income)
3. Sections 921-927 and 991-997 (computation of the combined taxable income of a related supplier and an FSC or a DISC).

Sections 864(e)(1) and (5) do not apply to the computation of subpart F income of controlled foreign corporations under sections 951 through 964, the computation of combined taxable income of a possessions corporation and its affiliates under section 936, or the computation of effectively connected income of foreign corporations under section 882.

The general rule of Temp. Treas. Reg. Sec. 1.861-11T is that taxable income of each member of an affiliated group within each statutory grouping shall be determined by allocating and apportioning the interest expense of each member according to apportionment fractions that are computed as if all members of the group were a single corporation. Stock in affiliated corporations is not counted in the apportionment fraction. Interest expense is treated as definitely related and allocable to all the gross income of the members of the group using all of the assets of all members of the group.

The term *affiliated group* is defined in Temp. Treas. Reg. Sec. 1.861-11T(d) and has the same meaning as in section 1504, except that the exception excluding possessions corporations (section 1504(b)(4)) is disregarded. In general, an affiliated group exists when a common parent corporation directly owns 80 percent of the voting power and value of another corporation and the remaining chain of corporations is connected through the collective ownership of members of the group meeting the same 80-percent-ownership test. The temporary regulations also provide that the ownership test can be satisfied either directly or indirectly. Life insurance companies are included in the definition only if the parent corporation elects to include the company in its consolidated tax return. Members of the group that are financial corporations (corporations described in section 581 that conduct business primarily with unrelated persons) are treated as a separate affiliated group. (Stock in such corporations is not taken into account in the apportionment formula used by the other members of the group.) A foreign corporation will be included in the affiliated group if the 80-percent-ownership test is met and if more than 50 percent of its gross income is effectively connected with the conduct of a U.S. trade or business. All of the assets and interest expense of the foreign corporation are taken into account if 80 percent of its gross

income is effectively connected income. A proration of assets and interest expense is required when the percentage of effectively connected income is between 50 percent and 80 percent.

The indebtedness of a member borrower is not considered an asset of the member lender. A member borrower must allocate interest expense incurred on loans from a member lender in the same manner as unrelated person interest expense using the group apportionment fractions computed under the special interest apportionment rules applying to corporations (Temp. Treas. Reg. Sec. 1.861-9T(f)). The member lender will characterize the related-party interest income in the same class of gross income as the class of gross income from which the member borrower deducts the related person interest expense. Back-to-back loans (member to nonmember to member) are subject to the related party indebtedness rules.

> *Example 5.20.* USCo, a domestic corporation, is the parent corporation of Subco, a domestic corporation. USCo and Subco constitute an affiliated group for purposes of the interest apportionment rules. Included in USCo's assets is a note from Subco for $100,000. Because the companies are members of the same affiliated group, the note is not considered an asset in the apportionment of interest expense. The apportionment fractions computed by the affiliated group are 50-percent domestic-source income, 40-percent foreign-source general limitation gross income, and 10-percent foreign-passive gross income. Subco will deduct its related person interest expense using these apportionment fractions. Assuming USCo received $10,000 of related party interest income from Subco, USCo will characterize the income as $5,000 domestic, $4,000 foreign-source general limitation, and $1,000 foreign-passive.[41]

When the apportionment of interest expense for purposes of determining the foreign tax credit limitations results in a loss in a specific limitation category and the affiliated group does not file a consolidated tax return, such loss is deductible against other limitation category income by the separate member. However, a corresponding amount of income of other members in the same limitation category as the loss must be recharacterized as the limitation income against which the member deducted the loss. These complex rules are described in detail in Temp. Treas. Reg. Sec. 1.861-11T(g).

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[41] Temp. Treas. Reg. Sec. 1.861-11T(e)(4), *example 1*.

Adjustments for Certain Assets

Taxpayers using an asset method of apportionment are subject to special characterization and adjustment rules for investments in 10-percent-owned corporations, controlled foreign corporations, and noncontrolled section 902 corporations in apportioning interest and other expenses to income into various separate limitation categories for the computation of foreign tax credit limitation under section 904(d) (Temp. Treas. Reg. Sec. 1.861-12T).

All corporate taxpayers using an asset method for apportioning interest and other expenses are required to increase the basis of stock in nonaffiliated 10-percent-or-more-owned corporations to reflect changes in the nonaffiliated corporation's earnings and profits while the taxpayer held the stock (Temp. Treas. Reg. Sec. 1.861-12T(c)(2)). This adjustment can be positive or negative and is made on an annual basis. A *10-percent-owned corporation* is defined as any corporation that is not part of the affiliated group and in which the corporate taxpayer owns directly or indirectly 10 percent or more of the total combined voting power of all classes of stock entitled to vote.

For a taxpayer using the tax book value method of apportioning interest and other expenses, the adjusted basis of any directly owned stock of a 10-percent-owned corporation is increased (decreased) by the increase (decrease) in the earnings and profits of such corporation attributable to such stock and accumulated during the period the taxpayer (or members of its affiliated group) held 10 percent or more of the stock.

The earnings and profits of a first-tier 10 percent-owned corporation must take into account that corporation's pro rata share of any lower-tier 10-percent-owned corporation's earnings and profits. The calculation begins with the lowest tier and works up to the first tier. *Earnings and profits* are defined in section 312 in the case of a domestic corporation and section 902 in the case of a foreign corporation (see chapter 11 for a more in-depth discussion of earnings and profits). In the case of a foreign corporation that meets the definition of a qualified business unit and has a functional currency other than the U.S. dollar, earnings and profits are translated into U.S. dollars using the average rate for the taxpayer's taxable year (section 989(b)(4)). This translation is done on an annual basis.

Example 5.21. Holdco, an affiliated group, owns 20 percent of the stock of Bankco, which owns 50 percent of the stock of ATM Inc. Holdco uses the tax book value method of apportioning interest expense. Its basis in the Bankco stock is $1,000 at its year-end. During the period in which Holdco

owned the Bankco stock, Bankco had undistributed earnings and profits of $80, and ATM Inc. had undistributed earnings and profits of $40. For purposes of increasing its basis in the Bankco stock, Holdco includes $4 of ATM Inc.'s earnings and profits (20% × 50% × $40) and $16 of Bankco's earnings and profits (20% × $80). For purposes of making the interest apportionment, Holdco's tax book value of Bankco stock is considered to be $1,020 ($1,000 + $16 + $4).[42]

Taxpayers using the fair market value method of apportionment are not required to adjust the stock basis of 10-percent-owned corporations because the fair market value of the stock is considered to reflect retained earnings and profits.

Special apportionment rules apply in characterizing the stock of a controlled foreign corporation (CFC) as an asset in the separate limitation categories for purposes of computing the foreign tax credit limitations under section 904(d). In general, if the tax book value method of apportionment is used, the basis of the CFC stock that is allocated to each separate limitation category is based on the source of income produced by the underlying assets of the CFC. These look-through rules apply to lower-tier subsidiaries of the CFC. This *chain rule* requires that the analysis begin with the lowest-tier subsidiary and work upward. The look-through rule applies to domestic corporations that are owned more than 50 percent but less than 80 percent. A portion of this stock will be exempt to the extent the dividends-received deduction applies to dividends paid by the corporation.

The tax book value of stock in each separate noncontrolled section 902 corporation, as increased or decreased for the appropriate change in earnings and profits, is attributable solely to each noncontrolled section 902 limitation category for purposes of computing the foreign tax credit limitation applicable to each such category.

Planning Implications of the Interest Apportionment Rules

The interest apportionment rules have been criticized by U.S. taxpayers as being anticompetitive.

Example 5.22. Consider a U.S. corporation (USCo) with a wholly owned foreign subsidiary, Forco. Assume the two corporations are of equal value. Also assume USCo holds only U.S. assets other than the stock in Forco.

[42]Temp. Treas. Reg. Sec. 1.861-12T(c)(2)(vii), example 1.

Forco holds only foreign assets. Forco earns $100 of general limitation income, pays foreign tax of $500, and remits the remaining $50 as a dividend to USCo. USCo includes the $50 dividend plus the foreign income tax of $50 paid by Forco on the dividend in income and is eligible for a $50 foreign tax credit (see chapter 7 for more details). In addition, USCo reports U.S.-source income of $1,000 and incurs $100 of interest expense. USCo reports taxable income of $1,000 ($1,000 + $50 + $50 − $100) and owes a pre-credit U.S. tax of $350 (assuming a 35-percent tax rate). Under the interest apportionment rules, USCo must apportion 50 percent of the interest expense, or $50, to its foreign-source income of $100. The foreign tax credit limitation is restricted to $17.50, computed as ($100 − $50)/$1,000 × $350, resulting in a residual U.S. tax of $17.50. The total tax paid on the $100 of foreign-source income is effectively $67.50 ($50 + $17.50), resulting in an effective tax rate of 67.5 percent.[43]

Proposals have been introduced in both houses of Congress to allow taxpayers to elect to compute foreign-source taxable income by allocating and apportioning all interest expense of the worldwide affiliated group on a group-wide basis.

Under the current rules, multinational companies may now find it advantageous to have the foreign subsidiary incur debt (quite the opposite from the perceived abuse of having the U.S. parent corporation incur the debt). Interest paid to a foreign lender may reduce foreign taxable income (thus reducing the foreign tax paid and any excess credit position). The higher the tax imposed by the foreign host country, the potentially more advantageous it becomes (all things being equal) to borrow money in that country. In addition, U.S. parent corporations may choose to issue preferred stock rather than debt to overcome the interest allocation rules.[44]

Research and Experimental Expenditures

Deductible expenditures for research and experimentation (under section 174) are considered to be definitely related to income "reasonably connected with the relevant broad product category (or categories) of the

[43]See John L. Loffredo, "Testimony before the House Ways and Means Committee" (June 30, 1999) and William A. Laitiner, "Testimony before the House Ways and Means Committee" (June 30, 1999).

[44]See Julie H. Collins and Douglas A. Shackelford, "Foreign Tax Credit Limitations and Preferred Stock Issues," *Journal of Accounting Research* (Supplement 1992): 103–124.

taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories) (Treas. Reg. Sec. 1.861-17(a)(1)).

For taxable years beginning after 1996, taxpayers are required to allocate their R&E expenses between the relevant product categories determined by reference to the three-digit classification of the Standard Industrial Classification Manual (SIC code) (Treas. Reg. Sec. 1.861-17(a)(2)(ii)).[45] Under prior regulations, taxpayers made the allocation using two-digit SIC code product categories. Categories may be aggre gated where research and experimentation is conducted with respect to more than one product category; however, categories in the list may not be subdivided for the purpose of allocation and apportionment (Treas. Reg. Sec. 1.861-17(a)(2)(i)). Research and experimentation (R&E) not clearly associated with any product category (or categories) will be considered conducted with respect to all the taxpayer's product categories.

An exception to this allocation arises when a political entity imposes legal requirements with respect to improvement or marketing of specific products or processes, and R&E activities undertaken to meet these requirements are not expected to generate gross income (beyond de minimis amounts) outside a single geographic source. In such cases, deductions for research and experimentation are allocable only to the grouping(s) of gross income within that geographic source as a class (section 864(f)(1)(A) and Treas. Reg. Sec. 1.861-17(a)(4)).

Exclusive Apportionment

Treas. Reg. Sec. 1.861-17(b) provides for an exclusive apportionment of R&E incurred in activities conducted primarily (*more than 50 percent*) in one geographic area (within or outside the United States). If such a location does not exist, no part of the deduction will be apportioned using the exclusive-apportionment method. The Treasury Department justifies exclusive apportionment as reflecting the view that R&E activities are often most valuable in the country where they are performed for two reasons. First, whereas research and experimentation may benefit a broad product category consisting of many individual products, only some of

[45]Individual products contained in each category are listed in Executive Office of the President, Office of Management and Budget, *Standard Industrial Classification Manual* (Washington, DC: U.S. Government Printing Office, 1987) (or later edition, as available).

those products may be sold in a foreign market as compared to selling all of the products in the domestic market. Second, products and processes created by the R&E may be tested in the domestic market before being used in foreign markets, in which case the expenditures have a lower value per unit of sales when used in foreign markets (Treas. Reg. Sec. 1.861-17(b)(2)(i)).

The extent to which a taxpayer can exclusively apportion U.S. or foreign-based R&E depends on whether the taxpayer elects to apportion the remaining R&E using the *sales method* or the *gross income method*. If the *sales method* is elected, the taxpayer can allocate 50 *percent* of the R&E to the appropriate classes of gross income from the geographic area in which the R&E was conducted (Treas. Reg. Sec. 1.861-17(b)(1)(i)). If the gross income method is elected, the taxpayer can allocate 25 *percent* of the R&E to the appropriate classes of gross income from the geographic area in which the R&E was conducted (Treas. Reg. Sec. 1.861-17(b)(1)(ii)).

A taxpayer may be able to justify a larger exclusive-apportionment percentage of research and experimentation than is provided for in these rules if it can be shown that such R&E is reasonably expected to have very limited or long-delayed application outside the geographic location where it was performed (Treas. Reg. Sec. 1.861-17(b)(2)(i)).

Sales Method

Treas. Reg. Sec. 1.861-17(c) allows taxpayers to apportion research and experimental expenses not exclusively apportioned under Treas. Reg. Sec. 1.861-17(a)(4) or Treas. Reg. Sec. 1.861-17(b)(1)(i) using the *sales method*. The amount of the expenditure apportioned to each grouping is based on the percentage of total sales from the product category within the statutory grouping and the residual grouping (Treas. Reg. Sec. 1.861-17(c)(1)). For example, if 70 percent of the total sales of a product are sourced within the United States, then 70 percent of the research and experimental expenses not exclusively apportioned will be apportioned to the gross income from such sales.

Sales include sales from the product category (or categories) that are associated with the R&E and leases of equipment. In the case of licensed products, the taxpayer must estimate the sales associated with the licenses or make a reasonable estimate using the transfer pricing rules under §482 (Treas. Reg. Sec. 1.861-17(c)(2)(ii)). Sales of the product by

uncontrolled parties and controlled corporations are also taken into account in making the allocation if the parties can reasonably be expected to benefit directly or indirectly from the research expense connected with the product category (Treas. Reg. Secs. 1.861-17(c)(2) and (c)(3)). These regulations state that a party can reasonably be expected to benefit from the taxpayer's research expense if the taxpayer can be expected to license, sell, or transfer intangible property to the party or transfer secret processes to it. For purposes of this apportionment, a *corporation controlled by the taxpayer* means any corporation related to the taxpayer under section 267(b) or is a member of a controlled group of corporations to which the taxpayer belongs, as defined in section 993(a)(3) or 927(d)(4) (Treas. Reg. Sec. 1.861-17(c)(3)(i)).

Gross Income Methods

Taxpayers may also elect to use one of two optional gross income methods (Treas. Reg. Sec. 1.861-17(d)(1)). Both options involve apportionment between the statutory grouping (or among statutory groupings) and the residual grouping of gross income. These optional methods are applied to the taxpayer's entire deduction for R&E expenses remaining after any exclusive apportionment and may not be applied on a product category basis (Treas. Reg. Sec. 1.861-17(d)(1)(ii)).

Option 1 (Treas. Reg. Sec. 1.861-17(d)(2)) allows a taxpayer to apportion R&E expense (after any exclusive apportionment under Treas. Reg. Sec. 1.861-17(a)(4) or Treas. Reg. Sec. 1.861-17(b)(1)(ii)) ratably in the same proportions that the amount of gross income in the statutory grouping (or groupings) and in the residual grouping bears, respectively, to the total amount of gross income provided two conditions are met:

1. The amount of R&E expense so apportioned to the *statutory group* (or groupings in the aggregate) is not less than 50 percent of the amount that would have been so apportioned had the taxpayer used the sales method; and
2. The amount of R&E expense so apportioned to the residual grouping is not less than 50 percent of the amount that would have been so apportioned had the taxpayer used the sales method.

If the first condition under option 1 is not met, *option 2* (Treas. Reg. Sec. 1.861-17(d)(3)) allows the taxpayer to apportion 50 percent of the amount of R&E expense as determined by the sales method to the statu-

tory grouping(s) (to be reallocated on the basis of gross income within each grouping), with the balance apportioned to the residual grouping. If the second condition of option 1 is not satisfied, option 2 allows the taxpayer to apportion 50 percent of the amount of R&E expense as determined by the sales method to the residual grouping, with the balance apportioned to the statutory grouping to be reallocated on the basis of gross income within each grouping.

The taxpayer elects either the sales method or the gross income method by applying the method on the first original tax return on which R&E expenses must be apportioned (Treas. Reg. Sec. 1.861-17(e)(1)). Once a taxpayer elects either method, the election is binding for the current year and the next four taxable years, unless prior consent of the commissioner of internal revenue is obtained (Treas. Reg. Sec. 1.861-17(e)(2)).

Example 5.23.[46] U.S. Corporation (USCo) manufactures and distributes small gasoline engines for lawn mowers, which are in SIC Industry Group 351. Forco, a wholly owned foreign subsidiary, also manufactures and sells these engines abroad. During 1999, USCo incurred $60,000 of R&E costs, which it deducted as a current expense, to invent and patent a new and improved gasoline engine. All of the R&E was conducted in the United States. Worldwide engine gross sales of both companies are as follows:

USCo gross sales	$500,000
Forco gross sales	300,000
Total	$800,000

USCo provides technology to Forco via a license for the manufacture of engines. Forco pays USCo an arm's-length royalty. During 1999, USCo's gross income was $160,000, which consisted of the following:

U.S.-source from domestic sales of engines	$140,000
Foreign-source royalties from Forco	10,000
U.S.-source interest income	10,000
Total gross income	$160,000

All of the R&E is definitely related to the gross income from U.S. sales and royalties from Forco. No R&E is allocated to U.S.-source interest income. In the computation of USCo's foreign tax credit limitation, the *statutory grouping* is foreign-source income from royalties (this income is put in the general limitation basket). U.S.-source gross income from engine sales is the

[46]Treas. Reg. Sec. 1.861-17(h), example 1.

residual grouping. R&E must be allocated between the two groupings in the computation of the foreign tax credit limitation.

Exclusive apportionment

Because more than 50 percent of the R&E was conducted in the United States, USCo can elect to apportion either 50 percent (if the sales method is used) or 25 percent (if the gross income method is used) of the R&E exclusively to U.S.-source income.

Sales method

If USCo elects the sales method, $30,000 (50 percent) of R&E is apportioned exclusively to U.S.-source income, and the remaining $30,000 of R&E must be allocated between U.S.-source income and foreign-source income using U.S. and foreign sales of the engine. The ratios are as follows:

U.S.: $500,000/($500,000 + $300,000) × $30,000 = $18,750

Foreign: $300,000/($500,000 + $300,000) × $30,000 = $11,250

Total R&E allocated to U.S.-source income:	$48,750
Total R&E allocated to foreign-source income:	$11,250

Gross income method

If USCo elects the gross income method, $15,000 (25 percent) of R&E is apportioned exclusively to U.S.-source income, and the remaining $45,000 is apportioned using U.S. and foreign-source gross income.

U.S.: $140,000/($140,000 + $10,000) × $45,000 = $42,000

Foreign: $10,000/($140,000 + $10,000) × $45,000 = $3,000

Option 1 cannot be used because the amount allocated to foreign source income is not equal to 50 percent or more of the amount allocated under the sales method (it must equal at least $5,625). USCo must use option 2, under which it would allocate 50 percent of the R&E allocated to foreign-source income under the sales method ($5,625) to foreign-source income. The remaining $39,375 is allocated to U.S.-source income.

Total R&E allocated to U.S.-source income:	$54,375
Total R&E allocated to foreign-source income:	$ 5,625

Affiliated Group Considerations

R&E expenses incurred by members of an affiliated group are apportioned by treating the affiliated group (as defined in Temp. Treas. Reg. Sec.

1.861-14T(d) as one taxpayer (Treas. Reg. Sec. 1.861-17(a)(3)). Such expenses are to be allocated to all income of all members of the group that is reasonably connected with the relevant broad product category (or categories) to which such expenses are definitely related. If not all of the members have gross income from the product category, then the expenses are apportioned only among those members that do derive gross income from the product category.[47]

Treasury Moratoriums Applied to the Regulation

The exclusive apportionment rules found in the regulations have been subject to ten congressional moratoriums since their inception in 1977. The exclusive apportionment has been as high as 64 percent (1989–1993) and as low as 30 percent. The research and experimental expense apportionment issue remains controversial because of the difficulty in quantifying the economic effects that result from the current provisions. On one hand, U.S. taxpayers argue that the current rules result in an excess tax burden relative to their foreign competitors, especially when foreign taxing jurisdictions do not permit the U.S. taxpayer to deduct the research and experimental expenses that have been sourced to foreign income under the rules pertaining to U.S. sources. Congress, on the other hand, must protect U.S. revenue sources from artificial manipulation of the sourcing rules, especially if there is little or no "economic reality" in the allocation method. An unanswered question, and one that is germane to most debates on this issue, is whether the exclusive apportionment methods encourage U.S. taxpayers to undertake more research activities within the United States.[48]

Stewardship Expenses Attributable to Dividends Received

If a corporation renders services for the benefit of a related corporation (that is, *supportive expenses*) and it charges for these services, the deductions for expenses incurred in connection with these services are consid-

[47]See Temp. Treas. Reg. Sec. 1.861-14T(j), examples 1 and 2, for illustration of the application of this rule.

[48]See U.S. Treasury Department, "The Relationship between U.S. Research and Development and Foreign Income" (issued May 19, 1995).

ered definitely related to the amounts charged and are allocated to such amounts.

Expenses that are incurred not for the benefit of the related corporation but rather for the corporation's own benefit are known as *stewardship* or *overseeing* expenses. These expenses are generally not billed to the related corporation, because they represent a duplication of expenses that the related corporation has independently incurred for itself.

An example of such an expense would be the expense related to the parent corporation's review of a financial analysis that had been prepared by a related corporation for purposes of obtaining a loan. Deductions resulting from stewardship or overseeing functions are incurred as a result of the ownership of the related corporation, and thus are considered definitely related and allocable to dividends received from the related corporation (Treas. Reg. Sec. 1.861-8(e)(4)).

If members of an affiliated group, other than the member that incurred the stewardship expenses, receive or may receive dividends from the related corporation, then the stewardship expense is allocated and apportioned as if all of the members that receive or may receive dividends from the related corporation are a single corporation (Temp. Treas. Reg. Sec. 1.861-14T(e)(4)).[49]

Legal and Accounting Fees and Expenses

Depending on the nature of the services rendered, fees and other expenses for legal and accounting services are allocable to specific classes of gross income or to all of the taxpayer's gross income (Treas. Reg. Sec. 1.861-8(e)(5)). For example, legal fees for patenting a process would be allocable to the royalties received for use of that process, whereas general bookkeeping services would be allocable to all of the taxpayer's gross income. Members of an affiliated group are treated as a single corporation for purposes of making the allocation (Temp. Treas. Reg. Sec. 1.861-14T(e)(5)).

Income Taxes

The deductions for state, local, and foreign income taxes allowed by section 164 are considered definitely related and allocable to the gross income with respect to which these taxes are imposed (Treas. Reg. Sec.

[49]See Temp. Treas. Reg. Sec. 1.861-14T(j), example 4, for an illustration.

1.861-8(e)(6)(i)). For example, if a U.S. corporation is subject to state income tax on both domestic- and foreign-source income, that part of the income tax that is attributable to the foreign portion of the income is definitely related and allocable to foreign-source income. A state franchise tax that is computed on the basis of income attributable to doing business within the state must be allocated and apportioned in the same manner as an income tax.[50]

Example 5.24. Tri-State Inc., a domestic corporation, has operations in three states and has a branch in a foreign country. In 1999, Tri-State Inc. had taxable income from its operations of $1 million, of which $200,000 is foreign-source general limitation income and $800,000 is domestic-source income. Each of the states applies an income tax on a unitary basis, in which Tri-State's federal taxable income is adjusted and then apportioned based on the relative amounts of payroll, property, and sales with respect to each state as compared to worldwide payroll, property, and sales. None of the states specifically exempts foreign-source income, as determined for federal purposes, from state taxation, even though a "water's edge" unitary allocation method theoretically taxes only domestic-source income. After making the appropriate adjustments and allocations, Tri-State has taxable income of $550,000, $200,000, and $200,000, respectively, in the three states. Tri-State has a total state income tax of $69,000, all of which is deductible for federal tax purposes.[51]

Allocation: The deduction of $69,000 for state income taxes is considered definitely related and allocable to the gross income with respect to which the taxes are imposed. Since the states do not specifically exempt foreign-source income from state taxation and the aggregate of taxable income subject to state taxation is $950,000, it is presumed that state income taxes are imposed on $150,000 of foreign-source income. An apportionment is thus required between foreign-source general limitation income and domestic income.

Apportionment: For purposes of computing the foreign tax credit limitation, there is one statutory grouping (foreign-source general limitation gross income) and one residual grouping (gross income from sources within the United States). The state income tax deduction must be apportioned between these two groupings based on the relative amounts of taxable

[50]This regulation reflects the position of the IRS in Rev. Rul. 87-65, 1987-2 C.B. 173.

[51]Treas. Reg. Sec. 1.861-8(g), example 25. See examples 26–33 for additional illustrations. The Tax Court has held that taxpayers can rely on these examples (*Chevron Corp.*, 104 T.C. 719 (1995)).

income subject to the state income tax (before deduction of the state income tax) allocated to each grouping as follows:

Apportioned to statutory grouping:

$$\frac{\$150{,}000}{\$950{,}000} \times \$69{,}000 = \$10{,}895$$

Apportioned to residual grouping:

$$\frac{\$800{,}000}{\$950{,}000} \times \$69{,}000 = \$58{,}105$$

Losses on the Sale, Exchange, or Other Disposition of Personal Property Other Than Stock

The deduction allowed for losses recognized on the sale, exchange, or other disposition of personal property described in sections 1221 (capital assets) and 1231(b) (section 1231 assets), *other than stock*, is allocated and apportioned to the class of gross income with respect to which *gain* from sale of such property would give rise in the hands of the seller (Treas. Reg. Sec. 1.861-8(e)(7)(i) and Temp. Treas. Reg. Sec. 1.865-1T(a)(1)). In most cases, the source rule used for apportioning such losses to the statutory and residual groupings of gross income would be the residence-of-the seller. For example, loss recognized by a U.S. resident on the sale of a bond would be apportioned to U.S.-source gross income.

If loss on the sale of personal property other than stock is recognized by a U.S. citizen or resident with a foreign tax home, such loss is allocated to reduce foreign-source income if gain on the sale of such property would have been taxable by a foreign country and the highest marginal tax rate imposed on such gains in the foreign country is at least 10 percent (Temp. Treas. Reg. Sec. 1.865-1T(a)(3)). Similarly, loss recognized by a U.S. resident with respect to property attributable to a foreign office or other fixed place of business (within the meaning of section 865(e)(3)) is allocated to reduce foreign-source income if gain on the sale of such property would have been taxable by the foreign country and the highest marginal tax rate imposed on such gains in the foreign country is at least 10 percent (Temp. Treas. Reg. Sec. 1.865-1T(a)(2)).

A partner's distributive share of loss recognized by a partnership with respect to personal property is allocated as if the partner had recognized the loss (Temp. Treas. Reg. Sec. 1.865-1T(a)(5)).

Loss recognized on the sale of depreciable property is allocated based on where gain related to any depreciation recapture from sale of such property would have been sourced under section 865(c)(1) (Temp. Treas. Reg. Sec. 1.865-1T(b)(1)).

Example 5.25. On January 2, 1998, U.S. Corporation (USCo) purchased a machine for $1,000. The machine produced goods that USCo sold within and outside the United States. The machine was located and used outside the United States throughout USCo's holding period. On December 15, 1999, USCo sold the machine and recognized a loss of $500. USCo had deducted $400 of depreciation on the machine, $250 of which was allocated and apportioned to foreign-source general limitation income and $150 of which was allocated and apportioned to U.S.-source income. Because the machine was used primarily outside the United States, gain on the sale of the machine would be foreign-source general limitation income to the extent of all of the depreciation adjustments (section 865(c)(1)(B) and (c)(3)(B)(ii)). Therefore, the entire $500 loss is allocated against foreign-source general limitation income.[52]

Loss on the sale of inventory is not subject to these allocation rules (Temp. Treas. Reg. Sec. 1.865-1T(c)(2)). Such losses are sourced based on the title-passage rule under section 865(b). These rules also do not apply to foreign currency losses governed by section 988 (Temp. Treas. Reg. Sec. 1.865-1T(c)(1)).

Special antiabuse rules are located in Temp. Treas. Reg. Sec. 1.865-1T(c)(6). These rules deal with tax-deferred transfers of assets with built-in losses (for example, in a reorganization, liquidation, section 351 transfer, or a transfer to a partnership) where one of the principal purposes of the transfer is to change the allocation of a built-in loss. In such cases, the loss recognized by the transferee is allocated as if the transferor had sold the property immediately before the transfer. Similar rules apply to changes of residence designed to change the allocation of a built-in loss.

Losses on the Sale, Exchange, or Other Disposition of Stock

Losses from the sale of stock are generally allocated to the class of gross income with respect to which gain from the sale of such stock would give rise in the hands of the seller (Treas. Reg. Sec. 1.865-2(a)(1)). For pur-

[52]Temp. Treas. Reg. Sec. 1.865-1T(e), example 1.

poses of this allocation rule, gain does not include gain that would be treated as a dividend under section 964(e)(1) or section 1248. In most cases, the source rule used for apportioning such losses to the statutory and residual groupings of gross income would be the residence-of-the-seller. For example, loss recognized by a U.S. resident on the sale of stock would be apportioned to U.S.-source gross income.

If loss on the sale of stock is recognized by a U.S. citizen or resident with a foreign tax home, such loss is allocated to reduce foreign-source income if gain on the sale of such property would have been taxable by a foreign country and the highest marginal tax rate imposed on such gains in the foreign country is at least 10 percent (Treas. Reg. Sec. 1.865-2(a)(3)). Similarly, loss recognized by a U.S. resident with respect to stock attributable to a foreign office or other fixed place of business (within the meaning of section 865(e)(3)) is allocated to reduce foreign-source income if gain on the sale of such property would have been taxable by the foreign country and the highest marginal tax rate imposed on such gains in the foreign country is at least 10 percent (Treas. Reg. Sec. 1.865-2(a)(2)).

Dividend Recapture Amount. Treas. Reg. Sec. 1.865-2(b)(1)(i) requires the taxpayer to allocate and apportion loss equal to the "dividend recapture amount" proportionately to the class or classes of gross income (or statutory and residual groupings) to which the dividend recapture amount was assigned. The *dividend recapture amount* includes an actual dividend (not including the gross-up amount included under section 78) or a deemed dividend under subpart F or the personal foreign investment company (PFIC) rules included in foreign personal holding company under section 954(c)(1)(A) (Treas. Reg. Sec. 1.865-2(d)(2)). The recapture period is the 24-month period preceding the date on which a taxpayer recognizes a loss with respect to stock (Treas. Reg. Sec. 1.865-2(d)(3)).

The dividend recapture rule does not apply to a loss recognized by the taxpayer if the dividend recapture amount with respect to the stock during the recapture period is less than 10 percent of the recognized loss (Treas. Reg. Sec. 1.865-2(b)(1)(ii)). This rule also does not apply to dividends that are characterized as passive income for purposes of computing the foreign tax credit limitation under section 904(d) (Treas. Reg. Sec. 1.865-2(b)(1)(iii)). This exception is intended to exempt most portfolio investors from the dividend recapture rule (see the preamble to the final regulations under Treas. Reg. Sec. 1.865-2).

Example 5.26. United States Corporation (USCo) owns 100 percent of Forco, a controlled foreign corporation. On May 5, 1998, Forco distributed a taxable dividend of $100 to USCo, which gave rise to a $5 withholding tax and a gross-up amount under section 78 of $45. The dividend was treated as general limitation income for foreign tax credit limitation purposes. On February 6, 2000, USCo sold its Forco stock and recognized a loss of $110. In 2000, USCo also recognized $1,000 of foreign-source general limitation income, $1,000 of foreign-source passive income, and $1,000 of U.S.-source income. The $100 dividend paid in 1998 constitutes a dividend recapture amount because it was included in USCo's income within the recapture period (24 months prior to the sale). The de minimis exception does not apply because the $100 dividend (not including the section 78 gross-up) exceeds 10 percent of the $110 loss recognized. The allocation of the loss is as follows:

1. To the extent of the $100 dividend recapture amount, the loss is allocated to the foreign-source general limitation gross income.
2. The remaining $10 of loss is allocated to U.S.-source gross income using a residence-of-the-seller rule (Temp. Treas. Reg. Sec. 1.865-1T(a)(1)).[53]

Special antiabuse rules are located in Treas. Reg. Sec. 1.865-2(b)(4). These rules deal with tax-deferred transfers of stock with built-in losses (for example, in a reorganization, liquidation, section 351 transfer, or a transfer to a partnership) where one of the principal purposes of the transfer is to change the allocation of a built-in loss. In such cases, the loss recognized by the transferee is allocated as if the transferor had sold the stock immediately before the transfer. Similar rules apply to changes of residence designed to change the allocation of a built-in loss.

A partner's distributive share of loss recognized by a partnership with respect to personal property is allocated as if the partner had recognized the loss (Treas. Reg. Sec. 1.865-2(c)).

The regulations under Treas. Reg. Sec. 1.865-2 were issued in response to section 865(j), which was enacted in 1986 and provides that the Treasury Department "may" prescribe regulations "relating to the treatment of losses from sales of personal property." Prior to release of the proposed regulations, the Tax Court held in *Black and Decker Corp.*[54] that a loss resulting from the worthlessness of a foreign subsidiary's stock was allocated to foreign-source income because dividends related to the stock

[53]Treas. Reg. Sec. 1.865-2(b)(1)(iv), example 1.

[54]62 T.C.M. 1204 (1991), *aff'd.* 986 F.2d 60 (1993).

were (would be) foreign-source. The Tax Court subsequently held in *International Multifoods Corporation*[55] that section 865(j) as enacted in the Tax Reform Act of 1986 should be interpreted to allocate loss on the sale of a foreign subsidiary's stock using a residence-of-the-seller rule. The regulations under Treas. Reg. Sec. 1.865-2 are consistent with this decision.

Net Operating Loss Deduction

A net operating loss deduction allowed under section 172 is allocated and apportioned in the same manner as the deductions giving rise to the net operating loss (Temp. Treas. Reg. Sec. 1.861-8T(e)(8)). The net operating loss deduction is apportioned between the statutory grouping and the residual grouping of gross income on the basis of amounts of the net operating loss attributable to the respective groupings in the year of the net operating loss.

Charitable Contributions

Under proposed regulations issued in 1991, charitable contributions are to be allocated solely to U.S.-source income if the taxpayer, at the time of the contribution, both designates the charitable contribution for use solely in the United States and reasonably believes that the contribution will be so used (Prop. Treas. Reg. Sec. 1.861-8(e)(12)). Charitable contributions are to be allocated solely to foreign-source gross income if the taxpayer, at the time of the contribution, knows or has reason to believe (1) the charitable contribution will be used solely outside the United States; or (2) the charitable contribution may necessarily be used only outside the United States. If neither of the 100-percent allocation criteria is met (meaning, the contribution may be used in the United States and outside the United States), the contribution deduction is allocated pro rata to U.S.- and foreign-source income based on gross income in each grouping.

The proposed regulations are based on the premise that charitable contributions create goodwill for donors in the location in which the donation is used (which will eventually translate into increased revenues), and therefore the deduction should be allocated using a place-of-

[55] 108 T.C. 579 (1997).

use criterion. Representatives of international charities argue that support given to such charities will diminish if the donor has to allocate a portion of the contribution to foreign-source income. No data have been published to support either argument.

6

Tax Treaties

In 1939 the United States signed its first income tax treaty, with France. The U.S. treaty network has expanded significantly since then. As of the beginning of 1999, the United States had income tax treaties in force with more than fifty countries, with five more signed treaties awaiting ratification. The U.S. Treasury Department is in the process of negotiating new treaties with several countries (primarily in South America) and renegotiating its treaties with many of its current treaty partners. The United States also has many treaties of friendship, commerce, and navigation that may contain provisions (usually nondiscrimination clauses) restricting double taxation.[1]

A *tax treaty* is a bilateral agreement between two contracting countries in which each agrees to modify its own tax laws to achieve reciprocal benefit. A treaty can be thought of as a third dimension in the international environment, after the tax laws of the home country and those of the host country. The general purpose of an income tax treaty is to eliminate or reduce the impact of double taxation so that residents or corporations paying taxes to one signatory will not have the full burden

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[1]See *United States Treaties and Other International Agreements*, U.S. Department of State (Washington, DC: Government Printing Office).

of taxes in the other signatory country. This end is accomplished by providing for exclusion from taxation or special rates of tax on certain classes of transactions and by providing competent authority as a redress mechanism in cases of double taxation.

In addition to tax treaties between the United States and other countries, U.S. treaty partners also have treaties with each other and with non-U.S. treaty partners, creating a worldwide network of more than 500 tax treaties.[2] International tax planners must work within these treaty networks to reduce the total tax burden of a taxpayer.

U.S. treaties generally do not affect the U.S. taxation of U.S. citizens, residents, and domestic corporations. Such taxpayers are taxed on a worldwide basis. U.S. citizens, residents, and domestic corporations benefit from treaties through concessions of foreign taxes by the foreign signatory.

Tax treaties generally take precedence over the Internal Revenue Code (section 894 and section 7852(d)), although there have been several instances in which Congress has specifically mandated that Code provisions will take precedence over existing treaties.

For example, Congress mandated a "treaty override" in Section 31 of the Revenue Act of 1962, which provided that the provisions of the Revenue Act of 1962 would take precedence over prior treaty obligations. The Foreign Investors Tax Act of 1966 provided, however, that if any provision in this Act was contrary to an existing treaty, the treaty would take precedence. The Tax Reduction Act of 1975 provided that sections 901(f) and 907 would take precedence over treaty provisions in effect at the time.[3] Rev. Rul. 80-201[4] held that the foreign tax credit per country limitation rules prescribed in the Tax Reform Act of 1976 would not override treaties that provided for computation of foreign tax credit limitations using the overall method. The Tax Reform Act of 1976 also added sections 6013(g) and 6013(h), which permit a nonresident alien to be treated as a U.S. resident for income tax purposes, usually for the purpose of filing a joint return with a resident spouse. Such person making

[2]See *United Nations Treaty Series* (New York: United Nations), which includes treaties and international agreements registered or filed and recorded with the Secretary of the United Nations, and Tax Analysts, *Worldwide Tax Treaty Index* (Arlington, VA: Tax Analysts, 1997).

[3]Rev. Rul. 80-233, 1980-2 C.B. 217.

[4]Rev. Rul. 80-201, 1980-2 C.B. 221.

this election is not permitted to use those treaty benefits that would otherwise be available because of residency in the treaty country. The Foreign Investment in Real Property Tax Act of 1980 provided that the Internal Revenue Code provisions related to disposition of U.S. real property interests would override U.S. treaty obligations after December 31, 1984.

The Tax Reform Act of 1986 contained several provisions that specified that the Code provision enacted overrode treaties in effect at the time, such as the dual consolidated loss provision (section 1503(d)). In other cases, Congress mandated that treaties overrode the Code provision passed, such as transportation income (section 863(c)). In the case of the branch profits tax (section 884), the treaty takes precedence over the Code provision as long as treaty shopping is not involved.

In addition, the Technical and Miscellaneous Revenue Act of 1988 provides that no Code provision in effect on July 16, 1954, applies if its application would be contrary to a U.S. treaty obligation in effect on July 16, 1954. Certain provisions such as amendments to the foreign tax credit limitation and alternative minimum tax on foreign tax credits, passed in the Tax Reform Act of 1986, apply regardless of treaty provisions in effect when it was passed.[5] This is an application of the constitutional principle that treaties and statutes are equal in status, and where there is a direct conflict the latter applies. A number of other provisions passed in the Tax Reform Act of 1986 will not apply if a treaty in effect prior to the effective date of this act contained a contrary provision. Some of these provisions are scholarships and fellowships, source of income from sales by individuals of personal property, source of income from transportation, and source of income from 80/20 companies, among others.

The 1988 act added section 6114, which provides that taxpayers taking a position that a U.S. treaty overrules or otherwise modifies an internal revenue law of the United States must disclose this position on their tax returns or, if no tax return is required, in a way that the Internal Revenue Service prescribes. Final regulations implementing this requirement are found in Treas. Reg. Sec. 301.6114. These rules apply to any U.S. treaty, including income tax; estate and gift tax; and friendship, commerce, and navigation. A treaty-based position is disclosed on Form 8833. Treas. Reg. Secs. 301.6114-1(a) and (b) list positions for which

[5]The Tax Court upheld this provision in *Lindsey*, 98 T.C. 672 (1992), involving the U.S.-Swiss treaty and *Jamieson*, 70 T.C.M. 1372 (1995), involving the U.S.-Canada treaty.

reporting is specifically required. Failure to file Form 8833 could result in a fine of $1,000 (individual) or $10,000 (corporation).

Exhibit 6.1 lists the income tax treaties in force as of May 1998, along with cites to Treasury explanations where applicable.[6] Since publication of this list, the United States has signed a new treaty with Venezuela and renegotiated its existing treaty with Italy. Neither treaty has yet been ratified by the U.S. Senate. Estate and gift tax conventions currently in force as of 1998 are listed in table 6.1. It must be remembered that each treaty is a separate, integrated document independent of treaties with other countries, although the language and intent in provisions of treaties with several countries are similar. Each treaty must be interpreted as a whole, bearing in mind the relationships among other clauses in the treaty. Items not defined in the treaty are defined according to the laws of the country imposing the tax.

Table 6.1

Estate and Gift Tax Treaties in Force (1998)

Australia*	Italy†
Austria*	Japan*
Denmark*	Netherlands†
Finland†	Norway†
France*	Sweden*
Germany*	Switzerland†
Greece†	Union of South Africa†
Ireland†	United Kingdom*

Source: Tax Analysts, *Worldwide Tax Treaty Index* (Arlington, VA: Tax Analysts, 1997).
*Estate and gift tax treaty.
†Estate tax treaty only.

Treaty Shopping

Treaty shopping involves using a bilateral tax treaty by a person who is a resident of a third country. For example, Ingemar Johansson, a subject of and resident of Sweden, formed a Swiss corporation in order to take

(continued on page 148)

[6]For the most current information concerning treaties, see Internal Revenue Service Publication No. 901, *U.S. Tax Treaties* (Washington, DC: GPO, 1998).

Exhibit 6.1
List of Tax Treaties

Country	Official Text Symbol[1]	General Effective Date	Citation	Applicable Treasury Explanations or Treasury Decision (T.D.)
Australia	TIAS 10773	Dec. 1, 1983	1986-2 C.B. 220	1986-2 C.B. 246
Austria	TIAS	Jan. 1, 1999		
Barbados	TIAS 11090	Jan. 1, 1984	1991-2 C.B. 436	1991-2 C.B. 466
Protocol	TIAS	Jan. 1, 1994		
Belgium	TIAS 7463	Jan. 1, 1971	1973-1 C.B. 619	
Protocol	TIAS 11254	Jan. 1, 1988		
Canada[2]	TIAS 11087	Jan. 1, 1985	1986-2 C.B. 258	1987-2 C.B. 298
Protocol	TIAS	Jan. 1, 1996		
China, People's Republic of	TIAS	Jan. 1, 1987	1988-1 C.B. 414	1988-1 C.B. 447
Commonwealth of Independent States[3]	TIAS 8225	Jan. 1, 1976	1976-2 C.B. 463	1976-2 C.B. 475
Cyprus	TIAS 10965	Jan. 1, 1986	1989-2 C.B. 280	1989-2 C.B. 314
Czech Republic	TIAS	Jan. 1, 1993		
Denmark	TIAS 1854	Jan. 1, 1948	1950-1 C.B. 77	T.D. 5692, 1949-1 C.B. 104; T.D. 5777, 1950-1 C.B. 76
Egypt	TIAS 10149	Jan. 1, 1982	1982-1 C.B. 219	1982-1 C.B. 243
Finland	TIAS	Jan. 1, 1991		
France	TIAS	Jan. 1, 1996		
Germany	TIAS	Jan. 1, 1990[4]		
Greece	TIAS 2902	Jan. 1, 1953	1958-2 C.B. 1054	T.D. 6109, 1954-2 C.B. 638
Hungary	TIAS 9560	Jan. 1, 1980	1980-1 C.B. 333	1980-1 C.B. 354
Iceland	TIAS 8151	Jan. 1, 1976	1976-1 C.B. 442	1976-1 C.B. 456
India	TIAS	Jan. 1, 1991		
Indonesia	TIAS 11593	Jan. 1, 1990		
Ireland	TIAS	Jan. 1, 1998		
Israel	TIAS	Jan. 1, 1995		
Italy	TIAS 11064	Jan. 1, 1985	1992-1 C.B. 442	1992-1 C.B. 473
Jamaica	TIAS 10207	Jan. 1, 1982	1982-1 C.B. 257	1982-1 C.B. 291
Japan	TIAS 7365	Jan. 1, 1973	1973-1 C.B. 630	1973-1 C.B. 653
Kazakstan	TIAS	Jan. 1, 1996		
Korea, Republic of	TIAS 9506	Jan. 1, 1980	1979-2 C.B. 435	1979-2 C.B. 458
Luxembourg	TIAS 5726	Jan. 1, 1964	1965-1 C.B. 615	1965-1 C.B. 642
Mexico	TIAS	Jan. 1, 1994	1994-2 C.B. 424	1994-2 C.B. 489
Protocol	TIAS	Oct. 26, 1995		
Morocco	TIAS 10195	Jan. 1, 1981	1982-2 C.B. 405	1982-2 C.B. 427
Netherlands	TIAS	Jan. 1, 1994		
New Zealand	TIAS 10772	Nov. 2, 1983	1990-2 C.B. 274	1990-2 C.B. 303
Norway	TIAS 7474	Jan. 1, 1971	1973-1 C.B. 669	1973-1 C.B. 693
Protocol	TIAS 10205	Jan. 1, 1982	1982-2 C.B. 440	1982-2 C.B. 454
Pakistan	TIAS 4232	Jan. 1, 1959	1960-2 C.B. 646	T.D. 6431, 1960-1 C.B. 755
Philippines	TIAS 10417	Jan. 1, 1983	1984-2 C.B. 384	1984-2 C.B. 412
Poland	TIAS 8486	Jan. 1, 1974	1977-1 C.B. 416	1977-1 C.B. 427
Portugal	TIAS	Jan. 1, 1996		
Romania	TIAS 8228	Jan. 1, 1974	1976-2 C.B. 492	1976-2 C.B. 504
Russia	TIAS	Jan. 1, 1994		
Slovak Republic	TIAS	Jan. 1, 1993		
South Africa	TIAS	Jan. 1, 1998		
Spain	TIAS	Jan. 1, 1991		
Sweden	TIAS	Jan. 1, 1996		
Switzerland	TIAS	Jan. 1, 1998		
Thailand	TIAS	Jan. 1, 1998		
Trinidad and Tobago	TIAS 7047	Jan. 1, 1970	1971-2 C.B. 479	
Tunisia	TIAS	Jan. 1, 1990		
Turkey	TIAS	Jan. 1, 1998		
United Kingdom	TIAS 9682	Jan. 1, 1975	1980-1 C.B. 394	1980-1 C.B. 455

[1] (TIAS)- Treaties and Other International Act Series.

[2] Information on the treaty can be found in Publication 597, *Information on the United States- Canada Income Tax Treaty.*

[3] The U.S.- U.S.S.R. income tax treaty applies to the countries of Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

[4] The general effective date for the area that was the German Democratic Republic is January 1, 1991.

Source: U.S. Internal Revenue Service Publication No. 901, *U.S. Tax Treaties* (Washington, D.C.: GPO, May 1998), 40.

advantage of favorable provisions in the United States-Switzerland Income Tax Treaty regarding income earned from a heavyweight championship boxing match that he fought while an employee of that corporation. The income from the fight was paid to the Swiss corporation. The IRS challenged this arrangement as a sham and prevailed on the subsequent litigation.[7] There have been several challenges by the U.S. government on matters that appear to involve treaty shopping.[8] Many current treaties have provisions prohibiting treaty shopping, and the Treasury Department is attempting to renegotiate those treaties that do not contain a treaty-shopping provision.

An example of the U.S. Treasury's attempt to prevent treaty shopping is found in Article 26 of the 1992 U.S.-Netherlands income tax treaty. Article 26 denies taxpayers the benefits of reduced withholding rates unless they are bona fide residents of the Netherlands and fall into one of the following five categories: corporations, individuals, pensions, charities, and government bodies. To qualify as a resident, a corporation must pass any of the following four tests: (1) stock exchange test, (2) shareholder test, (3) active trade or business test, or (4) headquarters test. These tests are complex and beyond the scope of this text.

Because of a concern that treaty benefits were being abused, Congress instructed the Treasury Department in 1982 to promulgate regulations that would help the government determine whether foreign persons were entitled to treaty benefits. Final regulations responding to this charge were issued in 1997 (Treas. Reg. Sec. 1.1441-6). Under this "self-certification" system, a foreign person claiming reduced income tax withholding under a U.S. treaty must provide the U.S. withholding agent with a Form W-8BEN or Form W-8IMY (if a foreign partnership).

Objectives of Tax Treaties

Avoidance of Double Taxation

International transactions, by their very nature, create an exposure to double and sometimes multiple taxation that could result in a heavy tax

[7] *Ingemar Johansson v. United States*, 336 F.2d 809 (CA-5, 1964).

[8] *Aiken Industries, Inc.*, 56 T.C. 595 (1968), *Perry R. Buss*, 50 T.C. 595 (1968), Rev. Rul. 84-153, 1984-2 C.B. 383, modified by Rev. Rul. 85-163, 1985-2 C.B. 349, and Rev. Rul. 84-152, 1984-2 C.B. 381.

burden. A primary objective of income tax treaties is to reduce the burden of double taxation. The United States, as well as many other countries, also relies on the foreign tax credit mechanism as a means of alleviating problems with double taxation.

For example, under U.S. tax law tax relief from double taxation takes the form of a unilateral reduction of taxes on designated items or classes of income. Foreign tax credits for taxes collected by the country where the transaction is sourced are provided for residents of the United States, where the income is remitted. The significance of the inclusion of the foreign tax credit in a treaty is threefold:

1. Treaties may expand on the foreign taxes that are eligible for the U.S. tax credit.
2. If foreign tax credit provisions are repealed from the Code, Congress might still permit credits to be taken under treaty provisions in effect.
3. Depending on the manner in which foreign-source income is taxed by the other country, treaties are a negotiating point for permitting the U.S. taxes that are paid by the other country's taxpayers to be credited by that country, thereby reducing the taxpayer's cost of operating in the United States.

Elimination of Troublesome Tax Problems Affecting International Commercial Activity

Income or other tax bases, such as estates or gifts, may be subject to several countries' tax laws, thereby placing a heavy compliance burden on taxpayers because of the differing tax laws and recordkeeping requirements. Tax treaties alleviate some of these problems by exempting certain classes of income or other tax bases from taxation, exempting earned income from taxation unless the taxpayer resides in the country in excess of a specified time period, exempting from estate tax property with a certain situs, exempting business income from the host country's tax laws unless the business activities meet the substantive requirements, a permanent establishment, and reducing the income tax base by modifying the source-of-income rules.

These exemptions and limitations tend to relieve taxpayers of some of the annoyances and inconveniences of recordkeeping and having substantial dealings with foreign tax authorities. In addition, a taxpayer is able to plan investments and operations with advance knowledge of the

foreign tax consequences. This tends to improve the flow of capital, goods, and services between countries.

Prevention of Fiscal Evasion

Treaties provide for the exchange of tax information between the contracting countries. This reciprocal exchange of information may improve the tax administration and enforcement of the respective tax laws of the countries involved. In addition to formal treaties, the United States also has exchange-of-information agreements with numerous countries.

Establishment of Procedures to Prevent Double Taxation

Many treaties establish procedures for taxpayers who have been subjected to double taxation due to a transfer pricing agreement or who may consider that the actions of one or both of the contracting states results in taxation not in accordance with the provisions of the convention. These treaties require that the government authorities, called *competent authority*, consult with one another to discuss these issues. Such consultations may not necessarily resolve the problems. Taxpayers may set this consultation process in motion by filing a request with the competent authority of their country of residence. The U.S. competent authority is the Secretary of the Treasury, but the responsibility has been delegated to the Assistant Commissioner (International), who acts with the concurrence of the Associate Chief Counsel (International). The procedures for requesting competent authority assistance are found in Rev. Proc. 96-13.[9]

The Effect of Treaties on U.S. Citizens, Residents, and Corporations

U.S. taxpayers can benefit from treaties that reduce tax on designated items or classes of income. For example, many treaties provide a low withholding tax rate or an exemption from tax on various types of investment income (for example, interest, dividends, rents, and royalties). Estate tax treaties exempt from taxation certain assets in a decedent's estate, such as stock in a corporation that is a resident of a treaty country.

For individuals, most treaties provide exemption from taxation by the foreign treaty country on income earned from personal services performed

[9]1996-1 C.B. 616.

in the treaty country for stipulated periods of time (usually 183 days or less, but two years or less for professors or teachers).

Taxpayers of one contracting country are not taxed in the other contracting country on commercial and industrial profits earned in that country unless the trade or business is conducted through a *permanent establishment*. A permanent establishment may constitute a more substantive presence in a country in connection with the conduct of a trade or business than would be allowed under internal law before being considered as doing business in the country. The effect of the permanent establishment rule is that markets for products can be established in a contracting country, and a greater degree of business dealings can take place without subjecting a taxpayer to taxation by the foreign contracting country. Also, under the terms of a treaty, a company resident in one treaty partner can operate in the territory of its treaty partner to a significant extent through the use of independent agents and other techniques designed to avoid having a permanent establishment.

As stated above, another treaty benefit is that U.S. taxpayers may be allowed to credit foreign taxes under an income tax treaty because treaties may permit credits for some foreign taxes that would not qualify under the rules in the Code. In addition, source-of-income rules for calculating the foreign tax credit are sometimes modified, which may affect the foreign tax credit limitation calculation (that is, the foreign income categories).

General Provisions

Certain provisions are present in most tax treaties. These provisions deal with the scope of the treaty, general definitions, the taxes that the treaty covers, definitions of residency, treatment of business and investment activities, treatment of personal services income, a nondiscrimination provision, a "savings" provision, a provision for mutual agreement, often called a "competent authority" provision, and an exchange-of-information provision. These are discussed below.

General Definitions

The treaty will define terms such as *person*, which generally includes an individual, an estate, a trust, a partnership or a company, a corporation, and an enterprise.

Taxes Covered

Treaties differ as to which taxes are covered under the treaty. Most income tax treaties provide that only income taxes and excise taxes imposed on insurance premiums are covered under the treaty, and taxes such as accumulated earnings taxes and personal holding company taxes are not covered. In some cases, U.S. state income taxes are covered, although this is the exception.

Residence

Residence is generally defined under the laws of a contracting state that is exercising tax jurisdiction of that person because of his or her domicile, residence, citizenship, place of management, place of incorporation, or other criterion. The treaty generally deals with those situations in which a person is deemed a resident of both contracting states and defines residency or prescribes the administrative means whereby residency status can be determined by competent authority (these are referred to as "tie-breaker" provisions).

Nondiscrimination

Most treaties contain a nondiscrimination provision that applies to nationals of one country resident in the other, and in more recent treaties, to corporations owned by residents of the other country. The test for discrimination is measured by the manner in which a country treats its residents, citizens, and its own corporations. The Internal Revenue Code may provide that a taxpayer can elect to be treated as a U.S. taxpayer if a Code provision conflicts with a nondiscrimination provision in a tax treaty. For example, section 897(i) permits a foreign corporation that holds a U.S. real property interest and is covered under a nondiscrimination provision to elect to be treated as a domestic corporation.

Savings Provision

Most treaties contain a provision that preserves the right of each of the signatory countries to tax its own citizens, residents, and corporations as if the treaty did not exist. For example, a U.S. citizen, a resident of another country whose treaty with the United States contains a savings clause, will be taxed by the United States as if the treaty did not exist.

The savings provision is quite important in the interpretation of a treaty. For example, a provision regarding real estate found in many

treaties states that income of whatever nature derived from real property shall be taxable only in the state in which the real property is situated. Such a treaty provision makes it appear that a U.S. person receiving income from property located in such a treaty country would not be taxed by the United States. A savings clause overrides such an interpretation, and this U.S. person will be taxed on the income by the treaty country and also by the United States.

Preservation Provision

Most treaties have a provision that prevents the taxpayers of a particular country from having their tax burden increased by any of the treaty provisions. Because the objective of tax treaties is to reduce tax burdens, a clause is included to prevent provisions from inadvertently increasing tax burdens.

The preservation provision states, in effect, that the provisions of a treaty shall not be construed to restrict in any manner any exemption, deduction, credit, or other allowance accorded by the laws of one of the contracting states in the determination of the tax imposed by such a state.

Industrial and Commercial Profits

An important provision in most treaties holds that a contracting country will not tax the business profits, often called *industrial and commercial profits*, of an enterprise of the other contracting state unless such enterprise has a permanent establishment. For example, an enterprise of country A conducting activities that give rise to profits in country B will not be taxed by country B if it does not carry on a trade or business through a permanent establishment in country B.

Although it varies greatly from treaty to treaty, the term *business profits* generally means income derived from any trade or business. Profits that are sometimes excluded from this definition (but usually included in income under some other treaty provision) are dividends, interest, royalties, rents, sale of capital assets, management charges, ships and aircraft income, and insurance premiums.

Permanent Establishment

If a permanent establishment does not exist, business profits derived in one country are not taxed by the country in which they are derived. If a permanent establishment exists in the contracting country, the income

derived therefrom is taxed by it. The definition of a permanent establishment varies from treaty to treaty. The determination of whether a permanent establishment exists depends on two general criteria.

The first criterion relates to the existence of physical facilities. If an enterprise has a facility such as a branch, an office, a factory, or a construction site, it will usually be deemed to have a permanent establishment. Even if the enterprise has such a facility, it will not be deemed to have a permanent establishment if the facility is used solely for purchasing, storage, display, or like activities.

The second criterion that could determine whether a permanent establishment exists relates to the presence of agents in the contracting country. If an enterprise has a dependent agent in a contracting state who operates on its behalf and who habitually exercises authority to conclude contracts in the name of that enterprise, then such activity by the agent may constitute a permanent establishment. The use of commission agents or brokers who solicit orders but do not have the authority to accept the orders generally will not constitute a permanent establishment. The use of commission agents or brokers who are independent and represent more than one enterprise in the conduct of their trade or business will usually not be deemed a permanent establishment. Mail-order activities generally do not constitute a permanent establishment.

Exemption of Ships and Aircraft

Almost all treaties have a provision in which the contracting countries reciprocally exempt from taxation an enterprise's income derived from ships and aircraft registered under the laws of the other contracting country. This exemption is granted whether or not a permanent establishment exists. For jurisdictions with a foreign, commerce, and navigation treaty, but no income tax treaty, this type of provision would be found there.

Source of Income

Many of the income tax treaties contain some source-of-income rules affecting one or more types of income such as dividends, interest, and sales income. The source-of-income rules generally follow those found in the Internal Revenue Code, but there are many exceptions. For U.S. taxpayers many of these source rules affect only the computation of the limitation on the foreign tax credit.

Allocation of Profits

Most treaties have a provision that allows each contracting country to calculate the profits attributable to a permanent establishment or allocate profits between related parties according to arm's-length standards. Many treaties have provisions allowing deductions for expenses that are reasonably allocable to income, including general and administrative expenses incurred elsewhere. This is a beneficial provision in situations in which a country might not allow deductions for costs and expenses incurred outside the country.

Often by the time a country reviews transactions between international affiliates, considerable time has passed. An adjustment in profits resulting in additional taxes levied by one country may not result in an adjustment in the other country, either because the statute of limitations period has expired or because the allocations are not recognized by the country. To mitigate some of these problems, some treaties contain provisions for refunds of taxes even when the statute of limitations has expired.

Investment Income

The term *investment income* is defined in each treaty but generally includes dividends, interest, royalties, and in some instances, capital gains. The treaty rules differ somewhat for each type of income.

The treaty provisions affecting investment income provide some of the most substantial benefits to residents of the contracting countries. Treaties provide for reciprocal reduction of tax rates on investment income and, in a few instances, provide an outright exemption. For example, without treaty provisions, the United States taxes investment income at a flat rate of 30 percent, but treaty provisions reduce this rate to as low as zero. Rates for various types of investment income are shown in exhibit 6.2. The treaty rate generally applies unless the recipient has a permanent establishment in the country of the source of the income, and the investment income is related to the permanent establishment. To qualify for these treaty benefits, one must be a resident of a particular contracting country as determined under the laws of that country, and further defined in the limitation of benefits provision of a treaty (for example, the U.S.-Netherlands treaty). A few of the remaining older treaties have a so-called *force-of-attraction doctrine* under which investment income is automatically considered related to the permanent establishment regardless of the facts.

Exhibit 6.2

Tax Rates for 1998 on Income Other Than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties

Income Code Number		1	2	3	6	7	9	10	11	12	13	14	21
Country of Residence of Payee					Dividends Paid by a				Copyright Royalties				
Name	Code	Interest Paid by U.S. Obligors General	Interest on Real Property Mortgages	Interest Paid to a Controlling Foreign Corporation	U.S. Corporation General[a]	U.S. Subsidiary to Foreign Parent Corporation[a]	Capital Gains[y]	Industrial Royalties	Motion Pictures and Television	Other	Real Property Income and Natural Resources Royalties[v]	Pensions and Annuities	Social Security Payment[a]
Australia	AS	[g]10	[g]10	[g]10	[g]15	[g]15	30	[g]10	[g]10	[g]10	30	[d]0	30
Austria (before 4-1-98)	AU	[h]0	30	[h]0	[h]15	[b,h]5	30	[h]0	[h]10	[h]0	30	[d]0	30
Austria (beginning 4-1-98)	AU	[g,m]0	[g,m,ff]0	[g,m]0	[g,x]15	[g,x]5	[g,l]0	[g]0	[g]10	[g]0	30	0	30
Barbados	BB	[g]5	[g]5	[g]5	[g,x]15	[b,g,x]5	[g,l]0	[g]5	[g]5	[g]5	30	[d,f]0	30
Belgium	BE	[g]15	[g]15	[g]15	[g]15	[b,g]5	[e,g,l]0	[g]0	[h]0	[g]0	30	[d,f]0	30
Canada	CA	[g]10	[g,ff]10	[g]10	[g,x]15	[g,x]5	[r]30	[g]0	[g]10	[g]0	30	15	0
China, People's Rep. of	CH	[g]10	[g]10	[g]10	[g]10	[g]10	30	[g,w]10	[g]10	[g]10	30	[d,mm]0	30
Commonwealth of Independent States		[n]0	30	30	30	30	[o]0	0	0	0	30	30	30
Cyprus	CY	[g]10	[g]10	[g]10	[g]15	[b,g]5	[g,l]0	[g]0	[g]0	[g]0	30	[d,f]0	30
Czech Republic	EZ	[g]0	[g,ff]0	[g]0	[g,x]15	[b,g,x]5	[g,l]0	[g]10	[g]0	[g]0	30	[d,f]0	30
Denmark	DA	[h]0	[h]0	[h]0	[h]15	[b]5	30	[h]0	[h]0	[h]0	30	[d]0	30
Egypt	EG	[h]15	30	[h]15	[h]15	[b,h]5	[e,h,l]0	[h]0	[h]0	[g]15	30	[d,f]0	0
Finland	FI	[g]0	[g]0	[g]0	[g,x]15	[b,g,x]5	[g,l]0	[g]5	[g]0	[g]0	30	[d,f]0	30
France	FR	[g]0	[g,ff]0	[g]0	[g,x]15	[g,x]5	[g,l]0	[g]5	[g]0	[g]0	30	[d,f]0	30
Germany	GM	[g]0	[g]0	[g]0	[g,x]15	[b,g,x]5	[g,l]0	[g]0	[g,dd]0	[g]0	30	[d]0	0
Greece	GR	[h]0	[h]0	30	30	30	30	[h]0	30	[h]0	30	[d]0	30
Hungary	HU	[g]0	[g]0	[g]0	[g]15	[b,g]5	[g,l]0	[g]0	[g]0	[g]0	30	[d,f]0	30
Iceland	IC	[g]0	[g]0	[g]0	[g]15	[b,g]5	[e,g,l]0	[g]0	30	[g]0	30	[d,f]0	30
India	IN	[g,aa]15	[g,aa]15	[g]15	[g,x]25	[b,g,x]15	30	[g,bb]10	[g]15	[g]15	30	[d,f]0	[ee]30
Indonesia	ID	[g]15	[g]15	[g]15	[g]15	[g]15	[g,l,z]0	[g,bb]10	[g]15	[g]15	30	[d,f,g]15	30
Ireland (before 1-1-98)	EI	[c,h]0	[c,h]0	30	[c,h]15	[b,c,h]5	30	[c,h]0	[c,h]0	[c,h]0	[c,h]15	[d]0	30
Ireland (beginning 1-1-98)	EI	[g]0	[g,ff]0	[g]0	[g,x]15	[g,x]5	[g,l]0	[g]0	[g]0	[g]0	30	[d,f]0	0
Israel	IS	[g,aa,ii]17½	[g,aa,ff,ii]17½	[g,aa,ii]17½	[g,x]25	[b,g,x]12½	[e,g,cc]0	[g]15	[g]10	[g]10	30	[f]0	0
Italy	IT	[g]15	[g]15	[g]15	[g]15	[b,g]5	[g,l]0	[g,s]10	[g]8	[g]5	30	[d,f]0	0
Jamaica	JM	[g]12½	[g]12½	[g]12½	[g]15	[b,g]10	[g,l]0	[g]10	[g]10	[g]10	30	[d,f,p]0	30
Japan	JA	[g]10	[g]10	[g]10	[g]15	[b,g]10	[e,g,l]0	[g]10	[g]10	[g]10	30	[d]0	0
Kazakstan	KZ	[g]10	[g,ff]10	[g]10	[g,qq]15	[g,qq]5	[g,l]0	[g,jj]10	[g]10	[g]10	30	[d,f]0	30
Korea, Rep. of	KS	[g]12	[g]12	[g]12	[g]15	[b,g]10	[e,g,l]0	[g]15	[g]10	[g]10	30	[d,f]0	30
Luxembourg[k]	LU	[h]0	30	[h]0	[h]15	[b,h]5	30	[h]0	[h]0	[h]0	30	[d]0	30
Mexico	MX	[g,aa]15	[g,aa,ff]15	[g]15	[g,x]15	[b,g,x]5	[g,l]0	[g]10	[g]10	[g]10	30	[d,l]0	30
Morocco	MO	[g]15	[g]15	[g]15	[g]15	[b,g]10	[e,g,l]0	[h]10	[g]10	[g]10	30	[d,f]0	30
Netherlands	NL	[g]0	[g]0	[g]0	[g,x]15	[b,g,x]5	[g,hh]0	[g]0	[g,dd]0	[g]0	30	[d,f,t]0	30
New Zealand	NZ	[g]10	[g]10	[g]10	[g]15	[g]15	[g,l]0	[g]10	[g]10	[g]10	30	[d]0	30
Norway	NO	[g]0	[g]0	[g]0	[g]15	[g]15	[e,g,l]0	[g]0	[h]0	[g]0	30	[d,f]0	30
Pakistan[i]	PK	30	30	30	30	[b,h]15	30	[h]0	30	[h]0	30	[d,j]0	30
Philippines	RP	[g]15	[g]15	[g]15	[g]25	[b,g]20	[g,l]0	[g]15	[g]15	[g]15	30	[q]30	30
Poland	PL	[g]0	[g]0	[g]0	[g]15	[b,g]5	[e,g,l]0	[g]10	[g]10	[g]10	30	30	30
Portugal	PO	[g]10	[g,ff]10	[g]10	[g,x]15	[g,x]15	[g,l]0	[g]10	[g]10	[g]10	30	[d,f]0	30
Romania	RO	[g]10	[g]10	[g]10	[g]10	[g]10	[e,g,l]0	[g]15	[g]10	[g]10	30	[d,f]0	0
Russia	RS	[g]0	[g,ff]0	[g]0	[g,qq]10	[b,g,qq]5	[g,l]0	[g]0	[g]0	[g]0	30	[d]0	30

Slovak Republic	LO	[g]0	[g,ff]0	[g]0	[g,x]15	[b,g,x]5	[g,l]0	[g]10	[g]0	[g]0	30	[d,f]0	30
South Africa (beginning 1-1-98)	SF	[g,m]0	[g,m,ff]0	[g,m]0	[g,x]15	[g,x]5	[l]0	[g]0	[g]0	[g]0	30	[d,kk]15	30
Spain	SP	[g]10	[g]10	[g]10	[g,x]15	[b,g,x]10	[g,l]0	[g,y]8	[g,y]8	[g,y]5	30	[d,f]0	30
Sweden	SW	[g]0	[g,ff]0	[g]0	[g,x]15	[g,x]5	[g,l]0	[g]0	[g]0	[g]0	30	[d]0	30
Switzerland (before 2-1-98)	SZ	[h]5	[h]5	[h]5	[h]15	[b,h]5	30	[h]0	[h]0	[h]0	30	[d]0	30
Switzerland (beginning 2-1-98)		[g,m]0	[g,m,ff]0	[g,m]0	[g,x]15	[g,x]5	[l]0	[g]0	[g]0	[g]0	30	[d]0	15
Thailand (beginning 6-1-98)	TH	[g,aa]15	[g,aa,ff]15	[g,aa]15	[g,x]15	[g,x]10	30	[bb]8	5	[ll]15	30	[d,f]0	30
Trinidad & Tobago	TD	30	30	30	30	30	30	[g]15	30	[g]0	30	[d,f]0	30
Tunisia	TS	[g]15	[g]15	[g]15	[g,x]20	[b,g,x]14	[g,l]0	[g,bb]10	[g]15	[g]15	30	[f]0	30
Turkey (beginning 1-1-98)	TU	[g,i,aa]15	[g,i,aa,ff]15	[g,i,aa]15	[g,x]20	[g,x]15	[g,l]0	[bb]5	10	10	30	[d]0	30
United Kingdom	UK	[g]0	[g]0	[g]0	[g]15	[b,g]5	30	[g]0	[h]0	[g]0	30	[d,f]0	0
Other Countries		30	30	30	30	30	30	30	30	30	30	30	30

[a] No U.S. tax is imposed on a dividend paid by a U.S. corporation that received at least 80% of its gross income from an active foreign business for the 3-year period before the dividend is declared.

[b] The reduced rate applies to dividends paid by a subsidiary to a foreign parent corporation that has the required percentage of stock ownership. In some cases, the income of the subsidiary must meet certain requirements (e.g., a certain percentage of its total income must consist of income other than dividends and interest). For Italy, the reduced rate is 10% if the foreign corporation owns 10% to 50% of the voting stock (for a 12-month period) of the company paying the dividends.

[c] The exemption or reduction in rate applies only if the recipient is subject to tax on this income in the country of residence. Otherwise, a 30% rate applies.

[d] Exemption does not apply to U.S. Government (federal, state, or local) pensions and annuities; a 30% rate applies to these pensions and annuities. For this purpose, railroad retirement tier 2, dual, and supplemental benefits are not considered U.S. Government pensions or annuities. U.S. Government pensions paid to an individual who is both a resident and national of China, Finland, France (if not a U.S. national), Hungary, India, Ireland (new treaty), Mexico, the Netherlands, Portugal, Russia, South Africa, Spain, Switzerland (new treaty), Thailand, Turkey, or the United Kingdom are exempt from U.S. tax. U.S. Government pensions paid to an individual who is both a resident and citizen of Kazakstan, New Zealand, or Sweden are exempt from U.S. tax.

[e] The treaty exemption that applies to U.S. source capital gains includes capital gains under section 871(a)(2) of the Internal Revenue code if they are received by a nonresident alien who is in the U.S. for no more than 183 days. (182 days for Belgium, Egypt, and Israel.)

[f] Includes alimony.

[g] Under the treaty the exemption or reduction in rate does not apply if the recipient has a permanent establishment in the United States and the property giving rise to the income is effectively connected with this permanent establishment. Under certain treaties, exemption or reduction in rate also does not apply if the property producing the income is effectively connected with a fixed base in the United States from which the recipient performs independent personal services. Even with the treaty, if the income is not effectively connected with a trade or business in the United States by the recipient, the recipient will be considered as not having a permanent establishment in the United States under Internal Revenue Code section 894(b).

[h] Under the treaty the exemption or reduction in rate does not apply if the recipient is engaged in a trade or business in the United States through a permanent establishment that is in the United States. However, if the income is not effectively connected with a trade or business in the United States by the recipient, the recipient will be considered as not having a permanent establishment in the United States to apply the reduced treaty rate to that item of income.

[i] Contingent interest that does not qualify as portfolio interest is treated as a dividend and is subject to the rate under column 6 or 7.

[j] Exemption is not available when paid from a fund under an employees' pension or annuity plan, if contributions to it are deductible under U.S. tax laws in determining taxable income of the employer.

[k] Exemption from or reduction in rate of tax does not apply to income of holding companies entitled to special tax benefits under the laws of Luxembourg.

[l] Exemption does not apply to gains from the sale of real property.

[m] The rate is 15% (30% for Switzerland) for contingent interest that does not qualify as portfolio interest.

[n] The exemption applies only to interest on credits, loans, and other indebtedness connected with the financing of trade between the United States and the C.I.S. member. It does not include interest from the conduct of a general banking business.

[o] The exemption applies only to gains from the sale or other disposition of property acquired by gift or inheritance.

[p] The exemption does not apply if the recipient was a resident of the United States when the pension was earned or when the annuity was purchased.

[q] Annuities paid in return for other than the recipient's services are exempt.

[r] Generally, if the property was owned by the Canadian resident on September 26, 1980, not as part of the business property of a permanent establishment or fixed base in the U.S., the taxable gain is limited to the appreciation after 1984. Capital gains on personal property not belonging to a permanent establishment or fixed base of the taxpayer in the U.S. are exempt.

[s] Under the treaty, the reduced rate for royalties with respect to tangible personal property is 7%.

[t] The exemption does not apply if (1) the recipient was a U.S. resident during the 5-year period before the date of payment, (2) the amount was paid for employment performed in the United States, and (3) the amount is not a periodic payment, or is a lump-sum payment in lieu of a right to receive an annuity.

[u] Applies to 85% of the social security payments received from the U.S. Government. The effective rate on the total social security payments received is 85% of the rate shown in the table. These rates also apply to the social security equivalent portion of tier 1 railroad retirement benefits (income code 22) received from the U.S. The remainder of tier 1, all of tier 2, dual, and supplemental railroad retirement benefits (income code 23) are taxed as shown in column 14, "Pensions and Annuities".

[v] Gains on the disposition of U.S. real property interests are considered effectively connected with a U.S. trade or business and thus are subject to graduated rates of tax rather than the flat percentage shown in this column.

[w] Tax imposed on 70% of gross royalties for rentals of industrial, commercial, or scientific equipment.

[x] The rate in column 6 applies to dividends paid by a regulated investment company (RIC) or a real estate investment trust (REIT). However, that rate applies to dividends paid by a REIT only if the beneficial owner of the dividends is an individual holding less than a 10% interest (25% in the case of Netherlands, Portugal, Spain, and Tunisia) in the REIT.

[y] Royalties not taxed at the 5% or 8% rate are taxed at a 10% rate, unless footnote (g) applies.

[z] The exemption does not apply if the recipient of the gain is an individual who is present in the United States for more than 119 days during the year.

[aa] The rate is 10% if the interest is paid on a loan granted by a bank or similar financial institution. For Mexico, the 10% rate also applies to bonds and securities that are regularly and substantially traded on a recognized securities market. For Thailand, the 10% rate also applies to interest from an arm's length sale or credit of equipment, merchandise, or services.

[bb] This is the rate for royalties for the use of, or the right to use, industrial, commercial, and scientific equipment. The rate for royalties for information concerning industrial, commercial and scientific know-how is subject to the rate in column 12.

[cc] The exemption does not apply to gain from the sale or other disposition of property described in Article 14(2)(c) (copyrights of literary, artistic, or scientific works).

[dd] The exemption does not apply to cinematographic items, or works on film, tape, or other means of reproduction for use in radio or television broadcasting.

[ee] U.S. social security benefits paid to individuals who are both residents and nationals of India, are exempt from tax if they are for services performed for the United States, its subdivisions, or local authorities.

[ff] Exemption or reduced rate does not apply to an excess inclusion for a residual interest in a real estate mortgage investment conduit (REMIC).

[gg] The rate in column 6 applies to dividends paid by a regulated investment company (RIC). Dividends paid by a real estate investment trust (REIT) are subject to a 30% rate.

[hh] The exemption does not apply to gains from the sale of U.S. real property. However, for U.S. real property that was owned continuously since June 18, 1980, by the Netherlands resident, the taxable gain may be limited to the appreciation after 1984. For details, see Article 14(2) of the treaty.

[ii] An election can be made to treat this interest income as if it were industrial and commercial profits taxable under article 8 of the treaty.

[jj] If the payments were for the use of, or the right to use, industrial, commercial, or scientific equipment, an election may be made to compute the tax on a net basis as if such income were attributable to a permanent establishment or fixed base in the U.S.

[kk] The reduced rate does not apply if the distribution is subject to a penalty for early withdrawal. Annuities that were purchased while the annuitant was not a resident of the United States are not taxable in the United States.

[ll] The rate is 5% for royalties on the use of any copyright of literary, artistic, or scientific work, including software.

[mm] Does not apply to annuities.

Source: U.S. Internal Revenue Service Publication No. 901, *U.S. Tax Treaties* (Washington, D.C.: GPO, May 1998), 27–29.

Dividends and Interest. Most countries impose not only a tax on profits of corporations but also a withholding tax on dividends when paid by such corporations to their shareholders. In addition, some countries impose branch profits taxes in lieu of withholding to put branch remittances on a par with dividends. The total foreign taxes payable with respect to profits realized in such a country may be considerably higher than the U.S. corporate rate. The result is that, without any relief, U.S. taxpayers could generate excess foreign tax credits.

Treaties somewhat alleviate the problem by providing for reduced rates of withholding taxes on dividends. The treaty concessions range from a reduction of rates to 10 to 15 percent on dividends in general and 5 percent on dividends received by a parent corporation. Another treaty concession dealing with dividends is a tax exemption by one contracting country on dividends paid by a corporation of the second contracting country to persons who are taxed as nonresident aliens and foreign corporations of the first country. This exemption applies whether or not the recipient has a permanent establishment in the first country.

Treaty provisions in some cases exempt interest income from taxation and in other cases lower the maximum withholding rates to 5, 10, or 15 percent. Some treaties provide special rules for taxation of interest based on the stock ownership of the corporation paying the interest or on interest from mortgages secured by real property. Interest that is effectively connected with a permanent establishment is usually not eligible for reduced rates provided by a treaty.

Royalties. Royalties are generally classified into three groups: (1) industrial royalties (that is, amounts paid for the use of intangibles such as patents, trademarks, secret processes, formulas, and designs), (2) natural resource royalties, and (3) copyright royalties (such as payments from motion pictures, television programs or books).

For industrial royalties, treaty provisions range from an outright tax exemption to a maximum 30-percent tax rate. Treaty provisions for natural resource royalties require rates of 15 percent to 30 percent; however, a reduction in rate usually applies only if the recipient is subject to income tax in the country of residence. Also, in many cases the reduced tax rate does not apply if the recipient is engaged in a trade or business in the United States. The tax treatment of film rentals generally ranges from an outright exemption to a maximum rate of 30 percent.

Real Property Income

Under most treaties the recipient of real property income will be taxed at a 15-percent or 30-percent tax rate, depending on the applicable treaty. Such treaties also allow the recipient to make an election that permits such income to be taxed on a net income basis, as if the recipient were engaged in a trade or business. Gains from the sale of real property interests in the United States are, however, taxed under section 897, which overrides treaty provisions exempting nonresidents from gain on such sales for sales after December 31, 1984.

Capital Gains

The treatment of capital gains under U.S. tax treaties ranges from exemption to a 30-percent rate. Under some treaties (1) U.S.-source capital gains received by a nonresident alien present in the United States for a period not exceeding 183 days are exempt from tax; (2) the exemption or reduction in rate does not apply if the recipient has a permanent establishment; and (3) the exemption or reduction in rate does not apply to gains from the sale of real property, which is taxed under section 897.

Personal Service Income

Treaties provide for certain exemptions from foreign taxation for professional and personal services earned by a resident of one contracting country while he or she is present in the other contracting country. The two contracting countries agree to modify their tax treatment of residents of the other country. To qualify for the treaty exemptions, one must generally be an individual resident of one country who is performing personal services in the other contracting country. In a few treaties the term *citizen* is used instead of *resident*.

The types of personal services that are exempt from foreign taxation are compensation for services where the person is performing those services when in the other country for limited periods of time, pensions and life annuities, and professors and teachers who are present for limited periods of time.

The conditions for exemption of compensation for services of a citizen or resident of one treaty country for services performed in the other coun-

try vary by treaty. In many cases it depends on the type of services rendered and the period of time the person is present in the other country.

For example, under the United States-Australian Income Tax Treaty, income derived by a resident of one country for performing as an entertainer or athlete in the other is taxable in the country in which the services are performed if his or her gross receipts exceed $10,000 or its equivalent in Australian dollars in the taxable year. Many treaties provide that personal services income will not be taxed in the country in which it is rendered provided the compensation does not exceed a specified limit (some treaties do not have a limit), and the person performing the services is not present in the country in excess of 183 days. The treatment of various types of personal services under income tax treaties is shown in exhibit 6.3.

Model Treaties

There has been growing recognition of the need to harmonize tax treaties in order to achieve uniform principles, definitions, rules, methods, and interpretations. Incongruities in tax laws and tax treaties as they presently exist have not completely solved problems of double taxation.

Several model tax treaties have been created, the most notable being those of the United Nations, the Organization for Economic Cooperation and Development (OECD) and the U.S. Treasury Department. The OECD model treaty was first drafted in 1963 and revised in 1977, 1992, and 1995. This model often becomes a significant reference point for treaty discussions between member countries.[10] The latest version of the United States Model Income Tax Convention was issued on September 20, 1996. This model is a starting point for facilitating negotiations between the U.S. government and other countries. The *United States Model Income Tax Convention of September 20, 1996* follows as exhibit 6.4 on pages 172 through 186.

[10]Members of the OECD are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

Treaty Interpretation

Commentaries have been written on the OECD Model Treaty's provisions that are extremely influential and helpful in interpreting treaties. In addition, the U.S. Treasury and the Joint Committee on Taxation provide the Senate Foreign Relations Committee with technical explanations of treaty provisions. The Senate Foreign Relations Committee will also issue a report in its recommendation to the Senate, which may contain reservations to or understandings of the treaty. At times, these explanations provide helpful insight into the meaning of treaty language, particularly when there has been a dispute or discussion of a provision at Senate hearings on a treaty.[11]

[11]In *National Westminster Bank PLC v. United States*, No. 95-758T (Fed. Cl. July 7, 1999), the judge relied heavily on the Commentary to the OECD Model Treaty regarding business profits in his decision that Treas. Reg. Sec. 1.882-5 violated the 1975 U.S.-U.K. Treaty.

Exhibit 6.3

Compensation for Personal Services Performed in the United States Exempt From U.S. Income Tax Under Income Tax Treaties

Country (1)	Category of Personal Services: Code[1] (2)	Category of Personal Services: Purpose (3)	Maximum Presence in U.S. (4)	Required Employer or Payer (5)	Maximum Amount of Compensation (6)	Treaty Article Citation (7)
Australia	16	Independent personal services[22]	183 days	Any contractor	No limit	14
	20	Public entertainment	183 days	Any contractor	$10,000	17
	17	Dependent personal services[15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment[15]	183 days	Any foreign resident	$10,000	17
	19	Studying and training: Remittances or allowances[10]	No limit	Any foreign resident	No limit	20
Austria (before 1-1-98)	15	Scholarship or fellowship grant	No limit	Any U.S. or foreign resident[5]	No limit	XIII(3)
	16	Independent personal services	183 days	Austrian resident contractor	No limit	X
			183 days	Other foreign or U.S. resident contractor	$3,000	X
	17	Dependent personal services	183 days	Austrian resident	No limit	X
			183 days	Other foreign or U.S. resident	$3,000	X
	18	Teaching	2 years	U.S. educational institution	No limit	XII
	19	Studying and training: Remittances or allowances	No limit	Any foreign resident	No limit	XIII(1) & (2)
		Compensation while gaining experience[2]	1 year	Austrian resident	$10,000[3]	XIII(4)
Austria (beginning 1-1-98)	16	Independent personal services[22]	No limit	Any contractor	No limit	14
	20	Public entertainment	No limit	Any contractor	$20,000[25]	17
	17	Dependent personal services[15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment	No limit	Any U.S. or foreign resident	$20,000[25]	17
	19	Studying and training:[10] Remittances or allowances	3 years[11]	Any foreign resident	No limit	20
Barbados	16	Independent personal services[7,22]	89 days	Any foreign contractor	No limit	14
			89 days	Any U.S. contractor	$5,000	14
	20	Public entertainment	No limit	Any contractor	$250 per day or $4,000 p.a.[6]	17
	17	Dependent personal services[7,15]	183 days	Any foreign resident	$5,000	15
	20	*Public entertainment*	No limit	Any U.S. or foreign resident	$250 per day or $4,000 p.a.[6]	17
	19	Studying and training:[20] Remittances or allowances[10]	No limit	Any foreign resident	No limit	20
Belgium	15	Scholarship or fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	21(1)
	16	Independent personal services[22]	182 days	Any contractor	No limit	14(2)(a)(b)
	20	Public entertainment	90 days	Any contractor	$3,000	14(2)(c)
	17	Dependent personal services[15]	182 days	Belgian resident	No limit	15
	18	Teaching[4]	2 years	U.S. educational institution	No limit	20
	19	Studying and training: Remittances or allowances	5 years	Any foreign resident	No limit	21(1)
		Compensation during training	12 consec. mo.	Belgian resident	$5,000	21(2)(b)
			5 years	Other foreign or U.S. resident	$2,000 p.a.	21(1)
		Compensation while gaining experience[2]	12 consec. mo.	Belgian resident	$5,000	21(2)(a)
		Compensation under U.S. Government program	1 year	U.S. Government or its contractor	$10,000	21(3)
Canada	16	Independent personal services[22]	No limit	Any contractor	No limit[12]	XIV
	17	Dependent personal services	No limit	Any U.S. or foreign resident	$10,000	XV
			183 days	Any foreign resident[15]	No limit[12]	XV
	19	Studying and training: Remittances or allowances[10]	No limit	Any foreign resident	No limit	XX

Country (1)	Code[1] (2)	Category of Personal Services: Purpose (3)	Maximum Presence in U.S. (4)	Required Employer or Payer (5)	Maximum Amount of Compensation (6)	Treaty Article Citation (7)
China, People's Rep. of	15	Scholarship or fellowship grant[24]	No specific limit	Any U.S. or foreign resident[5]	No limit	20(b)
	16	Independent personal services[22]	183 days	Any contractor	No limit	13
	20	Public entertainment[29]	No limit	Any contractor	No limit	16
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	14
	20	Public entertainment[29]	No limit	Any U.S. or foreign resident	No limit	16
	18	Teaching[4]	3 years	U.S. educational or research institute	No limit	19
	19	Studying and training:				
		Remittances or allowances	No specific limit	Any foreign resident	No limit	20(a)
		Compensation during training or while gaining experience	No specific limit	Any U.S. or foreign resident	$5,000 p.a.	20(c)
Commonwealth of Independent States	15	Scholarship or fellowship grant	5 years	Any U.S. or foreign resident	Limited[19]	VI(1)
	16	Independent personal services	183 days	Any U.S. or foreign contractor	No limit	VI(2)
	17	Dependent personal services	183 days	Any U.S. or foreign resident	No limit	VI(2)
	18	Teaching[4,18]	2 years	Any U.S. educational or scientific institution	No limit	VI(1)
	19	Studying and training:				
		Remittances or allowances	5 years	Any U.S. or foreign resident	Limited[19]	VI(1)
		Compensation while gaining experience	1 year	C.I.S. resident	No limit[19]	VI(1)
		Compensation under U.S. Government program	1 year	Any U.S. or foreign resident	No limit	VI(1)
Cyprus	15	Scholarship or fellowship grant[24]	Generally, 5 years	Any U.S. or foreign resident[5]	No limit	21(1)
	16	Independent personal services[22]	182 days	Any contractor	No limit	17
	20	Public entertainment	No limit	Any contractor	$500 per day or $5,000 p.a.[6]	19(1)
	17	Dependent personal services[15]	182 days	Any foreign resident	No limit	18
		Directors' fees	No limit	U.S. corporation	No limit[21]	20
	20	Public entertainment	No limit	Any U.S. or foreign resident	$500 per day or $5,000 p.a.[6]	19(1)
	19	Studying and training:				
		Remittances or allowances	Generally, 5 years	Any foreign resident	No limit	21(1)
		Compensation during training	Generally, 5 years	Any U.S. or foreign resident	$2,000 p.a.	21(1)
		Compensation while gaining experience[2]	1 year	Cyprus resident	$7,500	21(2)
		Compensation under U.S. Government program	1 year	U.S. Government or its contractor	$10,000	21(3)
Czech Republic	15	Scholarship or fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	21(1)
	16	Independent personal services[22]	183 days	Any contractor	No limit	14
	20	Public entertainment	183 days	Any contractor	$20,000 p.a.[30]	18
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment	183 days	Any foreign resident	$20,000 p.a.[30]	18
	18	Teaching[4,35]	2 years	Any U.S. educational or research institution	No limit	21(5)
	19	Studying and training:				
		Remittances and allowances	5 years	Any foreign resident	No limit	21(1)
		Compensation during training	5 years	Any U.S. or foreign resident	$5,000 p.a.	21(1)
		Compensation while gaining experience[2]	12 consec. mos.	Czech resident	$8,000 p.a.	21(2)
		Compensation under U.S. Government program	1 year	U.S. Government	$10,000	21(3)
Denmark	16	Independent personal services	180 days	Danish resident contractor	No limit	XI
			90 days	Other foreign or U.S. resident contractor	$3,000	XI
	17	Dependent personal services	180 days	Danish resident	No limit	XI
			90 days	Other foreign or U.S. resident	$3,000	XI
	18	Teaching	2 years	U.S. educational institution	No limit	XIV
	19	Studying and training:				
		Remittances or allowances	No limit	Any foreign resident	No limit	XIII

(continued)

Exhibit 6.3

Compensation for Personal Services Performed in the United States Exempt From U.S. Income Tax Under Income Tax Treaties (cont.)

Country (1)	Code[1] (2)	Category of Personal Services: Purpose (3)	Maximum Presence in U.S. (4)	Required Employer or Payer (5)	Maximum Amount of Compensation (6)	Treaty Article Citation (7)
Egypt	15	Scholarship or fellowship grant[24]	Generally, 5 years	Any U.S. or foreign resident[5]	No limit	23(1)
	16	Independent personal services	89 days	Any contractor	No limit	15
	20	Public entertainment	No limit	Any contractor	$400 per day	17
	17	Dependent personal services[14,15]	89 days	Egyptian resident	No limit	16
	20	Public entertainment	No limit	Any U.S. or foreign resident	$400 per day	17
	18	Teaching[4]	2 years	U.S. educational institution	No limit	22
	19	Studying and training:				
		Remittances or allowances	Generally, 5 years	Any foreign resident	No limit	23(1)
		Compensation during training	Generally, 5 years	U.S. or any foreign resident	$3,000 p.a.	23(1)
		Compensation while gaining experience[2]	12 consec. mos.	Egyptian resident	$7,500	23(2)
		Compensation under U.S. Government program	1 year	U.S. Government or its contractor	$10,000	23(3)
Finland	16	Independent personal services[22]	No limit	Any contractor	No limit	14
	20	Public entertainment	No limit	Any contractor	$20,000 p.a.[25]	17
	17	Dependent personal services[15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment	No limit	Any U.S. or foreign resident	$20,000 p.a.[25]	17
	19	Studying and training:				
		Remittances or allowances[10]	No limit	Any foreign resident	No limit	20
France	15	Scholarship or fellowship grant[24]	5 years[40]	Any U.S. or foreign resident[5]	No limit	21(1)
	16	Independent personal services[22]	No limit	Any contractor	No limit	14
	20	Public entertainment	No limit	Any contractor	$10,000[30]	17
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment	No limit	Any U.S. or foreign resident	$10,000[30]	17
	18	Teaching[4,39]	2 years[40]	U.S. educational or research institution	No limit	20
	19	Studying and training:[4]				
		Remittances or allowances	5 years[40]	Any foreign resident	No limit	21(1)
		Compensation during study or training	12 consec. mos.	French resident	$8,000	21(2)
			5 years	Other foreign or U.S. resident	$5,000 p.a.	21(1)
		Compensation while gaining experience	12 consec. mos.	French resident[2]	$8,000	21(2)
Germany	15	Scholarship or fellowship grant	No limit	Any U.S. or foreign resident[5]	No limit	20(3)
	16	Independent personal services[7,22]	No limit	Any contractor	No limit	14
	20	Public entertainment[22]	No limit	Any contractor	$20,000 p.a.[30]	17
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment[15]	183 days	Any foreign resident	$20,000 p.a.[30]	17
	18	Teaching[4]	2 years	U.S. educational or research institution	No limit	20(1)
	19	Studying and training:				
		Remittances or allowances[10]	No limit	Any foreign resident	No limit	20(2)
		Compensation during study or training	4 years	Any U.S. or foreign resident	$5,000 p.a.	20(4)
		Compensation while gaining experience[2]	1 year	Any German enterprise or foreign organization or institution	$10,000[28]	20(5)
Greece	16	Independent personal services	183 days	Greek resident contractor	No limit	X
			183 days	Other foreign or U.S. resident contractor	$10,000	X
	17	Dependent personal services	183 days	Greek resident	No limit	X
			183 days	Other foreign or U.S. resident	$10,000	X
	18	Teaching	3 years	U.S. educational institution	No limit	XII
	19	Studying and training:				
		Remittances or allowances	No limit	Any foreign resident	No limit	XIII
Hungary	16	Independent personal services[22]	183 days	Any contractor	No limit	13
	17	Dependent personal services[15]	183 days	Any foreign resident	No limit	14
	18	Teaching[4]	2 years	U.S. educational institution	No limit	17
	19	Studying and training:[20]				
		Remittances or allowances[10]	No limit	Any foreign resident	No limit	18(1)

Country (1)	Code[1] (2)	Category of Personal Services — Purpose (3)	Maximum Presence in U.S. (4)	Required Employer or Payer (5)	Maximum Amount of Compensation (6)	Treaty Article Citation (7)
Iceland	15	Scholarship and fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	22(1)
	16	Independent personal services[22]	182 days	Any contractor	No limit	18
	20	Public entertainment	90 days	Any contractor	$100 per day	18
	17	Dependent personal services[15]	182 days	Iceland resident[16]	No limit	19
	18	Teaching[4]	2 years	U.S. educational institution	No limit	21
	19	Studying and training:				
		Remittances or allowances	5 years	Any foreign resident	No limit	22(1)
		Compensation during training	5 years	U.S. or any foreign resident	$2,000 p.a.	22(1)
		Compensation while gaining experience[2]	12 consec. mo.	Iceland resident	$5,000	22(2)
		Compensation under U.S. Government program	1 year	U.S. Government or its contractor	$10,000	22(3)
India	16	Independent personal services[7,22]	89 days	Any contractor	No limit	15
	20	Public entertainment[22]	89 days	Any contractor	$1,500 p.a.[26]	18
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	16
	20	Public entertainment[15]	183 days	Any foreign resident	$1,500 p.a.[26]	18
	18	Teaching[4]	2 years	U.S. educational institution	No limit	22
	19	Studying and training:				
		Remittances or allowances	No limit	Any foreign resident[27]	No limit	21(1)
Indonesia	15	Scholarship and fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	19(1)
	16	Independent personal services[22]	119 days	Any contractor	No limit	15
	20	Public entertainment	No limit	Any contractor	$2,000 p.a.[25]	17
	17	Dependent personal services[15]	119 days	Any foreign resident	No limit	16
	20	Public entertainment	No limit	Any U.S. or foreign resident	$2,000 p.a.[25]	17
	18	Teaching[4]	2 years	U.S. educational institution	No limit	20
	19	Studying and training:				
		Remittances or allowances	5 years	Any foreign resident	No limit	19(1)
		Compensation during training	5 years	Any foreign or U.S. resident	$2,000 p.a.	19(1)
		Compensation while gaining experience	12 consec. mo.	Any U.S. or foreign resident	$7,500	19(2)
Ireland (before 1-1-98)	16	Independent personal services	183 days	Irish resident contractor	No limit	XI
	17	Dependent personal services	183 days	Irish resident	No limit	XI
	18	Teaching	2 years	U.S. educational institution	No limit	XVIII
	19	Studying and training:				
		Remittances or allowances[10]	No limit	Irish resident	No limit	XIX
Ireland	16	Independent personal services[22]	No limit	Any contractor	No limit	14
	20	Public entertainment	No limit	Any contractor	$20,000[25]	17
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment	No limit	Any U.S. or foreign resident	$20,000[25]	17
	19	Studying and training:[10]				
		Remittances or allowances	1 year[11]	Any foreign resident	No limit	20
Israel	15	Scholarship and fellowship grant	5 years	Any U.S. or foreign resident[5]	No limit	24(1)
	16	Independent personal services	182 days	Any contractor	No limit	16
	20	Public entertainment	No limit	Any contractor	$400 per day[26]	18
	17	Dependent personal services[14,15]	182 days	Israeli resident[16]	No limit	17
	20	Public entertainment	No limit	Any U.S. or foreign resident	$400 per day[26]	18
	18	Teaching[4,37]	2 years	U.S. educational institution	No limit	23
	19	Studying and training:				
		Remittances or allowances	5 years	Any foreign resident	No limit	24(1)
		Compensation during study or training	5 years	Any U.S. or foreign resident	$3,000 p.a.	24(1)
		Compensation while gaining experience[2]	12 consec. mo.	Israeli resident	$7,500	24(2)
		Compensation under U.S. Government program	1 year	U.S. Government or its contractor	$10,000	24(3)

(continued)

Exhibit 6.3

Compensation for Personal Services Performed in the United States Exempt From U.S. Income Tax Under Income Tax Treaties (cont.)

Country (1)	Code[1] (2)	Category of Personal Services: Purpose (3)	Maximum Presence in U.S. (4)	Required Employer or Payer (5)	Maximum Amount of Compensation (6)	Treaty Article Citation (7)
Italy	16	Independent personal services[7,22]	183 days	Any contractor	No limit	14
	20	Public entertainment	90 days	Any contractor	$12,000 p.a.[25]	17(1)
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment	90 days	Any U.S. or foreign resident	$12,000 p.a.[25]	17(1)
	18	Teaching[4]	2 years	U.S. educational institution	No limit	20
	19	Studying and training: Remittances or allowances	No limit	Any foreign resident	No limit	21
Jamaica	16	Independent personal services[22]	89 days	Any foreign contractor	No limit	14
			89 days	Any U.S. contractor	$5,000 p.a.	14
	20	Public entertainment	No limit	Any contractor	$400 per day or $5,000 p.a.[6]	18
	17	Dependent personal services[15]	183 days	Any foreign resident	$5,000 p.a.	15
	20	Public entertainment	No limit	Any U.S. or foreign resident	$400 per day or $5,000 p.a.[6]	18
		Directors' fees	No limit	U.S. resident	$400 per day[6]	16
	18	Teaching[4]	2 years	U.S. educational institution	No limit	22
	19	Studying and training:[20] Remittances or allowances[10]	No limit	Any foreign resident	No limit	21(1)
		Compensation during study	12 consec. mo.	Jamaican resident	$7,500 p.a.	21(2)
		Compensation while gaining experience[2]	12 consec. mo.	Jamaican resident	$7,500 p.a.	21(2)
Japan	15	Scholarship or fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	20(1)
	16	Independent personal services[22]	183 days	Any contractor	No limit	17
	20	Public entertainment	90 days	Any contractor	$3,000[6]	17
	17	Dependent personal services[15,17]	183 days	Japanese resident[16]	No limit	18
	18	Teaching[4]	2 years	U.S. educational institution	No limit	19
	19	Studying and training: Remittances or allowances	5 years	Any foreign resident	No limit	20(1)
		Compensation during training	5 years	U.S. or any foreign resident	$2,000 p.a.[6]	20(1)
		Compensation while gaining experience[2]	12 consec. mo.	Japanese resident	$5,000[6]	20(2)
		Compensation under U.S. Government program	1 year	U.S. Government or its contractor	$10,000[6]	20(3)
Kazakstan	15	Scholarship or fellowship grant[24,44]	5 years[31]	Any U.S. or foreign resident[5]	No limit	19
	16	Independent personal services[22]	183 days	Any contractor	No limit	14
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	15
	19	Studying and training:[4] Remittances or allowances	5 years	Any foreign resident	No limit	19
Korea, Rep. of	15	Scholarship or fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	21(1)
	16	Independent personal services[22]	182 days	Any contractor	$3,000 p.a.	18
	17	Dependent personal services[15]	182 days	Korean resident[16]	$3,000 p.a.	19
	18	Teaching[4]	2 years	U.S. educational institution	No limit	20
	19	Studying and training: Remittances or allowances	5 years	Any foreign resident	No limit	21(1)
		Compensation during training	5 years	Any foreign or U.S. resident	$2,000 p.a.	21(1)
		Compensation while gaining experience[2]	1 year	Korean resident	$5,000	21(2)
		Compensation under U.S. Government program	1 year	U.S. Government or its contractor	$10,000	21(3)

Country (1)	Code[1] (2)	Category of Personal Services: Purpose (3)	Maximum Presence in U.S. (4)	Required Employer or Payer (5)	Maximum Amount of Compensation (6)	Treaty Article Citation (7)
Luxembourg	15	Scholarship or fellowship grant	No limit	Any foreign resident[5]	No limit	XIV(1)
	16	Independent personal services	180 days	Luxembourg resident[43]	No limit	XII
			180 days	Any U.S. or foreign resident	$3,000	XII
	17	Dependent personal services[7]	180 days	Luxembourg resident[43]	No limit	XII
			180 days	Any U.S. or foreign resident	$3,000	XII
	18	Teaching[8]	2 years	U.S. educational institution	No limit	XIII
	19	Studying and training:				
		Remittances or allowances	No limit	Any foreign resident	No limit	XIV(1)
		Compensation during training	1 year	Any foreign resident	No limit	XIV(1)
		Compensation while gaining experience[2]	1 year	Any foreign resident	$5,000	XIV(2)
		Compensation under U.S. Government program	1 year	U.S. Government, its contractor, or a foreign resident	$10,000	XIV(3)
Mexico	16	Independent personal services[22]	183 days	Any contractor	No limit	14
	20	Public entertainment	No limit	Any contractor	$3,000 p.a.[30]	18
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment	No limit	Any U.S. or foreign resident	$3,000 p.a.[30]	18
	19	Studying and training:				
		Remittances or allowances	No limit	Any foreign resident	No limit	21
Morocco	15	Scholarship or fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	18
	16	Independent personal services[22]	182 days	Any contractor[12]	$5,000	14
	17	Dependent personal services[15]	182 days	Moroccan resident[12, 16]	No limit	15
	19	Studying and training:				
		Remittances or allowances	5 years	Any foreign resident	No limit	18
		Compensation during training	5 years	U.S. or any foreign resident	$2,000 p.a.	18
Netherlands	15	Scholarship or fellowship grant[24,33]	3 years	Any U.S. or foreign resident[5]	No limit	22(2)
	16	Independent personal services[22]	No limit	Any contractor	No limit	15
	20	Public entertainment	No limit	Any contractor	$10,000 p.a.[25]	18
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	16
	20	Public entertainment	183 days	Any foreign resident	$10,000 p.a.[25]	18
	18	Teaching[4,34]	2 years	U.S. educational institution	No limit	21(1)
	19	Studying and training:[33]				
		Remittances or allowances	No limit	Any foreign resident	No limit	22(1)
		Compensation while gaining experience	No limit	Any U.S. or foreign resident	$2,000 p.a.	22(1)
		Compensation while recipient of scholarship or fellowship grant	3 years	Any U.S. or foreign resident	$2,000 p.a.[36]	22(2)
New Zealand	16	Independent personal services[22]	183 days	Any contractor	No limit	14
	20	Public entertainment	183 days	Any contractor	$10,000[25]	17
	17	Dependent personal services[15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment[15]	183 days	Any foreign resident	$10,000[25]	17
	19	Studying and training:[10]				
		Remittances or allowances	No limit	Any foreign resident	No limit	20
Norway	15	Scholarship or fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	16(1)
	16	Independent personal services[22]	182 days	Any contractor	No limit	13
	20	Public entertainment	90 days	Any contractor	$10,000 p.a.	13
	17	Dependent personal services	182 days	Norwegian resident[16]	No limit	14
	18	Teaching[4]	2 years	U.S. educational institution	No limit	15
	19	Studying and training:				
		Remittances or allowances	5 years	Any foreign resident	No limit	16(1)
		Compensation during training	5 years	U.S. or any foreign resident	$2,000 p.a.	16(1)
		Compensation while gaining experience[2]	12 consec. mo.	Norwegian resident	$5,000	16(2)
		Compensation under U.S. Government program	1 year	U.S. Government or its contractor	$10,000	16(3)

(continued)

Exhibit 6.3
Compensation for Personal Services Performed in the United States Exempt From U.S. Income Tax Under Income Tax Treaties (cont.)

Country (1)	Code[1] (2)	Category of Personal Services: Purpose (3)	Maximum Presence in U.S. (4)	Required Employer or Payer (5)	Maximum Amount of Compensation (6)	Treaty Article Citation (7)
Pakistan	15	Scholarship or fellowship grant[24]	No limit	Pakistani nonprofit organization	No limit	XIII(1)
	16	Independent personal services[14]	183 days	Pakistani resident contractor	No limit	XI
	17	Dependent personal services[14]	183 days	Pakistani resident	No limit	XI
	18	Teaching	2 years	U.S. educational institution	No limit	XII
	19	Studying and training:				
		Remittances or allowances	No limit	Any foreign resident	No limit	XIII(1)
		Compensation during training	No limit	U.S. or any foreign resident	$5,000 p.a.	XIII(1)
		Compensation while gaining experience[2]	1 year	Pakistani resident	$6,000	XIII(2)
		Compensation while under U.S. Government program	No limit	U.S. Government, its contractor, or any foreign resident employer	$10,000	XIII(3)
Philippines	15	Scholarship or fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	22(1)
	16	Independent personal services[22]	89 days	Any foreign contractor	No limit	15
			89 days	Any U.S. resident	$10,000 p.a.	15
	20	Public entertainment	No limit	Any contractor	$100 per day or $3,000 p.a.	17
	17	Dependent personal services[15]	89 days	Any Philippines resident[16]	No limit	16
	20	Public entertainment	No limit	Any U.S. or foreign resident	$100 per day or $3,000 p.a.	17
	18	Teaching[4,38]	2 years	U.S. educational institution	No limit	21
	19	Studying and training:				
		Remittances or allowances	5 years	Any foreign resident	No limit	22(1)
		Compensation during study	5 years	Any U.S. or foreign resident	$3,000 p.a.	22(1)
		Compensation while gaining experience[2]	12 consec. mo.	Philippines resident	$7,500 p.a.	22(2)
		Compensation while under U.S. Government program	1 year	U.S. Government or its contractor	$10,000 p.a.	22(3)
Poland	15	Scholarship or fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	18(1)
	16	Independent personal services	182 days	Any contractor	No limit	15
	17	Dependent personal services[18]	182 days	Any foreign resident	No limit	16
	18	Teaching[4]	2 years	U.S. educational institution	No limit	17
	19	Studying and training:				
		Remittances or allowances	5 years	Any foreign resident	No limit	18(1)
		Compensation during training	5 years	U.S. or any foreign resident	$2,000 p.a.	18(1)
		Compensation while gaining experience[2]	1 year	Polish resident	$5,000	18(2)
		Compensation while under U.S. Government program	1 year	U.S. Government or its contractor	$10,000	18(3)
Portugal	15	Scholarship or fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	23(1)
	16	Independent personal services[22]	182 days	Any contractor	No limit	15
	20	Public entertainment	No limit	Any contractor	$10,000 p.a.[30]	19
	17	Dependent personal services[7,18]	183 days	Any foreign resident	No limit	16
	20	Public entertainment	No limit	Any U.S. or foreign resident	$10,000 p.a.[30]	19
	18	Teaching[4,41]	2 years[40]	U.S. educational institution	No limit	22
	19	Studying and training:[4]				
		Remittances or allowances	5 years[40]	Any foreign resident	No limit	23(1)
		Compensation during study or training	12 consec. mos.	Portuguese resident	$8,000	23(2)
			5 years[40]	Other foreign or U.S. resident	$5,000 p.a.	23(1)
		Compensation while gaining experience	12 consec. mos.	Portuguese resident[2]	$8,000	23(2)

Country (1)	Code[1] (2)	Category of Personal Services: Purpose (3)	Maximum Presence in U.S. (4)	Required Employer or Payer (5)	Maximum Amount of Compensation (6)	Treaty Article Citation (7)
Romania	15	Scholarship or fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	20(1)
	16	Independent personal services[22]	182 days	Any contractor	No limit	14
	20	Public entertainment	90 days	Any contractor	$3,000	14
	17	Dependent personal services[15]	182 days	Romanian resident	No limit	15
	20	Public entertainment	89 days	Romanian resident	$2,999.99	15
	18	Teaching[4]	2 years	U.S. educational institution	No limit	19
	19	Studying and training:				
		Remittances or allowances	5 years	Any foreign resident	No limit	20(1)
		Compensation during training	5 years	U.S. or any foreign resident	$2,000 p.a.	20(1)
		Compensation while gaining experience[2]	1 year	Romanian resident	$5,000	20(2)
		Compensation while under U.S. Government program	1 year	U.S. Government or its contractor	$10,000	20(3)
Russia	15	Scholarship or fellowship grant[24,44]	5 years[31]	Any U.S. or foreign resident[5]	No limit	18
	16	Independent personal services[22]	183 days	Any contractor	No limit	13
	17	Dependent personal services[7,15,32]	183 days	Any foreign resident	No limit	14
	19	Studying and training:[4]				
		Remittances	5 years[31]	Any foreign resident	No limit	18
Slovak Republic	15	Scholarship or fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	21(1)
	16	Independent personal services[22]	183 days	Any contractor	No limit	14
	20	Public entertainment	183 days	Any contractor	$20,000 p.a.[30]	18
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment	183 days	Any foreign resident	$20,000 p.a.[30]	18
	18	Teaching[4,35]	2 years	Any U.S. educational or research institution	No limit	21(5)
	19	Studying and training:				
		Remittances or allowances	5 years	Any foreign resident	No limit	21(1)
		Compensation during training	5 years	Any U.S. or foreign resident	$5,000 p.a.	21(1)
		Compensation while gaining experience[2]	12 consec. mos.	Slovak resident	$8,000	21(2)
		Compensation while under U.S. Government program	1 year	U.S. Government	$10,000	21(3)
South Africa	16	Independent personal services[22]	183 days	Any contractor	No limit	14
	20	Public entertainment	No limit	Any contractor	$7,500[30]	17
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment	No limit	Any U.S. or foreign resident	$7,500[30]	17
	19	Studying and training:[10]				
		Remittances or allowances	1 year[11]	Any foreign resident	No limit	20
Spain	15	Scholarship or fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	22(1)
	16	Independent personal services[22]	No limit	Any contractor	No limit	15
	20	Public entertainment	No limit	Any contractor	$10,000 p.a.[30]	19
	17	Dependent personal services[15]	183 days	Any foreign resident	No limit	16
	20	Public entertainment	No limit	Any U.S. or foreign resident	$10,000 p.a.[30]	19
	19	Studying and training:[4]				
		Remittances or allowances	5 years	Any foreign resident	No limit	22(1)
		Compensation during training	5 years	Any U.S. or foreign resident	$5,000 p.a.	22(1)
		Compensation while gaining experience[2]	12 consec. mo.	Spanish resident	$8,000	22(2)
Sweden	16	Independent personal services[22]	No limit	Any contractor	No limit	14
	20	Public entertainment	No limit	Any contractor	$6,000[42]	18
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment	No limit	Any U.S. or foreign resident	$6,000[42]	18
	19	Studying and training:				
		Remittances or allowances[10]	No limit	Any foreign resident	No limit	21
Switzerland (before 1-1-98)	16	Independent personal services[9]	183 days	Swiss resident contractor	No limit	X
			183 days	Other foreign or U.S. contractor	$10,000	X
	17	Dependent personal services[9]	183 days	Swiss resident	No limit	X
			183 days	Other foreign or U.S. contractor	$10,000	X
	18	Teaching	2 years	U.S. educational institution	No limit	XII
	19	Studying and training:				
		Remittances or allowances	No limit	Any foreign resident	No limit	XIII

(continued)

Exhibit 6.3

Compensation for Personal Services Performed in the United States Exempt From U.S. Income Tax Under Income Tax Treaties (cont.)

Country (1)	Code[1] (2)	Category of Personal Services: Purpose (3)	Maximum Presence in U.S. (4)	Required Employer or Payer (5)	Maximum Amount of Compensation (6)	Treaty Article Citation (7)
Switzerland	16	Independent personal services[22]	No limit	Any contractor	No limit	14
	20	Public entertainment	No limit	Any contractor	$10,000[25]	17
	17	Dependent personal services[7,15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment	No limit	Any U.S. or foreign resident	$10,000[25]	17
	19	Studying and training:[10]				
		Remittances or allowances	No limit	Any foreign resident	No limit	20
Thailand	15	Scholarship or fellowship grant	5 years	Any U.S. or foreign resident[5]	No limit	22(1)
	16	Independent personal services[22]	89 days	Any U.S. resident	$10,000	15
			89 days	Any foreign contractor	No limit[45]	15
	20	Public entertainment	No limit	Any contractor[46]	$100 per day or $3,000 p.a.[49]	19
	17	Dependent personal services[15,47]	183 days	Any foreign resident	No limit	16
	20	Public entertainment	No limit	Any U.S. or foreign resident[46]	$100 per day or $3,000 p.a.[49]	17
	18	Teaching or research[4,38]	2 years	Any U.S. or foreign resident	No limit	23
	19	Studying and training:				
		Remittances or allowances	5 years	Any foreign resident	No limit	22(1)
		Compensation during training	5 years	Any U.S. or foreign resident	$3,000 p.a.	22(1)
		Compensation while gaining experience	12 consec. mos.	Thai resident[2]	$7,500	22(2)
		Compensation under U.S. Government program	1 year	U.S. Government	$10,000[49]	22(3)
Trinidad and Tobago	15	Scholarship or fellowship grant[24]	5 years	Any U.S. or foreign resident[5]	No limit	19(1)
	16	Independent personal services[13]	183 days	Any foreign resident contractor	No limit[6]	17
			183 days	Any U.S. contractor	$3,000[6]	17
	17	Dependent personal services[13]	183 days	Any foreign resident	No limit[6]	17
			183 days	Any U.S. resident	$3,000[6]	17
	18	Teaching[4]	2 years	U.S. educational institution or U.S. Government	No limit	18
	19	Studying and training:				
		Remittances or allowances	5 years	Any foreign resident	No limit	19(1)
		Compensation during training	5 years	U.S. or any foreign resident	$2,000 p.a.[6]	19(1)
		Compensation during professional training	5 years	U.S. or any foreign resident	$5,000 p.a.[6]	19(1)
		Compensation while gaining experience[2]	1 year	Trinidad–Tobago resident	$5,000[6]	19(2)
		Compensation under U.S. Government program	1 year	U.S. Government or its contractor	$10,000[6]	19(3)
Tunisia	15	Scholarship or fellowship grant[10,24]	5 years	Any U.S. or foreign resident[5]	No limit	20
	16	Independent personal services[22]	183 days	U.S. resident contractor	$7,500 p.a.	14
	20	Public entertainment	No limit	Any contractor	$7,500 p.a.[25]	17
	17	Dependent personal services[15]	183 days	Any foreign resident	No limit	15
	20	Public entertainment	No limit	Any U.S. or foreign resident	$7,500 p.a.[25]	17
	19	Studying and training:[10]				
		Remittances or allowances	5 years	Any foreign resident	No limit	20
		Compensation during training	5 years	Any U.S. or foreign resident	$4,000 p.a.	20
Turkey	16	Independent personal services[22]	183 days	Any contractor	No limit	14
	20	Public entertainment[46]	No limit	Any contractor	$3,000[49]	17
	17	Dependent personal services[15,48]	183 days	Any foreign resident	No limit	15
	20	Public entertainment[46]	No limit	Any U.S. or foreign resident	$3,000[49]	17
	18	Teaching or research	2 years	Any foreign resident	No limit	20(2)
	19	Studying and training:[10]				
		Remittances or allowances	No limit	Any foreign resident	No limit	20(1)
United Kingdom	16	Independent personal services[22]	183 days	Any contractor	No limit[12]	14
	17	Dependent personal services[15]	183 days	Any foreign resident	No limit[12]	15
	18	Teaching[4]	2 years	U.S. educational institution	No limit	20
	19	Studying and training:				
		Remittances or allowances[10]	No limit	Any foreign resident	No limit	21

[1] Refers to income code numbers under which the income is reported on Forms 1042-S. Personal services must be performed by a nonresident alien individual who is a resident of the specified treaty country.

[2] Applies only if training or experience is received from a person other than alien's employer.

[3] Annual compensation for services wherever performed.

[4] Does not apply to compensation for research work primarily for private benefit.

[5] Grant must be from a nonprofit organization. In many cases, the exemption also applies to amounts from either the U.S. or foreign government. For Indonesia and the Netherlands, the exemption also applies if the amount is awarded under a technical assistance program entered into by the United States or the foreign government, or its political subdivisions or local authorities.

[6] Reimbursed expenses are not taken into account in figuring any maximum compensation to which the exemption applies. For Japan and Trinidad and Tobago, only reimbursed travel expenses are disregarded in figuring the maximum compensation.

[7] Does not apply to fees of a foreign director of a U.S. corporation.

[8] Does not apply to compensation for research work for other than the U.S. educational institution involved.

[9] Applies to public entertainment in accordance with U.S. reservation rejecting exclusion contained in Art. X(4) of the Switzerland treaty.

[10] Applies only to full-time student or trainee.

[11] The time limit pertains only to an apprentice or business trainee.

[12] Does not apply to compensation paid to public entertainers (actors, artists, musicians, athletes, etc.). For Canadian or U.K. resident public entertainers, the exemption does not apply if the gross receipts (including reimbursements) are more than $15,000 in any year.

[13] Does not apply to compensation paid to public entertainers that is more than $100 a day.

[14] Exemption applies only if the compensation is subject to tax in the country of residence.

[15] The exemption does not apply if the employee's compensation is borne by a permanent establishment (or in some cases a fixed base) that the employer has in the United States.

[16] The exemption also applies if the employer is a permanent establishment in the treaty country but is not a resident of the treaty country.

[17] This exemption does not apply in certain cases if the employee is a substantial owner of that employer and the employer is engaged in certain defined activities.

[18] The exemption is also extended to journalists and correspondents who are temporarily in the U.S. for periods not longer than 2 years and who receive compensation from abroad.

[19] Also exempt are amounts of up to $10,000 received from U.S. sources to provide ordinary living expenses. For students, the amount will be less than $10,000, determined on a case by case basis.

[20] A student or trainee may choose to be treated as a U.S. resident for tax purposes. If the choice is made, it may not be changed without the consent of the U.S. competent authority.

[21] Amounts received in excess of a reasonable fixed amount payable to all directors for attending meetings in the United States are taxable.

[22] Exemption does not apply to the extent income is attributable to the recipient's fixed U.S. base. For residents of Japan, this fixed base must be maintained in the U.S. for more than 183 days during the tax year for the exemption not to apply; for residents of Belgium, Iceland, Korea, and Norway, the fixed base must be maintained for more than 182 days; for residents of Morocco, the fixed base must be maintained for more than 89 days.

[23] Exemption does not apply if the recipient maintains a permanent establishment in the U.S. with which the income is effectively connected.

[24] Does not apply to payments from the National Institutes of Health (NIH) under its Visiting Associate Program and Visiting Scientist Program.

[25] Exemption does not apply if gross receipts (including reimbursements) exceed this amount.

[26] Exemption does not apply if net income (or gross income for Israel) exceeds this amount.

[27] Exemption does not apply to payments borne by a permanent establishment in the United States or paid by a U.S. citizen or resident or the federal, state, or local government.

[28] Exemption does not apply if compensation exceeds this amount.

[29] The exemption applies only to income from activities performed under special cultural exchange programs agreed to by the U.S. and Chinese governments.

[30] Exemption does not apply if gross receipts (or compensation for Portugal), including reimbursements, exceed this amount. Income is fully exempt if visit to the United States is substantially supported by public funds of the treaty country or its political subdivisions or local authorities.

[31] The 5-year limit pertains only to training or research.

[32] Compensation from employment directly connected with a place of business that is not a permanent establishment is exempt if the alien is present in the United States for a period not exceeding 12 consecutive months. Compensation for technical services directly connected with the application of a right or property giving rise to a royalty is exempt if the services are provided as part of a contract granting the use of the right or property.

[33] Exemption does not apply if, during the immediately preceding period, the individual claimed the benefits of Article 21.

[34] Exemption does not apply if, during the immediately preceding period, the individual claimed the benefits of Article 22.

[35] Exemption does not apply if the individual either (a) claimed the benefit of Article 21(5) during a previous visit, or (b) during the immediately preceding period, claimed the benefit of Article 21(1), (2), or (3).

[36] Exemption applies only to compensation for personal services performed in connection with, or incidental to, the individual's study, research, or training.

[37] Exemption does not apply if, during the immediately preceding period, the individual claimed the benefits of Article 24(1).

[38] Exemption does not apply if, during the immediately preceding period, the individual claimed the benefits of Article 22(1).

[39] Exemption does not apply if the individual previously claimed the benefit of this Article.

[40] The combined period of benefits under Articles 20 and 21(1) cannot exceed 5 years.

[41] Exemption does not apply if the individual either (a) previously claimed the benefit of this Article, or (b) during the immediately preceding period, claimed the benefit of Article 23. The benefits under Articles 22 and 23 cannot be claimed at the same time.

[42] Exemption does not apply if gross receipts (including reimbursements) exceed this amount during any 12-month period.

[43] The exemption also applies if the income is borne by an employer that is a permanent establishment of a U.S. enterprise in Luxembourg.

[44] Applies to grants, allowances, and other similar payments received for studying or doing research.

[45] A $10,000 limit applies if the expense is borne by a permanent establishment or a fixed base in the United States.

[46] This provision does not apply if visit to the United States is substantially supported by public funds of the treaty country or its political subdivisions or local authorities.

[47] Fees paid to a resident of Thailand for services as a director of a U.S. corporation are subject to U.S. tax, unless the services are performed in Thailand.

[48] Fees paid to a resident of Turkey for services performed in the United States as a director of a U.S. corporation are subject to tax.

[49] Exemption does not apply if gross receipts exceed this amount.

Source: U.S. Internal Revenue Service Publication No. 901, *U.S. Tax Treaties* (Washington, DC: GPO, May 1998), 30–39.

Exhibit 6.4

United States Model Income Tax Convention of September 20, 1996

TREASURY DEPARTMENT MODEL INCOME TAX TREATY

MODEL OF JUNE 16, 1981

CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND .... FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL

The United States of America and ...., desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, have agreed as follows:

Article 1

GENERAL SCOPE

1. This Convention shall apply to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention.

2. The Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded

(a) by the laws of either Contracting State; or

(b) by any other agreement between the Contracting States.

3. Notwithstanding any provision of the Convention except paragraph 4, a Contracting State may tax its residents (as determined under Article 4 (Residence)), and by reason of citizenship may tax its citizens, as if the Convention had not come into effect. For this purpose, the term "citizen" shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of income tax, but only for a period of 10 years following such loss.

4. The provisions of paragraph 3 shall not affect

(a) the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), under paragraphs 1(b) and 4 of Article 18 (Pensions, Annuities, Alimony, and Child Support), and under Articles 23 (Relief From Double Taxation), 24 (Non-Discrimination), and 25 (Mutual Agreement Procedure); and

(b) the benefits conferred by a Contracting State under Articles 19 (Government Service), 20 (Students and Trainees), and 27 (Diplomatic Agents and Consular Officers), upon individuals who are neither citizens of, nor have immigrant status in, that State.

Article 2

TAXES COVERED

1. The existing taxes to which this Convention shall apply are

(a) in the United States: the Federal income taxes imposed by the Internal Revenue Code (but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes), and the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations. The Convention shall, however, apply to the excise taxes imposed on insurance premiums paid to foreign insurers only to the extent that the risks covered by such premiums are not reinsured with a person not entitled to the benefits of this or any other convention which applies to these taxes;

(b) in ....

2. The Convention shall apply also to any identical or, substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting State shall notify each other of any significant changes which have been made in their respective taxation laws and of any official published material concerning the application of the Convention, including explanations, regulations, rulings, or judicial decisions.

Article 3

GENERAL DEFINITIONS

1. For the purposes of this Convention, unless the context otherwise requires

(a) the term "person" includes an individual, an estate, a trust, a partnership, a company, and any other body of persons;

(b) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;

(c) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

(d) the term "international traffic" means any transport by a ship or aircraft, except when such transport is solely between places in the other Contracting State;

(e) the term "competent authority" means

(i) in the United States: the Secretary of the Treasury or his delegate; and

(ii) in .... ;

(f) the term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam, or any other United States possession or territory;

(g) the term means ....

2. As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a common meaning pursuant to the provisions of Article 25 (Mutual Agreement Procedure), have the meaning which it has under the laws of that State concerning the taxes to which the Convention applies.

Article 4

RESIDENCE

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, provide, however, that

(a) this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein; and

(b) in the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries.

2. Where by reason of the provisions of paragraph 1, an individual is a resident of both Contracting States, then his status shall be determined as follows:

(a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (center of vital interests);

(b) if the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;

(c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;

(d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a company is a resident of both Contracting States, then if it is created under the laws of a Contracting State or a political subdivision thereof, it shall be deemed to be a resident of that State.

4. Where by reason of the provisions of paragraph 1 a person other than an individual or a company is a resident of both Contracting States, the competent authorities of the Contracting States shall settle the question by mutual agreement and determine the mode of application of the Convention to such person.

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially

(a) a place of management;

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop; and

(f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3. A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include

(a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

(f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (a) to (e).

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person—other than an agent of an independent status to whom paragraph 6 applies—is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of

business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Article 6

INCOME FROM REAL PROPERTY (IMMOVABLE PROPERTY)

1. Income derived by a resident of a Contracting State from real property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

2. The term "real property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated.

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of real property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

5. A resident of a Contracting State who is liable to tax in the other Contracting State on income from real property situated in the other Contracting State may elect for any taxable year to compute the tax on such income on a net basis as if such income were attributable to a permanent establishment in such other State. Any such election shall be binding for the taxable year of the election and all subsequent taxable years unless the competent authorities of the Contracting States, pursuant to a request by the taxpayer made to the competent authority of the Contracting State in which the taxpayer is a resident, agree to terminate the election.

Article 7

BUSINESS PROFITS

1. The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the business profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.

3. In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the

permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere.

4. No business profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. For the purposes of this Convention, the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment and shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where business profits include items of income which are dealt with separately in other Articles of the Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

7. For the purposes of the Convention, the term "business profits" means income derived from any trade or business, including the rental of tangible personal property and the rental or licensing of cinematographic films or films or tapes used for radio or television broadcasting.

Article 8

SHIPPING AND AIR TRANSPORT

1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

2. For the purposes of this Article, profits from the operation of ships or aircraft in international traffic include profits derived from the rental of ships or aircraft if such ships or aircraft are operated in international traffic by the lessee or if such rental profits are incidental to other profits described in paragraph 1.

3. Profits of an enterprise of a Contracting State from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic shall be taxable only in that State.

4. The provisions of paragraphs 1 and 3 shall also apply to profits from participation in a pool, a joint business, or an international operating agency.

Article 9

ASSOCIATED ENTERPRISES

1. Where

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which, but for those conditions would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment,

due regard shall be paid to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

3. The provisions of paragraph 1 shall not limit any provisions of the law of either Contracting State which permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between persons, whether or not residents of a Contracting State, owned or controlled directly or indirectly by the same interests when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons.

Article 10

DIVIDENDS

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed

(a) 5 percent of the gross amount of the dividends if the beneficial owner is a company which owns at least 10 percent of the voting stock of the company paying the dividends;

(b) 15 percent of the gross amount of the dividends in all other cases.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

4. The provisions of paragraph 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State, of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the dividends are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

5. A Contracting State may not impose any tax on dividends paid by a company which is not a resident of that State, except insofar as

(a) the dividends are paid to a resident of that State,

(b) the dividends are attributable to a permanent establishment or a fixed base situated in that State, or

(c) the dividends are paid out of profits attributable to one or more permanent establishments of such company in that State, provided that the gross income of the company attributable to such permanent establishment constituted at least 50 percent of the company's gross income from all sources.

Where subparagraph (c) applies and subparagraphs (a) and (b) do not apply, the tax shall be subject to the limitations of paragraph 2.

Article 11

INTEREST

1. Interest derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State.

2. The term "interest" as used in this Convention means income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities, and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures. Penalty charges for late payment shall not be regarded as interest for the purposes of the Convention.

3. The provisions of paragraph 1 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State, in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the interest is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

4. Interest shall be deemed to arise in a Contracting State when the payer is that State itself or a political subdivision, local authority, or resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

5. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

6. A Contracting State may not impose any tax on interest paid by a resident of the other Contracting State, except insofar as

(a) the interest is paid to a resident of the first-mentioned State;

(b) the interest is attributable to a permanent establishment or a fixed base situated in the first-mentioned State; or

(c) the interest arises in the first-mentioned State and is not paid to a resident of the other State.

Article 12

ROYALTIES

1. Royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State.

2. The term "royalties" as used in this Convention means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (but not including cinematographic films or films or tapes used for radio or television broadcasting), any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience. The term "royalties" also includes gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof.

3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State, in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the royalties are attributable to such permanent

establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

4. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right, or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

Article 13

GAINS

1. Gains derived by a resident of a Contracting State from the alienation of real property referred to in Article 6 (Income from Real Property (Immovable Property)) and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of

(a) shares of the stock of a company (whether or not a resident of a Contracting State) the property of which consists principally of real property situated in a Contracting State; or

(b) an interest in a partnership, trust, or estate (whether or not a resident of a Contracting State) to the extent attributable to real property situated in a Contracting State

may be taxed in that State. For the purposes of this paragraph, the term "real property" includes the shares of a company referred to in subparagraph (a) or an interest in a partnership, trust, or estate referred to in subparagraph (b).

3. Gains from the alienation of personal property which are attributable to a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, or which are attributable to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, and gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or such a fixed base, may be taxed in that other State.

4. Gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft, or containers operated in international traffic shall be taxable only in that State.

5. Gains described in Article 12 (Royalties) shall be taxable only in accordance with the provisions of Article 12.

6. Gains from the alienation of any property other than property referred to in paragraphs 1 through 5 shall be taxable only in the Contracting State of which the alienator is a resident.

Article 14

INDEPENDENT PERSONAL SERVICES

Income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State, unless such services are performed in the other Contracting State and the income is attributable to a fixed base regularly available to the individual in that other State for the purpose of performing his activities.

Article 15

DEPENDENT PERSONAL SERVICES

1. Subject to the provisions of Articles 18 (Pensions, Annuities, Alimony, and Child Support) and 19 (Government Service), salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if

(a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the taxable year concerned;

(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and

(c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived by a resident of a Contracting State in respect of an employment as a member of the regular complement of a ship or aircraft operated in international traffic may be taxed only in that State.

Article 16

LIMITATION ON BENEFITS

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless

(a) more than 75 percent of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and

(b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States.

For the purposes of subparagraph (a), a company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State.

2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the Convention.

3. Any relief from tax provided by a Contracting State to a resident of the other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other State, the income to which the relief relates bears significantly lower tax than similar income arising within that other State derived by residents of that other State.

Article 17

ARTISTES AND ATHLETES

1. Notwithstanding the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services), income derived by a resident of a Contracting

State as an entertainer, such as a theatre, motion picture, radio, or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State, except where the amount of the gross receipts derived by such entertainer or athlete, including expenses reimbursed to him or borne on his behalf, from such activities does not exceed twenty thousand United States dollars ($20,000) or its equivalent in .... for the taxable year concerned.

2. Where income in respect of activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete but to another person, that income of that other person may, notwithstanding the provisions of Articles 7 (Business Profits) and 14 (Independent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised, unless it is established that neither the entertainer or athlete nor persons related thereto participated directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions.

Article 18

PENSIONS, ANNUITIES, ALIMONY, AND CHILD SUPPORT

1. Subject to the provisions of Article 19 (Government Service)

(a) pensions and other similar remuneration derived and beneficially owed by a resident of a Contracting State in consideration of past employment shall be taxable only in that State; and

(b) social security benefits and other public pensions paid by a Contracting State to a resident of the other Contracting State or a citizen of the United States shall be taxable only in the first-mentioned State.

2. Annuities derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State. The term "annuities" as used in this paragraph means a stated sum paid periodically at stated times during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

3. Alimony paid to a resident of a Contracting State shall be taxable only in that State. The term "alimony" as used in this paragraph means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the State of which he is a resident.

4. Periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support paid by a resident of a Contracting State to a resident of the other Contracting State shall be taxable only in the first-mentioned State.

Article 19

GOVERNMENT SERVICE

1. Remuneration, including a pension, paid from the public funds of a Contracting State or a political subdivision or local authority thereof to a citizen of that State in respect of services rendered in the discharge of functions of a governmental nature shall be taxable only in that State. However, the provisions of Article 14 (Independent Personal Services), Article 15 (Dependent Personal Services) or Article 17 (Artistes and Athletes), as the case may be, shall apply, and the preceding sentences shall not apply, to remuneration paid in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or local authority thereof.

Article 20

STUDENTS AND TRAINEES

Payments received for the purpose of maintenance, education, or training by a student, apprentice, or business trainee who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State for the purpose of his full-time education or training shall not be taxed in that State, provided that such payments arise outside that State.

Article 21

OTHER INCOME

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from real property as defined in paragraph 2 of Article 6 (Income from Real Property (Immovable Property)), if the beneficial owner of the income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the income is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

Article 22

CAPITAL

1. Capital represented by real property referred to in Article 6 (Income from Real Property (Immovable Property)), owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.

2. Capital represented by personal property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, or by personal property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, may be taxed in that other State.

3. Capital represented by ships, aircraft, and containers owned by a resident of a Contracting State and operated in international traffic, and by personal property pertaining to the operation of such ships, aircraft, and containers shall be taxable only in that State.

4. All other elements of capital of a resident of a Contracting State shall be taxable only in that State.

Article 23

RELIEF FROM DOUBLE TAXATION

1. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income

(a) the income tax paid to .... by or on behalf of such citizen or resident; and

(b) in the case of a United States company owning at least 10 percent of the voting stock of a company which is a resident of .... and from which the United States company receives dividends, the income tax paid to .... by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.

For the purposes of this paragraph, the taxes referred to in paragraphs 1(b) and 2 of Article 2 (Taxes Covered) shall be considered income taxes. Credits allowed solely by reason of the preceding sentence, when added to otherwise allowable credits for taxes referred to in paragraphs 1(b) and 2 of Article 2, shall not in any taxable year exceed that proportion of the United States tax on income which taxable income arising in .... bears to total taxable income.

2. In accordance with the provisions and subject to the limitations of the law of .... (as it may be amended from time to time without amending the general principle hereof) .... shall allow to a resident or citizen of .... as a credit against the .... tax on income ....
....
....

3. For the purposes of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise exclusively as follows

(a) income derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention (other than solely by reason of citizenship in accordance with paragraph 2 of Article 1 (General Scope)) shall be deemed to arise in that other State;

(b) income derived by a resident of a Contracting State which may not be taxed in the other Contracting State in accordance with the Convention shall be deemed to arise in the first-mentioned State.

The rules of this paragraph shall not apply in determining credits against United States tax for foreign taxes other than the taxes referred to in paragraphs 1(b) and 2 of Article 2 (Taxes Covered).

Article 24

NON-DISCRIMINATION

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall apply to persons who are not residents of one or both of the Contracting States. However, for the purposes of United States tax, a United States national who is not a resident of the United States and a .... national who is not a resident of the United States are not in the same circumstances.

2. For the purposes of this Convention, the term "nationals" means

(a) in relations to ......, ...
....
....................; and

(b) in relation to the United States, United States citizens.

3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, relief, and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

4. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 11 (Interest), or paragraph 4 of Article 12 (Royalties) apply,

interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable capital of the first-mentioned resident, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

6. The provisions of this Article shall, notwithstanding the provisions of Article 2 (Taxes Covered), apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof.

Article 25

MUTUAL AGREEMENT PROCEDURE

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or national.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may agree

(a) to the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;

(b) to the same allocation of income, deductions, credits, or allowances between persons;

(c) to the same characterization of particular items of income;

(d) to the same application of source rules with respect to particular items of income;

(e) to a common meaning of a term;

(f) to increases in any specific amounts referred to in the Convention to reflect economic or monetary developments; and

(g) to the application of the provisions of domestic law regarding penalties, fines, and interest in a manner consistent with the purposes of the Convention.

They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.

Article 26

EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1 (General Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation

(a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

(b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

(c) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

3. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain the information to which the request relates in the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.

4. Each of the Contracting States shall endeavor to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by the Convention from taxation imposed by that other State does not enure to the benefit of persons not entitled thereto.

5. Paragraph 4 of this Article shall not impose upon either of the Contracting States the obligation to carry out administrative measures which are of a different nature from those used in the collection of its own taxes, or which would be contrary to its sovereignty, security, or public policy.

6. For the purposes of this Article, the Convention shall apply, notwithstanding the provisions of Article 2 (Taxes Covered), to taxes of every kind imposed by a Contracting State.

Article 27

DIPLOMATIC AGENTS AND CONSULAR OFFICERS

Nothing in this Convention shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements.

Article 28

ENTRY INTO FORCE

1. This Convention shall be subject to ratification in accordance with the applicable procedures of each Contracting State and instruments of ratification shall be exchanged at . . . as soon as possible.

2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect

(a) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of the second month next following the date on which the Convention enters into force;

(b) in respect of other taxes, for taxable periods beginning on or after the first day of January next following the date on which the Convention enters into force.

Article 29

TERMINATION

1. This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention at any time after 5 years from the date on which the Convention enters into force, provided that at least 6 months prior notice of termination has been given through diplomatic channels. In such event, the Convention shall cease to have effect

(a) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of January next following the expiration of the 6 months period;

(b) in respect of other taxes, for taxable periods beginning on or after the first day of January next following the expiration of the 6 months period.

DONE at . . . . . . in duplicate, in the English and . . . . . . languages, the two texts having equal authenticity, this . . . day of . . . . . 19. . FOR THE UNITED STATES OF AMERICA FOR . . . .

7

Foreign Tax Credit

The United States imposes a tax on the worldwide income of U.S. corporations, partnerships, trusts and estates, and citizens and resident aliens. Income earned outside the United States is likely to be taxed by the foreign jurisdiction as well. In fact, one of the largest expenditures incurred in foreign business activities is foreign taxes.[1] This dual claim on the right to tax foreign-source income creates the potential for international double or multiple taxation of income earned by a U.S. person outside the United States.

Before the enactment of the Revenue Act of 1918, the United States allowed U.S. persons to deduct foreign taxes in the computation of taxable income. Because U.S. and foreign tax rates were low during this period, the issue of multiple taxation of foreign-source income was not important. However, U.S. and foreign involvement in World War I forced governments to increase tax rates, thus increasing the tax burden on foreign-source income. In the 1918 act, Congress provided relief from

[1]U.S. corporations paid approximately $26.5 billion in income taxes to foreign governments in 1994, the most recent year for which statistics are available. See R. A. Robison and S. E. Nutter, "Corporate Foreign Tax Credit, 1994," *Internal Revenue Service Statistics of Income Bulletin* (Fall 1998): 172–230.

double taxation by allowing U.S. persons a credit against their U.S. tax liability for certain income and profits taxes paid to foreign countries and U.S. possessions.[2]

By granting U.S. taxpayers a credit for income taxes paid on foreign-source income, the United States did not relinquish its right to tax U.S. taxpayers on worldwide income. However, it did cede primary jurisdiction to foreign governments to tax U.S. persons on income sourced outside the United States. The United States retained the residual right to tax such foreign-source income to the extent of the difference between the amount of tax that would have been paid if the income was sourced in the United States and the amount of foreign taxes imposed on such income (that is, the United States taxes foreign-source income at a rate that represents the excess of the U.S. tax rate over the foreign tax rate).

The stated objective of using a credit mechanism to alleviate multiple international taxation is to achieve tax neutrality (sometimes referred to as capital export neutrality) between the taxation of foreign-source income and domestic-source income. In other words, foreign-source income of U.S. taxpayers should be taxed at the same aggregate rate as U.S.-source income.[3]

Through the foreign tax credit mechanism, the United States seeks, in principle, to collect only an incremental income tax on foreign-source income of U.S. taxpayers. The U.S. tax paid on such income is the difference between the U.S. tax that would have been imposed on such income if it had been domestic-source income and the foreign taxes imposed on that income. If the effective foreign tax rate is higher than the U.S. tax rate, generally no U.S. taxes are due. Any excess of foreign taxes over U.S. taxes may be carried back or forward to certain years in which the limitation for that year allows its use.[4]

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[2]Revenue Act of 1918 sections 222(a), 238(a), and 240(c). See also W. P. McClure and H. B. Bouma, "The Taxation of Foreign Income from 1909 to 1989: How a Tilted Playing Field Developed," *Tax Notes* (June 12, 1989): 1380–1410; E. Owens, *The Foreign Tax Credit: A Study of the Credit for Foreign Taxes Under United States Income Tax Law* (Cambridge, MA: Harvard Law School International Tax Program, 1961).

[3]For an in-depth discussion of the economic issues related to the foreign tax credit, see Joint Committee on Taxation, *Description and Analysis of Present-Law Rules Relating to International Taxation* (JX-40-99), June 28, 1999: 75–85, and Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS-6-91), May 30, 1991: 232-268.

[4]For 1994, $1.051 billion of the $26.5 billion of income taxes paid to foreign governments were subject to the credit limitation. See R. A. Robison and S. E. Nutter, *op. cit.*, 173.

The foreign tax credit does not completely eliminate the problem of double taxation for a number of reasons. First, foreign countries levy taxes other than income taxes, and the United States allows tax credits, with minor exceptions, only for foreign income taxes. Second, some foreign countries levy income taxes in excess of the U.S. tax rates, and the United States allows tax credits only up to a limit of the U.S. tax burden on such income. Furthermore, a foreign country may have source-of-income rules different from those of the United States, with the result that either residence claims or source claims overlap. Finally, many foreign countries use different rules of income recognition and deduction for the calculation of taxable income, whereas the foreign tax credit calculation is based on taxable income calculated according to U.S. tax laws.

Options for Treating Foreign Taxes

All foreign taxes levied by local, state, and national foreign governments on U.S. taxpayers (individuals as well as corporations) are eligible for deduction on U.S. tax returns if the taxes constitute trade or business expenses or expenses incurred in the production of income (sections 162, 164(a)(3), and 212). There is no limit on the amounts that can be deducted for these taxes in any one year, even if such deductions create a loss from operations. The deduction privilege applies to all foreign taxes, not just to foreign income taxes.

Foreign income, war profits, and excess profits taxes (*creditable foreign taxes*) are the only taxes that can be taken either as a credit or a deduction in any one year. Such taxes are either deducted (with no limitation as to the amount that can be deducted in any one year) or credited in their entirety (subject to the limitation imposed by section 904) for a particular taxable year. Taxpayers may switch from one option to another from year to year without permission from the commissioner of internal revenue. For example, a taxpayer may take a deduction for foreign income taxes in 1999 and subsequently take a credit for foreign income taxes in 2000. Treas. Reg. Sec. 1.901-1(d) provides that the election to credit taxes rather than deduct them (or vice versa) for a particular taxable year can be made or changed retroactively at any time before the expiration of the period prescribed by section 6511(d)(3)(A)(that is, ten years).

A tax credit reduces U.S. tax liability dollar for dollar, or by 100 percent of the amount of the credit. A tax deduction reduces U.S. tax lia-

bility at the marginal tax rate of the particular taxpayer involved. *Marginal tax rate* is defined as the rate imposed on the taxpayer's next increment of income. Marginal tax rates vary, depending on the type of taxpayer involved and the amount of income. A U.S. corporation is subject to a top marginal tax rate of 35 percent on taxable income above $10 million. A U.S. individual's top marginal tax rate is 39.6 percent, which is reached at various levels of taxable income depending on the taxpayer's filing status.

For a taxpayer with a net operating loss, the foreign tax credit is of no value in such year. A benefit might be received either in an earlier year (through a refund of previously paid taxes) or a later year (through a reduction of future taxes) if the unused credits can be used as a carryback or carryforward. The other alternative is to claim the foreign taxes as a deduction and increase the current-year net operating loss for carryback or carryforward purposes. A net operating loss has a longer carryback and carryforward period than a foreign tax credit.

Section 911 allows individuals satisfying certain requirements to exclude from U.S. taxation a prescribed amount of foreign-source earned income. A foreign tax credit or deduction is not allowed for foreign taxes paid or accrued on such excluded income (section 911(d)(6)).

Creditable Foreign Taxes

Section 901(b)(1) allows a credit for "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States." Determining which payments made to a foreign government are considered creditable foreign taxes has caused considerable difficulty over the years and continues to be a significant point of disagreement between the Internal Revenue Service and many taxpayers. As early as 1938, the Supreme Court ruled that a foreign tax system must resemble the U.S. income tax system in order for the tax to be creditable.[5] During the 1960s and 1970s, it came to the attention of the IRS that taxpayers were taking a credit for "taxes" that more closely resembled royalties, user fees, and profit-splitting arrangements than an income tax as defined by U.S. law. As a result, the IRS embarked on a rulings program in an effort to distinguish which taxes

[5] *Biddle v. Comm.*, 302 U.S. 573 (1938). See also *Inland Steel Co. v. United States*, 677 F.2d 72 (1982).

imposed by foreign countries qualified as creditable foreign taxes. The uncertainty caused by these rulings compelled the Treasury Department to issue proposed regulations in 1979 that attempted to provide definitive criteria for identifying creditable taxes. These regulations were subsequently reissued in various forms in 1980 and 1983. The final regulations in this area were issued in October 1983.

The basic criteria established in Treas. Reg. Sec. 1.901-2(a)(1) is that a foreign levy will be considered an "income" tax if and only if (1) it is a tax and (2) the predominant character of that tax is that of an income tax in the U.S. sense.

In addition, whether a foreign levy is an income tax is to be determined independently for each separate foreign levy.

Definition of a "Tax"

Treas. Reg. Sec. 1.901-2(a)(2)(i) defines a foreign levy as a tax if it is a "compulsory payment pursuant to the authority of a foreign country to levy taxes." This definition precludes penalties, fines, interest, or custom duties from qualifying as creditable taxes. In addition, the determination as to whether a levy is "compulsory" is to be determined by U.S. principles of law, not the laws of the foreign country.[6]

Before a tax can be creditable, it must be paid or accrued (Treas. Reg. Sec. 1.901-2(e)(1)). A tax is not considered paid or accrued to the extent it is reasonably certain that the amount will be refunded, credited, abated, or forgiven (Treas. Reg. Sec. 1.901-2(e)(2)). As long as the amount is not greater than a reasonable approximation of the taxpayer's final tax liability, it will not be considered reasonably certain that any part of the amount will be refunded. Treas. Reg. Sec. 1.901-2(e)(5) also requires that the taxpayer make an attempt to reduce the foreign tax liability over time and to exhaust all "effective and practical remedies" to reduce such foreign tax liability. This requirement is not interpreted to mean that the taxpayer must elect options to defer income when available or restructure transactions to minimize foreign taxes.

The regulations state that a levy in return for which the taxpayer receives a "specific economic benefit" is not considered a creditable tax.

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[6]*Riggs National Corp. v. Commissioner*, 63 F.3d 1363 (1999), *rev'g.* and *rem'g.* 107 T.C. 301 (1995) (payment made by the Central Bank of Brazil on behalf of the taxpayer to the Brazilian government was held to be compulsory).

Treas. Reg. Sec. 1.901-2(a)(2)(ii)(B) defines a *specific economic benefit* as "an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general."

This regulation notes that a concession to extract government-owned petroleum is a specific economic benefit, whereas the right to travel or ship freight on a government-owned airline is not because the latter, but not the former, is generally made available on substantially the same terms.[7]

Dual-Capacity Taxpayers. Taxpayers who are subject to a compulsory levy by a foreign government and also receive a specific economic benefit are referred to as dual-capacity taxpayers (Treas. Reg. Sec. 1.901-2(a)(2)(ii)(A)). A *dual-capacity taxpayer* must delineate the amount of the levy that qualifies as a creditable tax from the amount that represents a payment for a specific economic benefit. The methods for making such a delineation are found in Treas. Reg. Sec. 1.901-2A.

A dual-capacity taxpayer can avoid making the bifurcation of the levy if it can be shown that the levy is the same as the levy paid by others who are not in receipt of the economic benefit (Treas. Reg. Sec. 1.901-2A(a)(1)). Otherwise, the taxpayer must use either the facts-and-circumstances method (Treas. Reg. Sec. 1.901-2A(c)(2)) or the safe-harbor formula method (Treas. Reg. Sec. 1.901-2A(c)(3)).

Under the safe-harbor formula method, the amount of the levy that is a creditable tax is determined as follows:

$$(A - B - C) \times \frac{D}{1 - D}$$

where:
- A = Gross receipts (Treas. Reg. Sec. 1.901-2A(e)(2))
- B = Costs and expenses (Treas. Reg. Sec. 1.901-2A(e)(2))
- C = Actual amount of levy paid in the taxable year
- D = General income tax rate (Treas. Reg. Sec. 1.901-2A(e)(3))

[7]But see *Phillips Petroleum*, 104. T.C. 256 (1995), in which the Tax Court held that Norway's national, municipal, and "special" taxes on petroleum extracted within its borders were creditable taxes and not royalties.

Taxpayers must apply the safe-harbor formula on a per-country basis, and the election must be made on the first tax return for the first year to which the election will apply. Any taxpayer who does business with a foreign government or agency should determine whether it will be classified as a dual-capacity taxpayer for U.S. tax purposes.

U.S. Concept of Income

The second criterion for a foreign levy to be a creditable foreign tax is that the "predominant character of the foreign tax is that of an income tax in the U.S. sense" (Treas. Reg. Sec. 1.901-2(a)(2)(ii)(E)(3)). To satisfy this criterion, the foreign tax must be likely to reach "net gain in the normal circumstances in which it applies" (Treas. Reg. Sec. 1.901-2(b)(1)). Three requirements must be met under this criterion: realization, gross receipts, and net income (Treas. Reg. Secs. 1.901-2(b)(2), (b)(3), and (b)(4)).

The *realization test* requires that the net gain on which the foreign tax is imposed must be "realized" in the U.S. tax sense; that is, it must be the result of a transaction. If the foreign tax is imposed before or after the U.S. realization event, it may still be creditable if the pre-event or postevent is the transfer or processing of "readily marketable property." Treas. Reg. Sec. 1.901- 2(b)(2)(iii) defines property as readily marketable if it constitutes inventory and it can be sold on the open market without further processing or is exported from the foreign country.

The *gross receipts test* is satisfied if the predominant character of the foreign tax is that of a tax imposed on the net income attributable to actual gross receipts. This test may be satisfied if the foreign government uses a formula to approximate gross receipts, provided the result is not greater than the fair market value of the services provided by the taxpayer. The regulations use as an example a "headquarters company tax" imposed by a foreign country on the regional headquarters of a nonresident corporation (Treas. Reg. Sec. 1.901-2(b)(3)(ii), example (1)). For purposes of the tax, gross receipts of the headquarters are considered to be 110 percent of its costs and expenses. If it is likely that the formula does not produce an amount that is greater than the fair market value of the services provided by the headquarters, then the tax satisfies the gross receipts requirement.

Finally, the tax must be imposed on gross receipts less significant costs and expenses (the *net income test*). Expenses include capital expenditures attributable to the gross receipts. Treas. Reg. Sec. 1.901-2(b)(4)(i) states

that the foreign cost recovery period may be faster or slower than the U.S. rules, provided the recovery period is not so slow that it effectively denies the taxpayer a recovery of the cost. If the foreign law precludes the deductibility of a particular expense, it may still be deemed to meet the net income test provided it gives allowances that effectively compensate for the nonrecovery.[8] Another factor that supports the net income test is the offsetting of losses incurred in one activity in a trade or business against profits from another activity in the same trade or business.

Although a tax may meet the definition of an income tax in the U.S. sense, it is not considered a creditable tax to the extent it is selectively imposed on only those taxpayers whose home countries allow the foreign tax credit (Treas. Reg. Sec. 1.901-2(c)(1)). Such a tax is referred to as a *soak-up tax*.

Despite the extensive discussion in the regulations of the criteria to be used to determine if a foreign tax is an income tax using U.S. principles, the IRS continues to issue rulings on specific taxes imposed by foreign jurisdictions.[9] In addition, courts are still called upon to interpret the language of these regulations.[10]

Subsidies

Section 901(i) disallows as a creditable tax any income tax that is used (directly or indirectly) by the foreign country to subsidize the taxpayer, a party related to the taxpayer (as defined in section 482), or a party to the transaction or a related transaction. The form of the subsidy may include a rebate, refund, credit, deduction, payment, or discharge of an obligation, but the subsidy must be determined by reference to the amount of the tax or by reference to the base used to compute the amount of the tax.

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[8]See LTR 9429019 and LTR 9429020 (April 25, 1994), in which the IRS ruled the Canadian Petroleum and Gas Revenue Tax was not a creditable tax because its resource allowance of 25 percent of production revenue did not fully compensate for the nondeductibility of interest expense, exploration expense, cost depletion, and research and development costs.

[9]See Rev. Rul. 87-39, 1987-1 C.B. 180 (Uruguayan withholding tax is not creditable) and IRS Information Release (IR-INT-98-6, March 31, 1998) allowing for partial creditability for the Italian regional tax (IRAP).

[10]*Texasgulf Inc. v. Commissioner*, 172 F.3d 209 (CA-2, 1992), *aff'g.* 107 T.C. 51 (1996) (Ontario mining tax is creditable); *Texasgulf Inc. v. United States*, 17 Cl. Ct. 275 (1989) (Ontario mining tax is not creditable); *Phillips Petroleum*, 104 T.C. 256 (1995) (Norway's special tax on petroleum producers was fully creditable).

The use of an official foreign government exchange rate to convert foreign currency into U.S. dollars where a free exchange rate also exists is not considered a subsidy if (1) the use of the rate is not targeted to transactions that give rise to a claim for a foreign tax credit, (2) the rate applies to a broad range of international transactions, and (3) any reduction in the overall cost of the transaction is merely coincidental to the broad structure and operation of the official exchange rate.[11]

> *Example 7.1.* A foreign country imposes a 30-percent tax on nonresident lenders with respect to interest received from borrowers who are residents of the country. The government remits to resident borrowers an incentive payment for engaging in foreign loans in an amount equal to 20 percent of the interest paid to the nonresident lenders. During 1999, a U.S. person receives $100,000 of interest from a borrower who is a resident of this country, and the borrower withholds $30,000 as a tax. The borrower is then remitted $20,000 from the government (20 percent of the interest paid) as an incentive payment, making the net cost of the loan $10,000. Assuming the $30,000 tax withheld otherwise meets the definition of a creditable tax for U.S. purposes, the U.S. lender will be denied a credit for two-thirds of the amount withheld (20 percent/30 percent) because the incentive payment will be considered a subsidy under section 901(i). The incentive payment is considered a subsidy because it is provided to a party (the borrower) to the transaction and is computed with reference to the base used to compute the amount of the tax.[12]

Multiple (Cross-Credited) Levies

A foreign government may allow a taxpayer to reduce its tax liability for one levy ("first levy") by the amount of the taxpayer's liability for a different levy ("second levy"). In this case, the amount of the "second levy" considered paid is the entire liability for that levy, and the remainder of the amount paid is considered the amount paid for the "first levy" (Treas. Reg. Sec. 1.901-2(e)(4)). The amount of a "multiple levy" that is creditable may depend on whether the foreign government allows an "offset"

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[11]Treas. Reg. Sec. 1.901-2(e)(3)(iii).

[12]Treas. Reg. Sec. 1.901-2(e)(3)(iv), example 1. See also Rev. Rul. 78-258, 1978-1 C.B. 239; *Norwest Corp.* 69 F.3d 404 (CA-8, 1995) *aff'g.* 63 T.C.M. 3023 (1992); *Nissho Iwai American Corp.*, 89 T.C. 765 (1987); *First Chicago Corp.*, 61 T.C.M. 1774 (1991); *Continental Illinois Corp.*, 998 F.2d 513 (CA-7, 1993), *aff'g., rev'g., and rem'g.* 61 T.C.M. 1916 (1991).

system or a "greater than" system. If the income tax may be "offset" by a noncreditable tax (for example, an excise tax), only the excess of the income tax paid over the offset tax is creditable. If the taxpayer pays the greater of the income tax or a noncreditable tax, the entire amount of the income tax is creditable, provided it is the greater tax.

An example of a multiple levy is found in Rev. Rul. 91-45[13] relating to the imposition by the Mexican government of both an income tax and a 2-percent assets tax on foreign companies. The income tax ("second levy") paid could reduce the assets tax ("first levy"). The Internal Revenue Service held that the entire income tax paid was creditable in this case and that any amount paid over the income tax was attributable to the assets tax and not creditable. Mexico no longer imposes the 2-percent assets tax on U.S. companies with a permanent establishment in Mexico (see the Protocol to the U.S.-Mexico treaty).

"In Lieu of" Income Taxes

Taxes that do not qualify as income taxes may still qualify for credit under section 903. Prior to 1942, the foreign tax credit was allowed only for income, war profits, and excess profits taxes. In 1942, Congress broadened the scope to include taxes levied by foreign countries that have an income tax law in force but, for one reason or another, have imposed a substitution tax on a particular taxpayer. Treas. Reg. Sec. 1.903-1(a) states that a charge is considered to be a tax that is "in lieu of" an income tax if it meets the following conditions:

1. Except for minor modifications explained at Treas. Reg. Sec. 1.903-1(b), the charge is a tax (as defined in Treas. Reg. Sec. 1.901-2(a)(2)).
2. The taxpayer, in the absence of a specific waiver, would have been subject to the general income tax (that is, the levy is a substitute for the general income tax).
3. The foreign law is structured so that the amount of the charge will not be significantly greater than the amount that would otherwise be payable on income if the general income tax were applicable.
4. Liability for the substitute charge is not related to the availability of a credit for the charge against tax liability to another country (that is, it is a soak-up tax).

[13] 1991-2 C.B. 336.

Treas. Reg. Sec. 1.903-1(a) also makes the following general statements about whether an in-lieu-of tax qualifies for the credit:

1. The foreign country's purpose for imposing the foreign tax is immaterial (for example, because of administrative difficulty in determining income subject to the general income tax or deductions permitted under the general income tax).
2. All the income derived by persons subject to the substitute charge need not be exempt from the income tax.
3. The base of the substitute charge may be gross income, gross receipts or sales, or the number of units produced or reported. The base of the substitute charge need not bear any relationship to realized net income.
4. If the substitute charge is in lieu of another legal liability in addition to the general income tax, the amount of the substitute charge considered to be in lieu of the general income tax is the amount properly allocable to the general income tax.
5. In determining whether a charge is a tax in lieu of an income tax, the rules are applied independently to each separate charge imposed by the foreign government.

Treas. Reg. Sec. 1.903-1(b)(3) provides examples of when a foreign tax satisfies the substitution requirement. One situation described in the regulations is that of a foreign country that imposes a tax on realized net income, except that nonresidents are not subject to the tax. Instead, nonresidents are subject to a gross income tax on income from that country that is not attributable to a trade or business carried on in that country. The gross income tax meets the substitution requirement in this case (Treas. Reg. Sec. 1.903-1(b)(3), example 1).

If a tax is imposed by a country with which the United States has a tax treaty, the treaty should be consulted because many treaties contain specific provisions as to the creditability of certain taxes.

Disallowance of the Credit for Taxes Paid to Certain Countries

Otherwise creditable taxes paid to foreign countries are not allowed as a credit if the country is described in section 901(j)(2)(A). The countries described in section 901(j)(2)(A) include countries the government of which the United States does not recognize, countries with which the United States has severed relations or does not conduct such relations,

and countries that have been designated as repeatedly providing support for acts of international terrorism.[14]

The credit is denied on taxes paid or accrued on income attributable to the period beginning on the later of January 1, 1987, or six months after the country is designated as meeting one of the above descriptions and ending on the date the country no longer meets one of the above descriptions. Rev. Rul. 92-62[15] provides transition rules for when a country ceases to be described in section 901(j), as the Union of South Africa did in September 1991.

The limitation imposed by section 901(j) applies to credits allowed under sections 901, 902, 960, and 1248. Taxes that are not creditable under section 901(j) may still be deductible under section 164. Dividends received from a foreign country are not grossed up under section 78 for foreign taxes paid by the foreign corporation if such taxes are not creditable under section 901(j).

Taxpayers Eligible for the Credit

U.S. Citizens and Domestic Corporations

An individual who is a citizen of the United States may claim a foreign tax credit regardless of whether he or she resides within or outside the United States (section 901(b)(1)). A U.S. citizen electing the foreign-earned income exclusion under section 911 is not allowed foreign tax credits to the extent the foreign tax is properly allocable against such excluded gross income (that is, a foreign tax was imposed on the excluded income). An individual who uses the standard deduction may claim the benefits of the foreign tax credit.

A domestic corporation is eligible for a foreign tax credit on taxes paid or accrued to any foreign country or U.S. possession (section 901(b)(1)). A domestic corporation satisfying the provisions of section 936 (a U.S. possessions corporation) is precluded from deducting or taking a credit for any income taxes paid to the U.S. possession or a foreign country on the possessions-source income. A regulated investment company electing to currently distribute its income under section 853 similarly is denied the credit (Treas. Reg. Sec. 1.901-1(g)(3)).

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[14] Rev. Rul. 95-63, 1995-2 C.B. 85 lists Cuba, Iran, Iraq, Libya, North Korea, Sudan, and Syria as countries to which the provisions of section 901(j) currently apply.

[15] 1992-2 C.B. 193.

Resident Aliens of the United States or Puerto Rico

An individual who is a resident of the United States or Puerto Rico may claim a foreign tax credit for taxes paid or accrued during the taxable year to any foreign country or U.S. possession (section 901(b)(3)).

A resident alien electing the foreign earned income exclusion under section 911 is not allowed foreign tax credits to the extent the credit is properly allocable against excluded income. The President of the United States can impose a requirement that the country of which the resident alien is a citizen allow a reciprocal foreign tax credit to citizens of the United States residing in that country before the U.S. tax is creditable by the resident alien (section 901(c)). No president has exercised this privilege to date.

Nonresident Aliens and Foreign Corporations

Nonresident aliens and foreign corporations are allowed a foreign tax credit for foreign taxes paid or accrued on income effectively connected with a U.S. trade or business (section 901(b)(4)). The amount of the credit is limited by section 906, which does not allow the credit for income that would not have been taxed by the foreign country except for the fact that the taxpayer is a citizen or resident of the foreign country (in the case of individuals), or that the taxpayer was created under the laws of the foreign country or is domiciled in that country (in the case of a foreign corporation).

Section 1504(d) provides that foreign corporations 100-percent owned by domestic corporations and organized under the laws of a contiguous foreign country (Mexico and Canada) solely for the purpose of complying with certain foreign laws may be treated as domestic corporations. These foreign corporations can be included in a U.S. consolidated group for tax return purposes, and foreign taxes paid or accrued by such foreign subsidiaries may be taken as credits in the year paid or accrued rather than as deemed-paid credits on a dividend that may be paid in a later year.

S Corporations

Foreign taxes paid by an S corporation pass through to the shareholders (section 1366(a)(1)). An S corporation is not eligible for the deemed-paid foreign tax credit, nor can these deemed-paid taxes be passed through to the shareholders.

Partnerships

A U.S. citizen, resident alien, or U.S. entities that can, by law, be partners in a partnership (such as a domestic corporation)[16] can take as a credit their proportionate share of the foreign taxes of the partnership (section 901(b)(5)). The conduit principle applicable to the allocation of the income and expenses of the partnership applies to foreign taxes incurred by the partnership. In addition, because partners are allocated separately their distributive share of foreign taxes paid by the partnership (section 702(a)(6)), each partner makes a separate election to deduct or take a credit for the allocated share of creditable foreign taxes (section 703(b)(3)).

Estates and Trusts

Estates and trusts formed under the laws of the United States are allowed credits to the extent foreign taxes are not allocable to the beneficiaries (section 642(a)). Foreign income taxes paid by an estate are creditable by the estate, unless the tax is properly creditable on the final return of the decedent or if the estate is not liable for the tax.[17]

The beneficiary of an estate or trust formed under laws of the United States who is a U.S. citizen or resident alien in the United States is entitled to take as a credit a proportionate share of the taxes imposed on the estate or trust. Estates and trusts are required to gross up the income that is distributed by the taxes paid. If the distribution is made from the accumulated income of an accumulation trust, the beneficiary is permitted under throwback rules to credit foreign taxes paid by the trust on the income distributed.

Foreign Taxes Imposed on the Taxpayer

Direct Taxes

Except for deemed-paid taxes, a credit may be taken only by the party upon whom the foreign tax is directly imposed, even if another person

[16] Section 901(b)(5) applies only to individuals who are partners. It is generally considered, however, that the partnership statutes of sections 702–704 broaden the eligibility to all partners. See *Arundel Corp. v. United States*, 102 F. Supp. 1019 (Ct. Cl. 1952).

[17] *Lederman*, 6 T.C. 991 (1946).

(such as a withholding agent) remits the tax (Treas. Reg. Sec. 1.901-2(f)(1)). That is, only the person who has legal responsibility for payment of the tax may take a credit for the tax. Some examples of direct taxation are foreign taxes levied on wages, dividends, business conducted through a branch, investment transactions handled directly by U.S. shareholders, and direct exporting.

The determination of who actually bears the legal incidence of the foreign tax may be difficult when the structure of a country's tax laws differs significantly from that of the United States. As a general rule, one should follow the U.S. standards for deciding who bears the legal incidence of the tax. Additional guidance can sometimes be obtained by reviewing tax treaties or conventions with specific countries or rulings issued by the IRS.

The withholding tax is one of the more difficult types of taxes for identifying the actual taxpayer. Many foreign countries levy this type of tax on dividend payments and royalty payments. Generally the payor of the dividend or royalty is required to withhold the taxes and pay out only a net dividend or a net royalty to the payees. A question may arise as to whether the actual taxpayer is the party paying the taxes to the foreign country or the U.S. recipient of the net payment. In regard to this point, the IRS has issued a number of rulings on withholding taxes of various countries.[18]

When a foreign income tax is imposed on the combined income of two or more related taxpayers (for example, a married couple filing a joint return or a corporation filing a consolidated tax return with a subsidiary) and the taxpayers are jointly and severally liable for the tax, then the foreign tax is treated as imposed on each taxpayer separately based on his or her pro rata portion of the tax base (Treas. Reg. Sec. 1.901-2(f)(3)).

Indirect (Deemed-Paid) Taxes

Sections 902 and 960 allow certain U.S. corporate shareholders of a foreign corporation to claim a foreign tax credit when actual dividends are received (or deemed received in the case of a controlled foreign corporation). The amount of the *deemed-paid credit* is a proportionate share of the

[18]Some examples are Rev. Rul. 56-288, 1956-1 C.B. 321 (Australia); Rev. Rul. 63-51, 1963-1 C.B. 407, modified by Rev. Rul. 74-525, 1974-2 C.B. 411 (Belgium); *Brantman v. United States*, 167 F. Supp. 885 (N.D. Cal. 1958) (Singapore).

foreign income taxes paid by the foreign corporation on the income distributed or deemed distributed to the U.S. shareholder.[19]

The purpose of the deemed-paid credit is to equalize the tax burden of domestic corporations operating through a foreign branch or a foreign subsidiary. A domestic corporation operating through a foreign branch includes such foreign-source income on its domestic tax return in the year earned and is eligible for a direct foreign tax credit on income taxes it pays the foreign jurisdiction on such income. Under U.S. consolidated tax return rules, a domestic corporation may not include the income or loss of a foreign subsidiary on its domestic tax return. However, the United States does not tax the income of the foreign corporation unless it is effectively connected with a U.S. trade or business. Any foreign taxes paid by the foreign corporation are not eligible for credit on the tax return(s) of the domestic corporate shareholders.

The U.S. corporate shareholder includes dividends received from its foreign subsidiary on its U.S. tax return as income in the year received (or deemed paid). The amount of dividend income is net of any foreign taxes paid by the payor, and the dividend is not eligible for the dividends-received deduction unless the income was previously taxed as effectively connected with a U.S. trade or business. The deemed-paid credit allows the domestic corporation a credit at the time the dividend is included on the U.S. tax return, in a manner that treats the U.S. corporation as having paid the foreign taxes imposed on that income.

Before a domestic corporation is eligible for the deemed-paid credit, it must meet minimum stock-ownership requirements in the foreign corporation from which it receives dividends. The minimum ownership requirements are structured in terms of chain ownership (sections 902(a) and (b)). A domestic corporation is eligible for the deemed-paid credit on actual or deemed distributions from first- through sixth-tier foreign corporations only.

To qualify for the credit on distributions from a *first-tier* foreign corporation, a domestic corporation must own directly at least 10 percent of the voting stock of the first-tier foreign corporation (section 902(a)). The Internal Revenue Service has ruled that ownership requires actual own-

[19]Individuals who are shareholders in a foreign corporation are not allowed deemed-paid credits under section 902. An individual electing to be subject to tax at corporate rates under section 962 is eligible for deemed-paid tax credits under section 960.

ership; therefore, shares owned by members of an affiliated group cannot be aggregated to meet the 10-percent test.[20]

To be eligible for the credit on distributions from *second-* and *third-tier* foreign corporations, two ownership tests must be met. First, the first-tier foreign corporation must own at least 10 percent of the voting stock of the second-tier foreign corporation (section 902(b)(1)), and the second-tier foreign corporation must own at least 10 percent of the voting stock of the third-tier foreign corporation (section 902(b)(2)). Second, the domestic corporation must *indirectly* own at least 5 percent of the voting stock of the second- and third-tier foreign corporations, respectively, to receive a deemed-paid credit for dividends paid up the chain (section 902(b)(3)). These ownership requirements are illustrated as follows:

> *Example 7.2.* Alpha, a domestic corporation, owns 40 percent of the voting stock of Beta, a foreign corporation. Beta owns 10 percent of the voting stock of Gamma, a foreign corporation. Alpha also directly owns 5 percent of the voting stock of Gamma. Alpha will be allowed a deemed-paid foreign tax credit on a dividend from Beta to Alpha because Alpha owns 10 percent or more of the voting power of Beta. A deemed-paid credit on dividends from Gamma, which ultimately are paid to Alpha from Beta, will not be available because both the 10-percent direct ownership and the 5-percent indirect ownership requirements are not met. Beta owns 10 percent of Gamma, but Alpha holds only a 4-percent indirect ownership (40% × 10%) in Gamma. The additional 5-percent direct ownership of Alpha in Gamma may not be combined with the 4-percent indirect ownership in order to satisfy the indirect ownership requirements.

For taxable years beginning after August 5, 1997, a deemed-paid credit is allowed for dividends paid by fourth- through sixth-tier foreign corporations provided (1) such foreign corporation is a controlled foreign corporation (CFC) (as defined in section 957) and (2) the domestic corporation is a U.S. shareholder (as defined in section 951(b)) in such foreign corporation (section 902(b)(2)). Congress increased the levels of foreign corporations eligible for the deemed-paid credit in 1997 to alleviate the need to restructure foreign operations after acquisition to qualify for the credit.

The ownership requirements for first- through third-tier foreign corporations must be met only on the dates the dividends are received from

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[20]Rev. Rul. 85-3, 1985-1 C.B. 222; see also *First Chicago Corp.*, 96 T.C. 421 (1991).

the foreign corporation (Treas. Reg. Sec. 1.902-1(c)(1)(ii) and (d)(1)(ii)). Thus, it is possible to receive deemed-paid credits for taxes paid by a foreign corporation for years when the requisite ownership did not exist in the corporation. Furthermore, once the ownership requirements are met, the deemed-paid credit applies to all dividends received, not just to dividends on voting stock.

Example 7.3. Domestic corporation Alpha acquired 50 percent of the voting stock of foreign corporation Beta in 1999. There was no ownership in Beta prior to this time. Shortly thereafter, Beta distributed to Alpha dividends attributable to its earnings and profits of 1997 and 1998. Alpha may still take full deemed-paid credits for foreign taxes paid by Beta with respect to these dividends even though the foreign taxes were paid in years that are prior to Alpha's acquisition of Beta.

A deemed-paid credit is available on dividends from a fourth- through sixth-tier foreign corporation for only those taxes paid with respect to periods during which the foreign corporation was a controlled foreign corporation (CFC).

Section 1248 provides that gain from the sale, liquidation, or redemption of stock of CFC by a domestic corporation may be treated, in whole or in part, as dividend income rather than capital gain. The portion of the gain taxed as dividend income is the earnings and profits attributable to such stock that were accumulated in taxable years beginning after December 31, 1962. Under Treas. Reg. Sec. 1.1248-1(d), the domestic corporation may take a deemed-paid foreign tax credit on such gain as if it had been distributed as a dividend. This treatment may provide a more desirable tax result than treatment as capital gain.

Section 960(a), applicable to domestic corporations, and section 962, applicable to individuals (including trusts and estates under Treas. Reg. Sec. 1.962-2(a)), provide that when certain undistributed income of a CFC must be included in income under the provisions of subpart F (sections 951-964), the shareholders are entitled to deemed-paid credits for the foreign taxes paid by the CFC on the undistributed income. Prior to the enactment of subpart F, earnings of foreign corporations (other than foreign personal holding companies) were taxed only when distributed, and the deemed-paid credit was structured on this same-time basis. When subpart F required shareholders to be taxed on undistributed income, section 960 was created to extend the deemed-paid credit allowance to this undistributed income (the provisions of subpart F are discussed in detail

in chapter 8). The stock ownership requirements to take deemed-paid credits under sections 960 and 962 are the same as the requirements of section 902, explained previously.

Section 853 allows regulated investment companies that pay out at least 90 percent of their income annually and have invested more than 50 percent of the value of their total assets in stock of foreign corporations to elect to pass eligible foreign tax credits (direct foreign taxes only) on to their shareholders. The tax credits are allocated to shareholders according to their share of the regulated investment company's dividend income. Such dividends must be grossed up by the amount of foreign taxes that, in effect, pass through the regulated investment company.

When Credits May Be Taken

The timing rules governing when foreign taxes may be taken as credits against a taxpayer's U.S. income tax liability should be considered not only from the standpoint of proper compliance with the tax laws, but also with regard to the effects such rules can have on the limitations to foreign tax credits in any one year. The limitation formulas are discussed in detail below. Because the formulas are affected by timing factors, a mismatching of income and taxes may result, thereby reducing a taxpayer's credit limitation in that year.

Cash Method Taxpayer

A cash method taxpayer usually takes a deduction or a credit in the year the tax is paid. Section 905(a) allows a cash-basis taxpayer to elect to take a foreign tax credit in the year in which such taxes accrue rather than in the year such taxes are paid. This special allowance gives recognition to the fact that the payment of foreign taxes may be made several years after the year in which the income is earned. This provision helps to prevent the mismatching of income and credits that can result in reduced credits because of the credit limitation.

Once the election to accrue foreign taxes for purposes of the credit is made, it is binding in future years. The election applies to all foreign taxes eligible for credit. The division of foreign taxes—crediting some when paid and some when accrued—is not allowed. However, in the year of an election that changes a cash-basis taxpayer to the accrual basis, a dou-

bling up of the foreign taxes of the previous year (when paid) plus the current year (when accrued) is permissible.[21]

Example 7.4. Mussina, a cash-basis U.S. taxpayer, elects in 1999 to take a credit for foreign taxes when they accrue rather than as they are paid. In 1999 Mussina paid foreign taxes owed for 1997 and 1998 and accrued taxes owed for income earned in 1999. Mussina is entitled to take a credit in 1999 for the taxes paid from cash-basis years (1997 and 1998) and the taxes accrued for the year of the change to the accrual election.

This special provision for cash method taxpayers applies only to taking the foreign taxes as a credit, not as a deduction. Cash method taxpayers who elect to deduct foreign taxes may deduct these taxes only in the year paid.

The three situations in which, with certain exceptions (discussed below), taxes are considered paid are—

1. Years in which actual payment is made to a foreign government.
2. Years in which taxes have been withheld from income or from gains by a withholding agent, even though the withholding agent may not pay the taxes to the foreign government until a later year.[22] However, if the withholding agent never forwards the taxes to the foreign government, then the amount of the credit must be refunded to the U.S. government.
3. Years in which estimated taxes are paid if the taxes represent a legal tax liability.

Accrual Method Taxpayer

A taxpayer who regularly uses the accrual method of accounting does not have the option to treat foreign taxes either on the accrual or cash basis. An accrual method taxpayer must accrue foreign taxes for purposes of the credit.

The timing of the accrual of foreign taxes is generally determined according to the same principles as the accrual of other expenditures; that is, the taxes are creditable (or deductible, as the case may be) in the year in which all the events that fix the amount and liability to the taxpayer have occurred (Treas. Reg. Sec. 1.446-1(c)(1)(ii)). The events that fix the liability (and therefore, the timing) are determined by the laws of the

[21] *Ferrer*, 35 T.C. 617 (1961).

[22] *Lederman*, 6 T.C. 991 (1946).

foreign country. In general, a tax is accrued to a foreign country at the end of the foreign taxable year. In cases in which the taxpayer's domestic and foreign taxable years differ, the accrued foreign taxes are creditable in the domestic taxable year within which the foreign taxable year ends.[23] The commissioner of internal revenue may require an accrual basis taxpayer to post an income tax bond to cover potential adjustments if the amount of foreign taxes ultimately paid differs from the amount claimed. This bond is filed on Form 1117 by both individuals and corporations.

"Proof of Credits" Requirement

Section 905(b) allows a credit for foreign taxes paid or accrued only if the taxpayer establishes "to the satisfaction of the Secretary" the following:

1. The total amount of income derived from sources outside the United States;
2. The amount of income derived from each country and the tax paid or accrued on such income; and
3. All other information necessary for verifying and computing the foreign tax credit.

A claim for a foreign tax credit must be accompanied by Form 1116 (individuals) or Form 1118 (corporations). Treas. Reg. Sec. 1.905-2(a)(2) states that the form "must be carefully filled in with all the information called for and with the calculations of credits indicated." For tax returns whose original due date falls on or after January 1, 1998, the taxpayer must be prepared to provide, upon request of the district director, receipts for taxes already paid or the return on which each accrued tax was based (Treas. Reg. Sec. 1.905-2(a)(2)). The receipt or return must be either the original, a duplicate original, or a duly certified or authenticated copy of the original. If the taxpayer establishes to the satisfaction of the district director that such direct evidence is impossible to obtain, the district director may accept secondary evidence such as a copy of the check issued for payment of the tax or excerpts from the taxpayer's accounts showing the amount of foreign income and taxes (Treas. Reg. Sec. 1.905-2(b)).

Subsequent Adjustments to the Foreign Tax Credit Claimed

Section 905(c) requires taxpayers to redetermine their foreign tax credit in three situations: (1) the accrued taxes paid differ from the amounts

[23]*Santa Fe Drilling Co. v. Riddell*, 217 F. Supp. 630 (S.D. Cal. 1963).

claimed as a credit; (2) accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate; and (3) any tax paid is refunded. The taxpayer is required to notify the Secretary of the Treasury, who will then redetermine the amount of the taxpayer's U.S. tax liability for the year or years affected. Notification is made by filing either Form 1040X (individual) or Form 1120X (corporation) along with the appropriate Form 1116 or Form 1118. Detailed compliance rules are found in Temp. Treas. Reg. Sec. 1.905-4T.

For taxable years beginning after 1997, a redetermination of the U.S. tax liability is not required if the change is due solely to foreign currency fluctuation. For years prior to 1998, a redetermination was not required if the amount of the foreign tax change was less than the lesser of (1) $10,000 or (2) 2 percent of the total dollar amount of the foreign tax initially accrued (Temp. Treas. Reg. Sec. 1.905-3T(d)(1)).

Special rules apply when the redetermination applies to foreign taxes deemed paid under section 902 or section 960. In these cases, the taxpayer adjusts the pools of accumulated earnings and profits and accumulated foreign taxes for the amount of the refund or additional taxes owed. A redetermination of the taxpayer's U.S. tax liability is required, however, if the foreign tax liability is in a "hyperinflationary currency" (Temp. Treas. Reg. Sec. 1.905-3T(d)(4)(i)).

A taxpayer who receives a refund of foreign taxes will not be charged interest on the amount of tax due from the U.S. tax adjustment, provided the foreign government does not pay interest to the taxpayer with the refund. If the foreign government pays interest with the refund, the Internal Revenue Service will charge interest on the tax adjustment up to the amount of interest received from the foreign government.

Example 7.5. U.S. taxpayer Bordick paid foreign income taxes of $2,000 in 1997. In 1999, he received a refund of $500 of these taxes along with interest of $50. If Bordick owes additional U.S. tax due to this refund, he will be charged interest on the deficiency up to $50. The interest owed (up to $50) will be calculated using the appropriate U.S. rate of interest on the tax due.

Exceptions to the General Rules of Cash or Accrual

Completed Contract Method. A U.S. taxpayer who has elected to report income on the completed-contract method may defer taking a credit for foreign taxes paid until completion of the contract.[24]

[24]Rev. Rul. 53-288, 1953-2 C.B. 27.

Blocked Income. The regulations under section 461 provide that income that would otherwise be taxable in a particular year, except that monetary, exchange, or other restrictions imposed by a foreign country block distribution of the income, does not have to be recognized until the blockage is removed. Treas. Reg. Sec. 1.905-1(b) states that the credit with respect to such amounts is deferred until the year the blockage is removed and the amounts are included in gross income.

Contested Taxes. Tax liabilities for a particular year that are being contested by a taxpayer cannot be deducted until the year of settlement.[25] A foreign tax credit arising from a contested tax is treated as accruing in the taxable year to which the foreign tax relates for refund tax purposes, although the credit may not be accrued until the amount of the foreign tax is actually determined. Any claim for a refund for overpayment of U.S. tax resulting from the foreign tax credit ultimately allowed must be made within ten years of the due date of the federal income tax return for the year to which the foreign tax relates.[26]

Taxes Paid in Foreign Currency

Because U.S. tax returns must be filed on the basis of U.S. dollar equivalencies, the amount of foreign tax credit must be expressed in U.S. dollars, even though the foreign taxes are paid in foreign currencies. Taxpayers who claim the credit on the cash basis convert foreign taxes into U.S. dollars at the rates of exchange prevailing on the date the foreign taxes were paid or withheld (section 986(a)(2)(A)). For taxable years beginning after 1997, taxpayers who claim the credit on the accrual basis convert foreign taxes paid and accrued into U.S. dollars at the average exchange rate for the taxable year to which the taxes relate (section 986(a)(1)(A)). For taxable years beginning before 1998, accrued taxes at year-end were translated using the exchange rate prevailing on the last day of the foreign tax year in which the accrual was made (Temp. Treas. Reg. Sec. 1.905-3T(b)(1)).

Refunds of foreign taxes received by cash-basis taxpayers are translated into U.S. dollars using the exchange rate for the date of payment of the foreign taxes (Temp. Treas. Reg. Sec. 1.905-3T(b)(4)). Such refunds

[25]*Dixie Pine Products v. Comm.*, 320 U.S. 516 (1944).

[26]Rev. Rul. 84-125, 1984-2 C.B. 125 (amplifying Rev. Rul. 58-55, 1958-1 C.B. 266, and Rev. Rul. 77-487, 1977-2 C.B. 479, and clarifying Rev. Rul. 70-290, 1970-1 C.B. 160).

are deemed to be paid on a last-in, first-out (LIFO) basis if there is more than one payment date.

Holding Period Requirement

The credit for foreign income taxes withheld or deemed paid is denied unless, in the case of common stock, the taxpayer holds the stock for more than 15 days during the 30-day period beginning on the date that is 15 days before the date on which the stock becomes ex-dividend (section 905(k)(1) and (2)). In the case of preferred stock, the taxpayer must hold the stock for more than 45 days during the 90-day period beginning on the date that is 45 days before the date on which the stock becomes ex-dividend (section 905(k)(3)). This holding period requirement was enacted by Congress in 1997 and applies to dividends paid or accrued more than thirty days after the provision's date of enactment (August 5, 1997).

Dividend Distributions From Foreign Corporations (Section 902)

A domestic corporation that receives a dividend from a foreign corporation is eligible to claim a credit for foreign income taxes paid by the distributing foreign corporation on the earnings from which the dividend was distributed, provided the minimum ownership requirements of sections 902(a) and 902(b) have been satisfied. The amount of foreign taxes "deemed paid" by the recipient of the dividend is in proportion to the relative amount of earnings distributed to the recipient. A general formula for computing deemed-paid foreign taxes is as follows:

$$\begin{array}{c}\text{Foreign income taxes} \\ \text{paid or accrued by payor}\end{array} \times \frac{\text{Dividends received}}{\text{Earnings and profits of the payor}}$$

One of the policy issues involving the deemed-paid credit has been whether to calculate the credit on a separate-year basis or on an accumulated ("pooling") basis. Under a separate-year basis, the foreign taxes and earnings and profits of the foreign corporation are maintained for each year, and subsequent dividend distributions are treated as paid out of these separate earnings and profits accounts on some flow assumption [such as last-in, first-out (LIFO)]. A separate deemed-paid credit is

required for distributions paid out of each separate earnings and profits account. Under a pooling approach, a distribution is treated as paid out of accumulated undistributed earnings and profits, and the deemed-paid credit is based on a weighted-average foreign tax paid on the earnings distributed.

Prior to the enactment of the Tax Reform Act of 1986, the United States employed a separate-year calculation approach. Congress felt that this approach was subject to foreign tax credit manipulation, whereby a U.S. corporation could maximize the deemed-paid credit by accumulating earnings and profits in its foreign subsidiaries in years the subsidiary was subject to low taxes and having the subsidiary distribute dividends in years the subsidiary was subject to high taxes (this technique was often referred to as the *rhythm method*). In addition, the separate-year approach could result in a loss of deemed-paid foreign tax credits if distributions were made in a year in which the foreign corporation had a deficit in its current-year earnings and profits.

As a result, for tax years beginning in 1987, an accumulated earnings calculation is now required. All distributions received in tax years beginning in 1987 are treated as first made from the foreign payor's earnings and profits accumulated in taxable years beginning after 1986 (section 902(c)(6)(B)). Distributions in excess of these "post-1986 earnings" are treated as having been made from pre-1987 years on a LIFO basis, and the calculation of the deemed-paid credit is made using the pre-1987 separate-year calculation rules.

Distributions Paid Out of Earnings From Years Beginning After 1986

Section 902(a) allows a domestic corporation receiving a dividend from a foreign corporation in which it owns 10 percent of the voting stock to claim a deemed-paid foreign tax credit using the following formula:

$$\frac{\text{Dividends from "post-1986 undistributed earnings"}}{\text{Post-1986 undistributed earnings}} \times \text{Post-1986 foreign income taxes paid or accrued}$$

The amount of the deemed-paid credit claimed by the U.S. corporation is added to the actual dividend received in computing the corporation's gross income (section 78). The dividend is "grossed up" by the full

amount of the deemed-paid credit, without regard to any foreign tax credit limitations imposed on the total foreign credit for the year. The gross-up prevents the taxpayer from obtaining a deduction as well as a credit for the foreign taxes paid by the distributing corporation, given that the amount of the dividend is already net of the taxes paid.

Post-1986 Undistributed Earnings. Distributions received in taxable years beginning after 1986 are treated as having been paid from a pool of earnings and profits accumulated since the first taxable year beginning in 1987. If a domestic corporate shareholder meets the 10-percent ownership test in a year beginning after December 31, 1986, the earnings taken into account in determining the pool are only those earnings accumulated on and after the first day of the first taxable year in which the ownership requirements are met (section 902(c)(3)(A)). The accumulated pool of earnings and profits is referred to as the foreign corporation's "post-1986 undistributed earnings" (Treas. Reg. Sec. 1.902-1(a)(9)).

Section 902(c)(1) defines *post-1986 undistributed earnings* as the foreign corporation's "earnings and profits" (computed using the rules of sections 964(a) and 986) accumulated in taxable years beginning after December 31, 1986, and including the year in which the dividend is distributed, but without reduction for dividends distributed during such taxable year. Section 964(a) states that, with certain modifications, the earnings and profits of the foreign corporation are to be determined using the rules applicable to domestic corporations (section 312 and related regulations). Among the modifications to the computation of foreign earnings and profits are the disallowance of deductions for illegal bribes, kickbacks, or other payments described by section 162(c), and a restriction on depreciation methods when the foreign corporation derives less than 20 percent of its gross income from U.S. sources (section 312(k)(4)). In addition, earnings and profits for purposes of the deemed-paid credit are calculated without regard to whether the earnings of the foreign corporation include "blocked income" (income unavailable for distribution due to currency or other restrictions imposed under foreign law); that is, earnings and profits are calculated without regard to section 964(b).

The regulations under Treas. Reg. Sec. 1.964 provide for two alternative methods for computing foreign earnings and profits. If the foreign corporation's books and records are kept in U.S. dollars and the accounting method is a generally accepted U.S. method, the U.S. shareholder may elect to have the foreign corporation's earnings and profits deter-

mined "in every respect" as if it were a domestic corporation (Treas. Reg. Sec. 1.964-1(f)). If the above election is not made, the earnings and profits must be computed in the following manner:

1. Prepare a profit and loss statement from the foreign corporation's books and records.
2. Adjust the statement to conform to U.S. generally accepted accounting principles if such adjustments are "material" (Treas. Reg. Sec. 1.964-1(b)).
3. Adjust the statement to U.S. tax accounting standards for computing earnings and profits (Treas. Reg. Sec. 1.964-1(c)). This might require making adjustments for bad debts, installment sales, depreciation, and so on. These adjustments are made only if they are "material."

Chapter 11 provides a more comprehensive discussion of the computation of foreign earnings and profits.

Section 986(b) requires that the foreign corporation's post-1986 earnings and profits be computed in the corporation's functional currency (FC) or, if necessary, translated into U.S. dollars using the "appropriate exchange rate." For actual distributions, the dividend is translated into U.S. dollars using the exchange rate on the date the dividend is paid (section 989(b)(1)). The average exchange rate is used for subpart F income (section 951(a)(1)(A)). The remaining pool of post-1986 earnings and profits is reduced by the functional currency amount of the dividend.

Post-1986 Foreign Income Taxes. *Post-1986 foreign income taxes* is defined in section 902(c)(2) as being the sum of the foreign income taxes with respect to the taxable year of the foreign corporation in which the dividend is paid, plus the foreign income taxes with respect to prior taxable years beginning after December 31, 1986, to the extent such foreign taxes were not deemed paid with respect to dividends distributed by the corporation in prior years. The pool of post-1986 foreign income taxes must be maintained in U.S. dollars. Foreign taxes are translated using the translation rules found in section 986(a) (that is, the spot rate for cash-basis taxpayers and the average rate for accrual-basis taxpayers).

Distributions From a First-Tier Foreign Corporation. The computation of the deemed-paid foreign tax credit on distributions from a first-tier foreign corporation is illustrated by the following examples:

Example 7.6. Glass Co. is a wholly owned foreign subsidiary of U.S. corporation Scotland Yarn. Glass Co. records its foreign earnings in its functional currency (u) and translates its foreign taxes into U.S. dollars at an exchange rate of $2:1u. All of Glass Co.'s earnings are non-subpart F general limitation income. Glass Co. reported the following tax results for 1998 and 1999:

Year	*Taxable Income (u)*	*Foreign Taxes (u)*	*Undistributed Earnings (u)*	*Foreign Taxes ($)*
1998	1,000	200	800	400
1999	2,000	400	1,600	800
Total	3,000	600	2,400	1,200

At the end of 1999, Glass Co. distributed a dividend of 800u to Scotland Yarn. Scotland Yarn's deemed-paid credit is $400, computed as follows:

$$800u/2{,}400u \times \$1{,}200 = \$400.$$

The dividend included in Scotland Yarn's gross income is determined by using the exchange rate in effect on the date the dividend is paid. Assuming the exchange rate was $2.00:1u, the 800u dividend would be included in gross income at $1,600 (800u × $2). In computing its dividend income from Glass Co., Scotland Yarn grosses up the actual dividend received ($1,600) by the amount of the deemed-paid foreign tax credit ($400), making the total amount included in Scotland Yarn's gross income $2,000. Glass Co.'s remaining post-1986 undistributed earnings and profits is 1,600u (2,400u − 800u), and its remaining post-1986 foreign income taxes is $800 ($1,200 − $400). If the foreign government of the country in which Glass Co. is located assessed a withholding tax on the dividend distribution, Scotland Yarn would be eligible to take a direct foreign tax credit on that tax.

Example 7.7. U.S. corporation Scotland Yarn owns 10 percent of foreign corporation Glass Co. The remaining 90 percent of Glass Co. is owned by Baker St. Ltd., a foreign corporation. Glass Co. records its foreign earnings in its functional currency (u) and translates its foreign taxes into U.S. dollars at an exchange rate of $2:1u. During 1999, Glass Co. paid a dividend of 800u, 80u of which went to Scotland Yarn. Glass Co. reported the following tax results for 1998 and 1999:

Year	*Taxable Income (u)*	*Foreign Taxes (u)*	*Undistributed Earnings (u)*	*Foreign Taxes ($)*
1998	1,000	200	800	400
1999	2,000	400	1,600	800
Total	3,000	600	2,400	1,200

At the end of 1999, Glass Co. distributed a dividend of 800u to Scotland Yarn. Scotland Yarn's deemed-paid credit is $40, computed as follows:

80u/2,400u × $1,200 = $40.

In computing its dividend income from Glass Co., Scotland Yarn grosses up the actual dividend received (80u × exchange rate on date paid) by the amount of the deemed-paid foreign tax credit ($40). Glass Co.'s remaining post-1986 undistributed earnings and profits are reduced by the entire dividend paid (800u), leaving 1,600u (2,400u − 800u). Glass Co.'s remaining post-1986 foreign income taxes are reduced by the deemed credit allocated to Scotland Yarn ($40) plus the amount of deemed credit that would have been allocated to Baker St. Ltd. had it been eligible for the credit (720u/2,400u × $1,200 = $360), leaving a balance of $800 ($1,200 − $40 − $360). Note that the ending balances are the same as when Glass Co. was a wholly owned subsidiary. The dividend, the section 78 gross-up, the deemed-paid credit, and any withholding tax would be placed in the noncontrolled section 902 basket.

Distributions When There Are Multiple Tiers of Foreign Corporations. Deemed-paid foreign tax credits are available on income taxes paid by second- and third-tier foreign corporations provided the ownership requirements of section 902(b) are met. The deemed-paid credit under section 902 is calculated only when the first-tier foreign corporation makes a distribution to the U.S. corporate shareholder. If earnings of the third- or second-tier foreign corporations have been distributed up to the first-tier foreign corporation, the calculation of the foreign taxes paid by the first-tier foreign corporation includes a proportionate share of the foreign taxes paid by the third- or second-tier foreign corporations on the earnings distributed to the first-tier corporation.

Example 7.8. These calculations are illustrated using an extension of the previous example (see also Reg. Sec. 1.902-1(f), example 3).

Assume that Scotland Yarn owns 50 percent of Glass Co., which in turn owns 40 percent of Watson PLC, which in turn owns 30 percent of Holmes Ltd. All other shareholders are foreign corporations. Glass Co., Holmes PLC, and Watson Ltd. are all incorporated in the same foreign country and were created in 1998. All three corporations use the same functional currency (u) and the exchange rate is $2:1u. During 1999, Glass, Watson, and Holmes reported the following tax results:

Glass Co.

Year	*Taxable Income (u)*	*Foreign Taxes (u)*	*Undistributed Earnings (u)*	*Foreign Taxes ($)*
1998	1,000	200	800	400
1999	2,000	400	1,600	800
Total	3,000	600	2,400	1,200

Watson PLC

Year	*Taxable Income (u)*	*Foreign Taxes (u)*	*Undistributed Earnings (u)*	*Foreign Taxes ($)*
1998	1,000	200	800	400
1999*	2,000	400	1,600	800
Total	3,000	600	2,400	1,200

Holmes Ltd.

Year	*Taxable Income (u)*	*Foreign Taxes (u)*	*Undistributed Earnings (u)*	*Foreign Taxes ($)*
1998	1,000	200	800	400
1999	2,000	400	1,600	800
Total	3,000	600	2,400	1,200

*Taxable income is before any dividends received from a lower-tier subsidiary.

During 1999, each of the corporations paid the following dividend amounts:

- Holmes: 600u (180u to Watson)
- Watson: 800u (320u to Glass)
- Glass: 1000u (500u to Scotland Yarn)

The computation of the section 902 deemed-paid credit on the dividend paid to Scotland Yarn must take into account the dividends and foreign taxes paid by Glass, Watson, and Holmes. The calculation proceeds from the lowest-tier corporation (3rd-tier) to the highest-tier corporation.

Deemed-Paid Credit on Dividend From Holmes to Watson

The 180u dividend from Holmes to Watson carries with it a proportionate share of the foreign taxes in Holmes's post-1986 foreign tax pool. The computation is made using the section 902 formula as follows:

$$\frac{180u}{2{,}400u} \times \$1{,}200 = \$90$$

The 180u dividend is added to Watson's post-1986 earnings, and the $90 of allocated foreign taxes is added to Watson's post-1986 foreign taxes. No gross-up is made for the $90 of foreign taxes to the dividend. Holmes reduces its post-1986 undistributed earnings pool by the full amount of the dividend (600u) and reduces the foreign tax pool by the full amount of the foreign taxes allocated to the full dividend (600u/2,400u × $1,200 = $300).

Deemed-Paid Credit on Dividend From Watson to Glass

The 320u dividend from Watson to Glass carries with it a proportionate share of the foreign taxes in Watson's post-1986 foreign tax pool, including the amounts received and "deemed-paid" on the dividend from Holmes. Watson's post-1986 undistributed earnings pool is 2,580u, and the post-1986 foreign tax pool is $1,290.

The computation is made using the section 902 formula as follows:

$$\frac{320u}{2{,}580u} \times \$1{,}290 = \$160$$

The 320u dividend is added to Glass Co.'s post-1986 undistributed earnings, and the $160 of allocated foreign taxes is added to Glass Co.'s post-1986 foreign taxes. No gross-up is made for the $160 of foreign taxes to the dividend. Watson reduces its post-1986 undistributed earnings pool by the full amount of the dividend (800u) and reduces the foreign tax pool by the full amount of the foreign taxes allocated to the full dividend (800u/2,580u × $1,290 = $400).

Deemed-Paid Credit on Dividend From Glass to Scotland Yarn

The 500u dividend from Glass to Scotland Yarn carries with it a proportionate share of the foreign taxes in Glass Co.'s post-1986 foreign tax pool, including the amounts received and "deemed-paid" on the dividends from Holmes and Watson. Glass Co.'s post-1986 undistributed earnings pool is 2,720u, and the post-1986 foreign tax pool is $1,360.

The computation is made using the section 902 formula as follows:

$$\frac{500u}{2{,}720u} \times \$1{,}360 = \$250$$

In computing its dividend income from Glass Co., Scotland Yarn grosses up the actual dividend received (500u × exchange rate on date paid) by the amount of the deemed-paid foreign tax credit ($250). Glass Co.'s remaining post-1986 undistributed earnings and profits are reduced by the *entire dividend paid* (1,000u), leaving 1,720u (2,720u − 1,000u). Glass Co.'s remain-

ing post-1986 foreign income taxes are reduced by the deemed credit allocated to Scotland Yarn ($250) plus the amount of deemed credit that would have been allocated to Baker St. Ltd. had it been eligible for the credit (500u/2,720u × $1,360 = $250), leaving a balance of $860 ($1,360 – $250 – $250). The dividend, the section 78 gross-up, the deemed-paid credit, and any withholding tax would be placed in the noncontrolled section 902 basket.

This problem becomes more complicated as the foreign corporations have different functional currencies and the exchange rates between these currencies change (the dividends have to be converted into the functional currency of the upper-tier corporation when added to the upper-tier corporation's post-1986 undistributed earnings).

The pooling approach requires that a U.S. domestic corporation with foreign subsidiaries compute the earnings and profits of each foreign corporation on an annual basis, even if no dividends are paid (these are sometimes referred to as eternal pools). This requirement adds to the administrative complexity of doing business overseas through a foreign subsidiary. In addition, the pooling rules apply to each subsidiary separately and to each category of foreign income subject to a separate foreign tax credit limitation calculation under section 904(d). Some degree of flexibility thus exists to selectively distribute dividends from high- and low-taxed subsidiaries to maximize the amount of creditable taxes for the year.

Distributions Paid Out of Earnings From Years Beginning Before 1987

Distributions in excess of post-1986 earnings are deemed paid out of the "accumulated profits" of taxable years beginning prior to 1987 on a separate-year basis using a LIFO flow assumption (that is, using the rules in effect before the enactment of the Tax Reform Act of 1986) (section 902(c)(6)(A)).

The computation of "accumulated profits" for purposes of the pre-1987 section 902 credit is governed by former section 902(c)(1) and Treas. Reg. Sec. 1.902-3, which define accumulated profits as "the amount of its [foreign corporation's] gains, profits, or income computed without reduction by the amount of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income by any foreign country or by any possession of the United States."

There has been considerable controversy as to the interpretation of "accumulated profits." The IRS position was that accumulated profits are

essentially equivalent to accumulated earnings and profits as that term is used in section 312. Treas. Reg. Sec. 1.902-3(e), as it applies to former section 902, defines *accumulated profits* of a foreign corporation as the sum of the earnings and profits of such corporation for the taxable year plus the foreign income taxes imposed on the gains, profits, and income to which such earnings and profits are attributable. Treas. Reg. Sec. 1.902-3(g) permits the U.S. shareholder to use a modified version of Treas. Reg. Sec. 1.964-1 to compute earnings and profits (see the previous discussion of the calculation of earnings and profits under section 964). Taxpayers argued that "accumulated profits" was not equivalent to accumulated earnings and profits and, therefore, the calculation of accumulated earnings should be dictated by foreign tax law rather than U.S. tax law. The IRS position was sustained at the Claims Court, but the taxpayer position was upheld at the U.S. Court of Appeals for the Federal Circuit. In 1989, the U.S. Supreme Court held that "accumulated profits" was to be interpreted to mean accumulated earnings and profits.[27] In addition, the Tax Court has held that "accumulated profits" includes only those earnings subject to foreign taxation.[28] The U.S. Supreme Court decision in *Goodyear* regarding the computation of pre-1987 accumulated profits is reiterated in Treas. Reg. Sec. 1.902-1(a)(10).

The formula for calculating the deemed-paid credit under section 902 for pre-1987 distributions is as follows:

$$\text{Foreign income tax paid or accrued on profits paid from prior year 19XX} \times \frac{\text{Dividend received in current year and deemed paid out of accumulated profits from prior year 19XX}}{\text{Accumulated profits from prior year 19XX less Foreign taxes paid on such accumulated profits}}$$

The translation of all components of the formula (dividends, profits, and taxes) is made at the exchange rate in effect on the date of the dividend distribution, even though the taxes have been paid several years before.[29]

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[27] *United States v. Goodyear Tire and Rubber Co. and Affiliates*, 110 S. Ct. 462 (1989), *rev'g. and rem'g.* 856 F.2d 170 (CA-FC, 1988), *rev'g.* 14 Cl. Ct. 23 (1987).

[28] *Vulcan Materials Co.*, 96 T.C. 410 (1991), dealing with the imposition of a Saudi Arabian income tax only on earnings allocable to foreign shareholders.

[29] *Bon Ami Co.*, 39 B.T.A. 825 (1939).

The amount of deemed-paid foreign taxes on distributions from a lower-tier foreign subsidiary to a higher-tier foreign subsidiary is computed using the rules for the year from which the earnings being distributed arise. However, if preeffective date profits (for example, 1986) of a lower-tier foreign subsidiary are distributed to a higher-tier foreign subsidiary in a posteffective date year (for example, 1999), the increase in the earnings and profits of the higher-tier foreign subsidiary is considered part of post-1986 earnings when a dividend out of those earnings is subsequently distributed to a U.S. corporate shareholder.

The pooling rules do not apply until the beginning of the first taxable year after 1986 in which a U.S. corporation meets the requisite 10-percent-ownership test in the foreign corporation (section 902(c)(3)(A)). For example, if a U.S. corporation purchases 100 percent of a foreign corporation in 1995, the pooling rules are applied to distributions from the foreign corporation beginning in 1995. A distribution out of earnings from 1994 and prior years will be treated under the pre-Tax Reform Act of 1986 (separate-year) rules.

Deficits in Undistributed Earnings (Accumulated Profits)

For post-1986 tax years in which earnings and profits are pooled, a deficit in earnings and profits in one year reduces the pool of post-1986 undistributed earnings from which a distribution is deemed to be paid. The pool of post-1986 foreign income taxes is not reduced unless the deficit in post-1986 undistributed earnings results in a refund of prior-year foreign taxes. Even though permanent loss of deemed-paid credits is reduced under the pooling approach, it is still possible for a corporate shareholder to receive a "dividend" from a foreign corporation and not receive a corresponding deemed-paid credit. This situation can occur when the foreign corporation has positive current earnings and profits and a deficit in post-1986 undistributed earnings (that is, the accumulated deficit from prior post-1986 years exceeds current earnings) and a deficit in pre-1987 accumulated profits. In this case, the corporate shareholder has a dividend (because the distribution is from current earnings), but there is not a corresponding deemed-paid credit because post-1986 undistributed earnings (the denominator of the fraction) are negative.[30]

[30]This result is specifically sanctioned in Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (H.R. 3838, 99th Cong., 2d sess.) (Washington, DC: U.S. Government Printing Office, 1987), 907.

Deficits in pre-1987 tax years are carried back and offset against the most recent year's positive accumulated earnings and profits.[31] Because the deemed-paid credit calculation is made on a separate-year basis for these years, it is possible that prior-year foreign taxes paid can be permanently lost if the foreign jurisdiction does not allow a corresponding carryback of the current-year deficit and a subsequent refund of prior foreign taxes paid. This result can occur if the carryback of the deficit eliminates or reduces the prior year's earnings and profits such that a distribution made during that year is no longer considered a dividend under section 316(a). A recharacterization of the distribution reduces the numerator in the section 902 formula (to zero if the deficit carryback eliminates the prior-year earnings and profits). If the foreign jurisdiction does not allow a refund of foreign taxes paid in that year, the deemed-paid credit on those taxes is permanently lost because there is no provision for a carryforward of "unused" foreign taxes in the separate-year calculation formula. Although the Tax Court held that it was appropriate to carry back a current-year deficit to offset prior year's earnings when the deficit could be carried back under both foreign and U.S. law, it did not resolve the issue as to whether such a carryback was appropriate when foreign law did not allow a result similar to U.S. law.[32] After the court's decision, the IRS continued to maintain its position that the deficit must be carried back regardless of foreign law.[33]

Deficits in post-1986 earnings and profits are carried back to pre-1987 earnings and profits only when there is a distribution in a post-1986 tax year.[34] The amount carried back reduces the pre-1987 earnings and profits and is removed from the pool of post-1986 undistributed earnings. When a deficit in post-1986 accumulated earnings and profits is carried back to a pre-1987 year, it is possible that the recipient of the distribution could lose permanently a deemed-paid credit taken in the pre-1987 year, as discussed above.

Deficits in pre-1987 years are carried forward and included in post-1986 undistributed earnings as of the first day of the first taxable year beginning after December 31, 1989.[35] The foreign income taxes associated with the pre-1987 tax years are not carried forward and included in the post-1986 pool of foreign income taxes.

[31]Rev. Rul. 74-550, 1974-2 C.B. 209.

[32]*Champion International Corp.*, 81 T.C. 424 (1983), *acq*. 1984-2 C.B. 1.

[33]Rev. Rul. 87-72, 1987-2 C.B. 170.

[34]Treas. Reg. Sec. 1.902-2(a).

[35]Treas. Reg. Sec. 1.902-2(b).

Limitation on the Amount of the Credit

Overview

Through the foreign tax credit mechanism, the United States reserves for itself the residual right to tax foreign-source income earned by U.S. taxpayers to the extent the foreign tax rate imposed on that income is less than the U.S. rate of tax that would have been imposed on that income if it were U.S.-source income. The foreign tax credit should not reduce U.S. tax imposed on U.S.-source income, however. To this end, the United States limits the amount of the credit allowable in cases in which the foreign tax rate imposed on foreign-source income exceeds the U.S. rate imposed on comparable U.S.-source income.[36]

Ideally, the limitation should be computed for each separate transaction. Under such a system, the U.S. taxpayer would be allowed a credit for the lower of the foreign or U.S. tax rate imposed on the income resulting from that transaction. If the foreign tax rate was lower than the U.S. rate, the U.S. taxpayer would owe the U.S. government a residual tax for the difference. Such an approach would prevent the U.S. taxpayer from averaging differential foreign tax rates imposed on different sources of income or on income earned in different taxing jurisdictions. A per-item limitation would not be feasible from an administrative and compliance standpoint, and for that reason it has never been used to limit the foreign tax credit.

A second approach, and the one employed by the United States in different variations since 1921, is to restrict the foreign tax credit to a proportion of the total U.S. tax liability on worldwide income, with the proportion being determined by a ratio of the taxpayer's foreign-source taxable income to worldwide taxable income. As a general formula, the foreign tax credit limitation is computed as follows:

$$\frac{\text{Total foreign taxable income from all foreign countries}}{\text{Total taxable income from all sources}} \times \text{Total U.S. income tax} = \text{Foreign tax credit limitation}$$

This formula approach allows foreign-source income that is taxed at different rates to be averaged in the computation of the overall limita-

[36]For a more in-depth discussion of the alternative mechanisms to restrict the foreign tax credit, see Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers* (JCS 25-85), July 18, 1985, 24-45.

tion. As a result, foreign-source income that is taxed at a rate in excess of the U.S. tax rate can be averaged with foreign-source income taxed at a rate below the U.S. tax rate. As long as the effective average foreign tax rate is at or below the average U.S. tax rate, the entire amount of foreign taxes paid on all sources of income may be creditable in the current year.

Example 7.9. U.S. Corporation (USCo) reported worldwide taxable income for 1999 of $1,000. Included in the computation were two sources of foreign-source taxable income: $250 of foreign-source interest taxable at a rate of 20 percent and $250 of foreign-source business income taxable at a 50-percent rate. Foreign taxes paid for 1999 were $175 ($50 + $125). The U.S. tax rate imposed on the $1,000 of taxable income was 35 percent (U.S. tax before any foreign tax credit was $350). Using the general credit limitation formula, the foreign tax credit would be limited to $175 ($500/$1,000 × $350). Therefore, USCo could credit the entire amount of foreign taxes paid against its U.S. tax liability for 1999. This result holds even though USCo paid an effective foreign tax rate on the business income of 50 percent, a rate in excess of the U.S. tax rate imposed on that income. By averaging the income taxed at 50 percent with income taxed at 20 percent, USCo has reduced its overall average effective foreign tax rate to exactly 35 percent. As a result, USCo receives a full credit for its foreign taxes paid and does not owe the U.S. government any incremental tax on its foreign-source income.

The availability of averaging high-taxed with low-taxed foreign-source income can be limited in one of two ways, both of which have been used by the United States. One approach is to require taxpayers to compute a separate limitation formula for each taxing jurisdiction in which foreign-source income is generated. This *per-country limitation* approach was used by the United States in various forms from 1932 to 1975. A second approach is to require taxpayers to compute the limitation formula for income regardless of where the income was earned (an *overall limitation* approach). From 1932 to 1954, taxpayers were limited to the lesser of the overall or per-country limitation. In 1954, Congress required taxpayers to use the per-country limitation. From 1960 to 1975 the taxpayer could elect either the per-country or overall limitation. Since 1976, U.S. taxpayers must use an overall limitation.

When an overall limitation approach is used (that is, all foreign-source income is averaged), restrictions on foreign tax rate averaging can be accomplished by requiring taxpayers to compute a separate limitation formula for different categories of income. Income subject to source manipulation, highly taxed income, and income that is lightly taxed are segregated from the general limitation calculation, and the credit for foreign taxes imposed on such income is limited using a separate formula. The United States has used such an approach since 1976.

Prior to the enactment of the Tax Reform Act of 1986, the United States required taxpayers to compute a separate foreign tax credit limitation for five categories of foreign-source income: certain types of interest from passive investments, income from a domestic international sales company (DISC) or a former DISC, dividends from a foreign sales company (FSC), FSC foreign trade income, and foreign oil and gas extraction income.

During the debate prior to the passage of the Tax Reform Act of 1986, the Reagan administration proposed a return to the per-country limitation approach. Congress rejected this proposal and instead opted to create more categories (*baskets*) of foreign-source income subject to separate credit limitation calculations. The income selected for this treatment was income that was subject to jurisdiction manipulation or generally was subject to a low or zero rate of foreign tax. The objective was to limit the ability of U.S. taxpayers to average high-tax and low-tax foreign-source income to maximize the foreign tax credit available. Congress believed that such an approach was necessary because the lowering of the top marginal U.S. tax rates to 28 percent (for individuals) and 34 percent (for corporations) would likely create excess foreign tax credits and put pressure on U.S. taxpayers to find ways to average low-taxed foreign-source income with high-taxed foreign-source income.[37]

Congress retained the separate limitation calculations for DISC dividends, FSC dividends, FSC trade income, and oil and gas extraction income. The separate limitation calculation for interest from passive investments was expanded to five separate limitation calculations for various types of passive income. The categories of passive income are—

1. Passive income.
2. High withholding tax interest.
3. Financial services income.
4. Shipping income.
5. Dividends from noncontrolled foreign corporations that are eligible for the section 902 deemed-paid credit (that is, dividends paid from foreign corporations that are 10- to 50-percent owned by U.S. corporate taxpayers). A separate limitation is computed for the dividends paid from each such corporation.

[37]Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 859-861.

Income that does not fall into one of these specific categories is combined in a "general limitation" category. Special "look-through" rules are applied to classify deemed distributions from CFCs into the appropriate separate limitation category(ies).

The Separate Limitation Categories of Foreign-Source Income

Section 904(d) lists and defines each of the categories of foreign-source income subject to a separate limitation calculation except for oil and gas extraction income, which is subject to the limitation imposed by section 907. In almost every case, the definition of these categories is highly complex.

Passive Income. *Passive income* is defined in section 904(d)(2)(A)(i) as any income that is of a kind that would be "foreign personal holding company income (as defined in section 954(c))." This includes dividends, interest, rents, royalties, annuities, deemed distributions of subpart F passive income, gains from the sale of property that are treated as passive income, net commodities gains, and net foreign currency gains (Treas. Reg. Sec. 1.954-2(a)(1)). Passive income also includes amounts that are includable in the recipient's gross income under section 551 (foreign personal holding company) and section 1293 (passive foreign investment company).

Section 904(d)(2)(A)(iii) lists the following exceptions to the definition of passive income:

1. Any income described in a different limitation category;
2. Interest received from financing the exportation of goods manufactured, grown, or extracted in the United States (export-financing interest); and
3. High-taxed income.

Passive income subject to a different limitation category includes (1) deemed distributions from a controlled foreign corporation that are subject to the look-through rules of section 904(d)(3); (2) dividends from a noncontrolled foreign subsidiary (owned 10 to 50 percent by U.S. taxpayers); (3) rents and royalties derived from the "active" conduct of a trade or business (Treas. Reg. Sec. 1.904-4(b)(2)); (4) passive income derived by an entity predominantly engaged in the active conduct of

banking, insurance, or similar financial services activity; and (5) passive foreign base company shipping income.

Export financing interest means any interest derived from financing the sale for use or consumption outside the United States of any property that is manufactured, produced, grown, or extracted in the United States by the taxpayer or a related person, provided that not more than 50 percent of the fair market value of the property can be attributable to property imported into the United States (section 904(d)(2)(G)). For purposes of this definition, fair market value is the appraised import value of the property as determined under section 402 of the Tariff Act of 1930. Export financing interest is treated as general limitation income.

An exception to the definition of export financing interest applies to *related-person factoring income*, as defined in sections 864(d)(1) and (d)(6). Such income is generally income of a controlled foreign corporation from a loan for the purpose of financing the purchase of inventory or services of a related person and income from a trade or service receivable acquired from a related person. A *related person* in this context means a person meeting the control test of section 954(d)(3) (that is, one who owns 50 percent of total voting power or value of the corporation). Furthermore, under the "interaction rule" of Treas. Reg. Sec. 1.904-4(h)(3), export financing interest that is also related-person factoring income is treated as passive income rather than general limitation income.

> *Example 7.10.* Forco, a wholly owned foreign subsidiary (CFC) of USCo, purchases USCo's uncollected trade receivables of foreign obligors at a discount (that is, USCo factors the receivables to Forco). The income derived by Forco on the collection of the receivables is both related-person factoring income and export financing interest. Therefore, the income is classified as passive income for purposes of the foreign tax credit limitation calculation.

High-taxed income is defined in section 904(d)(2)(F) as passive income subject to an effective foreign income tax rate in excess of the highest U.S. tax rate (39.6 percent for individuals or 35 percent for corporations). This includes both a withholding tax or a deemed-paid tax computed under sections 902 and 960. The determination of the effective tax rate is made after expenses have been allocated to the income under Treas. Reg. Sec. 1.861-8 and section 864(e). For purposes of determining whether income is high-taxed income, the U.S. taxpayer treats all passive income subject to the following withholding rates as one item of income:

(1) 15 percent or greater, (2) less than 15 percent but greater than zero percent, and (3) no withholding rate. The passive income of each controlled foreign corporation is also grouped and treated as a separate item of income (Treas. Reg. Sec. 1.904-4(c)(4)). All passive rents and royalties are grouped together as one item (even if received from different controlled foreign corporations) (Treas. Reg. Sec. 1.904-4(c)(5)). Passive income earned by a foreign qualified business unit (QBU) is grouped as one item if it is earned within the QBU's country of operation; income from sources outside the country of operation is grouped according to the withholding tax imposed on the income (Treas. Reg. Secs. 1.904-4(c)(3) and (c)(4)).

Example 7.11. USCo receives $100 of passive rental revenues from a foreign person. A withholding tax of $30 is imposed on the rental income. After application of Treas. Reg. Sec. 1.861-8, $40 of expenses are allocated to the rental income, reducing the net rental income to $60. The effective tax rate is now 50 percent ($30/$60), which exceeds the top corporate marginal tax rate of 35 percent. The passive income is reclassified as general limitation income (that is, the rental income is "kicked out" of the passive limitation category).

High Withholding Tax Interest. *High withholding tax interest* means any interest subject to a foreign withholding tax of 5 percent or more (section 904(d)(2)(B)). A *withholding tax* is defined as any tax imposed by a foreign country or possession of the United States that is determined on a gross basis (Treas. Reg. Sec. 1.904-4(d)). Interest on which taxes are withheld by a foreign authority as a collection mechanism (such as U.S. withholding on wages or backup withholding on interest) is not automatically classified as high withholding tax interest. Export financing interest is expressly excluded from this category.

Congress created this separate category to combat the practice of foreign jurisdictions of imposing a high withholding tax on interest paid to foreign (U.S.) lenders. Because the interest was frequently calculated net of taxes, it was the borrower who bore the tax, not the U.S. lender. The U.S. lender got the full benefit of the tax credit, however.

Financial Services Income. Section 904(d)(2)(C) defines *financial services income* as income earned by a person "predominantly engaged" in the active conduct of a banking, financing, or a similar business, or income that is derived from the investment of an insurance company of its unearned premiums or necessary reserves. Specific examples of active

financial services income are provided in Treas. Reg. Sec. 1.904-4(e)(2)). Such income includes income from making personal, mortgage, industrial, or other loans; income from providing trust services; income from arranging foreign exchange transactions; and income from providing traveler's check services.

High withholding tax interest and dividends from a noncontrolled section 902 corporation are specifically excluded from this category (section 904(d)(2)(C)(iii)). Export financing interest earned by a U.S. person predominantly engaged in the active conduct of a banking or similar business and subject to a gross basis tax of 5 percent or greater is treated as financial services income rather than overall limitation income. Export financing interest subject to a tax of less than 5 percent is classified as general limitation income.

This separate limitation category was designed to prevent nonfinancial companies from setting up a financing entity to generate low-taxed interest income that was exempt from the prior law passive interest category. So as not to discriminate against banks and insurance companies, Congress allowed entities that are predominantly engaged in the active conduct of a banking, insurance, financing, or similar business (a "financial services entity") to treat all of their passive income as financial services income and average low-taxed and high-taxed income from such a business.

Shipping Income. *Shipping income* generally includes foreign-base company shipping income, as defined in section 954(f) (section 904(d)(2)(D)). This is income derived from the use of any aircraft or vessel in foreign commerce, the income from services related to such activities, and the sale or disposition of the vessel. Income from ocean and space activities, as defined in section 863(d)(2), is classified as shipping income for purposes of the foreign tax limitation calculation. Shipping income does not include any dividend from a noncontrolled section 902 corporation, any financial services income, or any high withholding tax interest. Dividends and interest derived from working capital associated with a taxpayer's foreign shipping operations are categorized as passive (foreign personal holding company) income for foreign tax credit limitation purposes. Congress segregated foreign base company shipping income to combat the practice of U.S. taxpayers of generating foreign shipping income that was not subject to any foreign tax to increase their overall credit limitation.

Dividends From Each Noncontrolled Section 902 Corporation. Dividends received from each noncontrolled section 902 corporation are subject to a separate foreign tax credit limitation calculation (section 904(d)(2)(E)). A *noncontrolled section 902 corporation* is any foreign corporation in which a U.S. taxpayer meets the stock ownership requirements of section 902(a) (that is, the shareholder owns directly 10 percent or more of the voting stock of the foreign corporation). However, if the foreign corporation meets the definition of a *controlled foreign corporation* (CFC) (that is, the U.S. shareholders own more than 50 percent of the voting stock or value of the corporation), the dividends paid to a 10-percent-or-more U.S. shareholder out of earnings and profits accumulated while the corporation was a CFC are subject to the look-through rules of section 904(d)(3).

Because the focus of this rule is on dividends eligible for the deemed-paid credit under section 902, the separate limitation category rule applies only to U.S. shareholders eligible to take the section 902 credit on the receipt of the dividend (that is, only corporate shareholders are subject to this separate category rule). Under regulations to be issued by the U.S. Treasury, a CFC may be treated as a noncontrolled section 902 corporation with respect to dividends paid out of earnings and profits accumulated while the corporation was a CFC in cases in which the distribution is out of earnings and profits for periods during which the recipient was not a "related person" with respect to the CFC. A related person for this purpose is defined under section 954(d)(3), except that in cases to be provided in the regulations, the 50-percent ownership requirement is reduced to a 10-percent ownership requirement.

The conference agreement to this latter provision anticipates that the U.S. Treasury Department will allow look-through treatment under section 904(d)(3) on dividends paid by a CFC in cases in which it is administratively difficult for the shareholder and the Internal Revenue Service to determine whether the dividend is attributable to earnings and profits that predate the shareholder's status as a 10-percent-or-more shareholder. The conference agreement also anticipates that when a first-tier CFC sells all or a majority of the stock of its wholly owned second-tier CFC to a U.S. corporation, dividends paid from the acquired foreign corporation to the U.S. acquiring corporation out of preacquisition earnings and profits will be subject to the noncontrolled section 902 corporation foreign tax credit limitation. This result is based on the premise that the acquiring corporation should be able to determine

whether the distribution is from preacquisition or postacquisition earnings and profits.[38]

Dividends from earnings and profits accumulated while the foreign corporation was neither a CFC nor a noncontrolled section 902 corporation are subject to the noncontrolled section 902 corporation limitation calculation rather than the passive income limitation calculation.

The foreign taxes subject to this separate limitation calculation include foreign withholding taxes imposed on the dividends and foreign taxes deemed paid under section 902. This limitation takes precedence over the other separate limitations (that is, passive, financial services, or shipping income). A special rule applies to high withholding tax interest earned by a noncontrolled section 902 corporation. Taxes in excess of 5 percent imposed on such interest are not treated as foreign taxes for purposes of determining the U.S. shareholder's section 902 deemed-paid credit.

> *Example 7.12.* USCo owns 30 percent of foreign corporation Netherco. No other U.S. person owns any direct or indirect interest in Netherco, and Netherco is not a passive foreign investment corporation. During 1999, Netherco paid USCo a dividend of $100, out of which $10 of foreign taxes is withheld. A $40 deemed-paid credit is available on the dividend. USCo reports gross income of $140 ($100 + $40) and pays a U.S. gross tax of $49 (35% × $140). Total foreign taxes eligible for credit are $50. Under the separate limitation category for dividends from noncontrolled section 902 corporations, USCo's foreign tax credit limitation is $49. The excess credit of $1 must be carried forward (or back) and can only offset U.S. tax imposed on future (or prior) dividends received from Netherco.

Congress enacted this separate limitation category to prevent U.S. taxpayers from creating foreign corporations to collect and pool their foreign-source income. If the foreign corporation was not a CFC, it would not be subject to the look-through rules discussed subsequently and the dividend would be categorized as passive income. By allowing taxpayers to pool their dividends from each nonmajority-owned corporation, Congress would be permitting "cross-crediting" of income subject to different rates of tax in cases where the foreign corporations were not part of a single economic unit. Therefore, Congress adopted a company-by-

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[38]Senate Committee on Finance, *Technical Corrections Bill of 1988: Report to Accompany S. 2238*, 100th Cong., 2d sess., 1988, S Rept. 100-445, 262.

company approach in which the corporate payor is not controlled by the U.S. shareholder(s). In addition, Congress recognized that it was not practical to impose look-through rules on a 50-percent-or-less owned foreign corporation because the nonmajority U.S. shareholder might have difficulty accessing the foreign corporation's tax information.

These "10/50 basket" rules were highly controversial within the U.S. tax community because of the administrative complexity involved in computing a separate foreign tax credit limitation for dividends from each fifty-percent-or-less owned foreign joint venture. After much lobbying, Congress enacted the following changes to the 10/50 dividend rules in 1997: (1) for earnings and profits accumulated after December 31, 2002, dividends from noncontrolled foreign corporations will be subject to look-through treatment; and (2) dividends from noncontrolled foreign corporations paid out of earnings and profits accumulated before January 1, 2003 will be subject to a single foreign tax credit limitation. The Clinton administration and members of Congress have proposed applying look-through rules to all 10/50 dividends and accelerating the effective date.

The separate limitation calculations for dividends from noncontrolled foreign corporations can be avoided by "checking-the-box" and classifying the foreign joint venture as a flow-through entity for U.S. tax purposes and by creating a holding company that is a CFC (and subject to look-through rules) to collect the U.S. taxpayer's 10/50 dividends (a "10/50 mixer corporation").

General Limitation Income. Foreign-source income of the U.S. taxpayer that is not classified into a separate category is pooled into a category known as *general limitation income* (section 904(d)(1)(I)). This category includes active trade or business income and exceptions to the separate limitation categories (for example, export financing interest and high-taxed passive income).

Actual and Deemed Distributions From Controlled Foreign Corporations

Under the general jurisdiction rules discussed above, the United States taxes U.S. citizens, residents, and domestic corporations on their worldwide income and foreign persons on their U.S.-source or "effectively connected" income. A U.S. controlled foreign corporation is not taxed by

the United States on foreign-source income that is not effectively connected with a U.S. trade or business. The U.S. shareholders are not subject to U.S. tax on those earnings until they are repatriated in the form of a dividend, interest, rent, or a royalty. An exception to this general rule applies to certain kinds of income earned by a foreign corporation in which more than 50 percent of the total voting power or value of stock is owned by U.S. shareholders on any day of its taxable year (section 957(a)). If the ownership requirement is met for an uninterrupted period of 30 days or more, income of the "controlled foreign corporation" ("subpart F income") is deemed to be distributed as a dividend to U.S. persons who own at least 10 percent of the CFC's total voting power at year-end, regardless of whether the earnings are repatriated (section 951(a)(1)(A)).

Absent any conduit (look-through) rules, a U.S. taxpayer operating a branch in a foreign country could be subject to more separate credit limitations than a U.S. taxpayer operating a subsidiary. In the branch operation, the branch earnings are separately analyzed and partitioned into separate credit categories. In the subsidiary operation, the focus would be on the nature of the payment (for example, a dividend) to the U.S. parent corporation and not the underlying nature of the earnings that constituted the payment. The look-through rules of section 904(d)(3) are intended to harmonize the credit limitation treatment of branch and subsidiary earnings.

The look-through rules of section 904(d)(3) apply only to dividends, interest, rents, and royalties received or accrued by a "United States shareholder" from a CFC and to deemed dividends to such shareholders under section 951(a)(1)(A). A *United States shareholder* has the meaning given to it by section 951(b) (that is, a U.S. individual, corporation, estate, trust, or partnership that owns at least 10 percent of the voting power of the foreign corporation). A *controlled foreign corporation* has the same meaning as section 957(a) (that is, a foreign corporation that is owned more than 50 percent in value or voting power by "United States shareholders" on any day during the taxable year of the foreign corporation), except that a U.S. shareholder includes any member of the controlled group of the U.S. shareholder. For this purpose, a controlled group means an affiliated group as defined in section 1504(a)(2) except that a 50-percent ownership test is substituted for the 80-percent ownership requirement (Treas. Reg. Sec. 1.904-5(a)(3)).

The look-through rules do not apply to dividends, interest, rents, or royalties paid to persons who do not meet the definition of a United States shareholder, nor do the rules apply to a controlled foreign corpo-

ration that avoids the application of the subpart F deemed distribution rules through the de minimis exception of section 954(b)(3)(A) (section 904(d)(3)(E)). The de minimis exception applies when the CFC's *foreign base company income* (as defined in section 954(a)) and its *gross insurance income* (as defined in section 954(b)(3)(C)) are less than the lesser of 5 percent of its gross income or $1 million. This exception does not apply to financial services income.

The portion of a dividend that is paid out of the CFC's passive income is recharacterized as general limitation income if it is subject to a foreign tax rate greater than 90 percent of the maximum rate imposed on U.S. corporations (that is, 31.5 percent) (Treas. Reg. Sec. 1.904-5(d)(2)). This *high-tax kick-out* exception also applies to interest, rents, and royalties paid by the CFC. Again, the test is made at the U.S. shareholder level. (For example, royalties paid to a U.S. shareholder out of a CFC's passive income are recharacterized as general limitation income if the foreign withholding taxes imposed on the net royalty income received results in a foreign effective tax rate in excess of 31.5 percent.)

The general approach of the look-through rules is to characterize interest, rents, royalties, dividends, and deemed dividend distributions paid to the U.S. shareholder as separate or general limitation income by reference to the CFC's underlying pool of earnings out of which the payments arose.

Subpart F Inclusions. Income included in gross income under section 951(a)(1)(A) as a deemed dividend is treated as income in a separate category in the same proportion as the income of the CFC out of which the dividend is deemed distributed (section 904(d)(3)(B)).

> *Example 7.13.* Portuco, a wholly owned foreign subsidiary of USCo, reported 200u of net income during 1999, 85u of which was foreign base company shipping income, 15u of which was foreign personal holding company income, and 100u of which was non-subpart F general limitation income. The shipping income and personal holding company income are included in USCo's gross income as deemed dividends under section 951(a)(1)(A). Because 85u of the subpart F inclusion is attributable to shipping income of Portuco, USCo categorizes 85u of the dividend (as translated) as shipping income for purposes of the foreign tax credit limitation calculation. Similarly, USCo categorizes the remaining 15u dividend as passive limitation income.[39]

[39] Treas. Reg. Sec. 1.904-5(c)(1)(ii), example 1.

If a CFC's gross foreign base company income and gross insurance income exceed 70 percent of its total gross income, all of the CFC's gross income is treated as foreign base company income and is includable in the gross income of the U.S. shareholders (section 954(b)(3)(B)). However, for purposes of categorizing such a deemed dividend, the look-through rules apply only to the portion of the income that represents subpart F income without the application of section 954(b)(3)(B).

> *Example 7.14*. Franco, a wholly owned foreign corporation of USCo, a U.S. corporation, reported 100u of gross income, of which 75u was foreign personal holding company income and 25u of which was non-subpart F income. Under section 954(b)(5), the entire 100u is currently taxable to USCo under section 951. USCo treats 75u of the gross income (as translated) as passive limitation income and the remaining 25u as general limitation income.[40]

Interest. Interest received by a U.S. shareholder from a CFC is generally treated as income in a separate category to the extent the interest is properly allocable to income of the CFC in such a category (section 904(d)(3)(C)). Interest received from a CFC by a U.S. shareholder (or a related person) and subject to the look-through rules (*related-person interest*) is subject to a netting rule (Treas. Reg. Sec. 1.904-5(c)(2)(ii)). Such interest is first categorized as passive income to the extent of the CFC's *foreign personal holding company (FPHC) income*. This is after allocation of any directly related expenses using the principles of Treas. Reg. Sec. 1.861-8.

The CFC paying related-person interest must allocate such interest and all other expenses against its separate limitation income using the allocation rules of Treas. Reg. Sec. 1.904-5(c)(2)(ii). These allocation rules require the CFC to allocate its expenses using the following criteria:

1. Any expenses (including unrelated-person interest) that are directly related to a class of gross income from a specific property are allocated and apportioned under the principles of Treas. Reg. Sec. 1.861-8 to income in each separate category.
2. Related-person expense is allocated to the amount of FPHC income (but not below zero).
3. If the related-person interest exceeds the CFC's FPHC income, the remaining amount is allocated to the other categories of gross income

[40] Treas. Reg. Sec. 1.904-5(e)(2).

using either the asset or gross income methods of Treas. Reg. Sec. 1.861-8. Under the asset method, the excess related-person interest is allocated according to the ratio of the value of the CFC's assets in each separate category (other than passive) over the value of the CFC's total assets. A similar formula is used for the gross income method (see Treas. Reg. Sec. 1.904-5(c)(2)(ii)(D)).

4. Any other expenses (including unrelated-person interest) are allocated to the separate limitation categories using either the asset or gross income allocation method. The asset method formula used to apportion expenses other than related-person interest is similar to the formula used to allocate excess related-person interest (Treas. Reg. Sec. 1.904-5(c)(2)(ii)(E)). If other expenses are allocated to passive assets, the value of the passive assets is reduced by any related-person debt allocated to such assets. The related-person debt allocated to the passive assets is computed by multiplying total related-person debt times the ratio of related-person interest allocable to passive income under Treas. Reg. Sec. 1.904-5(c)(2)(ii)(C) over total related-person interest (Treas. Reg. Sec. 1.904-5(c)(2)(iii)(B)). Similar formulas are used if the gross income method is used.

Example 7.15. Czechco, a wholly owned foreign subsidiary of USCo, reported 200u of foreign personal holding company income that is passive income for purposes of section 904(d)(2)(A). Czechco also reported 100u of foreign base company sales income that is general limitation income. Czechco has 2,000u of passive assets and 2,000u of general limitation assets. During 1999, Czechco paid 150u of interest to USCo on a loan of 1,500u and 100u of interest to an unrelated person on a loan of 1,000u. No other expenses were incurred.[41]

Asset method of interest allocation:

Under the netting rule, USCo categorizes the 150u interest payment (as translated) from Czechco as passive income to the extent Czechco has passive income for the year (which in this case is 200u). Therefore, all of the interest received by USCo is classified as passive income. Czechco allocates its interest expenses against its separate category income under the asset method using the following procedure:

1. Because all of the related-person interest is allocated to passive income under Treas. Reg. Sec. 1.904-5(c)(2)(ii)(C), none of the related-person

[41] Treas. Reg. Sec. 1.904-5(c)(2)(iv), examples 1 and 2.

interest payment is allocated against general limitation income under Treas. Reg. Sec. 1.904-5(c)(2)(ii)(D).

2. The entire amount of related-person debt is allocated to passive assets under Treas. Reg. Sec. 1.904-5(c)(2)(iii)(B) ($1,500 × $150/$150).
3. The remaining nonrelated-person interest expense of 100u is allocated to Czechco's passive and general limitation income using the asset method found in Treas. Reg. Sec. 1.904-5(c)(2)(ii)(E).

Passive = 100u × (2,000u − 1,500u)/(4,000u − 1,500u) = 20u
General limitation = 100u × 2,000u/(4,000u − 1,500u) = 80u

Gross income method of interest allocation:

If the gross income method of allocation is used, Czechco allocates the 100u of unrelated-person interest expense using a formula similar to the asset method, except that interest expense is substituted for asset value and related-person interest is substituted for related-person debt.

Passive = 100u × (200u − 150u)/(300u − 150u) = 33
General limitation = 100u × 100u/(300u − 150u) = 67u

Rents and Royalties. Rents and royalties received or accrued from a CFC by a U.S. shareholder are treated as income in a separate category to the extent such expenses were allocated against the income of the CFC in that separate category under the principles of Treas. Reg. Sec. 1.861-8 (Treas. Reg. Sec. 1.904-5(c)(3)). For example, if a U.S. shareholder receives a royalty payment from a CFC that earned only general limitation income, that royalty is treated as general limitation income by the U.S. shareholder.

Dividends. Dividends paid by a CFC to a U.S. shareholder are treated as income in a separate category in proportion to the ratio of the CFC's earnings and profits attributable to income in each category to total earnings and profits of the CFC (section 904(d)(3)(D) and Treas. Reg. Sec. 1.904-5(c)(4)). Dividends for this purpose include amounts included in the U.S. shareholder's gross income under section 951(a)(1)(B) as a pro rata share of the CFC's increase in earnings invested in U.S. property (section 904(d)(3)(G)).

Example 7.16. Thaico, a wholly owned foreign corporation of USCo, has current earnings and profits of 1,000u, of which 600u is attributable to general limitation income (which is not subpart F income) and 400u of which is from dividends received from a noncontrolled section 902 corporation. At the end of 1999, Thaico paid USCo a dividend of 200u, all of which was

from current earnings and profits. The dividend is categorized as 120u of general limitation income (600u/1,000u × 200u) and 80u of noncontrolled section 902 dividend income (400u/1,000u × 200u).[42]

If part of a dividend is deemed paid out of subpart F income that was previously included in the U.S. shareholder's gross income and is therefore not taxed when received (section 959(d)), the U.S. shareholder reduces the earnings and profits ratios by the untaxed amount in applying the look-through rules.

Example 7.17. Indiaco, a wholly owned foreign subsidiary of USCo, reported 20u of passive foreign personal holding company income and 60u of manufacturing income, and received 20u of dividends from a noncontrolled section 902 corporation. At the end of 1999, Indiaco paid USCo a 40u dividend. Assuming gross income and earnings and profits are equal (total earnings and profits are 100u), USCo includes the 20u of foreign personal holding company income in gross income as a subpart F inclusion and treats it as passive limitation income. Of the 40u dividend, 20u is treated as a distribution of previously taxed income and is not included in USCo's gross income. The remaining 20u of dividend is included in USCo's gross income and is treated as 5u of noncontrolled section 902 dividend limitation income (20u × 20u/(100u − 20u)) and 15u of general limitation income (20u × 60u/(100u − 20u)).

Special antiabuse rules apply where a dividend is paid to a U.S. shareholder, the payor (CFC) is the recipient of a related-party loan, and it appears that the loan was made to alter the characterization of the dividend for purposes of the look-through rules (Treas. Reg. Sec. 1.904-5(c)(4)(ii)). In such a case, the character of the dividend is determined by the lender's earnings and profits rather than the earnings and profits of the payor of the dividend. The regulations state that a loan is not considered made for the purpose of altering the characterization of the dividend if the loan would have been made or maintained on substantially the same terms, whether or not the dividend was paid (for example, a loan by a related party lender to a CFC that arises from the sale of inventory in the ordinary course of business).

Application of Look-Through Rules to Partnerships and Other Pass-Through Entities. In general, a partner's distributive share of partnership income is characterized as income in a separate category to the extent that the distributive share is a share of income earned or accrued by the partnership

[42]Treas. Reg. Sec. 1.904-5(c)(4)(iii), example 1.

in such category (Treas. Reg. Sec. 1.904-5(h)(1)). Payments of interest, rents, or royalties from a partnership to a partner described in section 707 (that is, payments to a partner not acting in his or her capacity as a partner) are characterized under the look-through rules, provided the rules would have applied had the partnership been a foreign corporation and the payment is to a partner who owns 10 percent or more of the value of the partnership. This rule also applies if the payment is to a member of the partner's affiliated group (a 50-percent ownership test is substituted for the 80-percent requirement of section 1504(a)).

The look-through rules do not apply to payments from a partnership to a limited partner or corporate general partner that owns less than 10 percent of the value in the partnership. In such cases, the payment is treated as passive limitation income. The look-through rules do apply to a less-than-10-percent partner if the interest is held in the ordinary course of the partner's trade or business (that is, the partner or a member of the partner's affiliated group engages in the same, or a related trade or business, as the partnership). In addition, if any portion of the partner's distributive share of income is a share of high withholding tax interest, that portion of the distributive share is treated as high withholding tax interest by the partner, even if the partner is a less-than-10-percent partner (Treas. Reg. Sec. 1.904-5(h)(2)(ii)). For purposes of this exception, value is defined to include an interest in the capital or profits of the partnership.

The look-through rules also apply to distributions and payments made between related "look-through entities" (Treas. Reg. Sec. 1.904-5(i)(1)). A *look-through entity* includes a CFC, partnership, and presumably an S corporation and a simple trust. (The latter two entities were included in the proposed regulations but are not mentioned in the final regulations.) Look-through entities are related if one entity owns more than 50 percent of the total voting power or value of the other entity or if U.S. shareholders own at least 50 percent of the voting power or value of both entities.

Ordering Rules. The look-through rules apply to payments and subpart F inclusions in the following order: rents and royalties, interest, subpart F inclusions and distributive shares of partnership income, and dividends. If an entity is both a recipient and a payor of any of these categories of income, the income received is characterized before the income that is paid (Treas. Reg. Sec. 1.904-5(k)(2)). If two related persons pay each

other interest, the interest payments offset each other and only the entity with the net interest paid is treated as having paid interest.[43]

Source Rules Applicable to United States-Owned Foreign Corporations

Although the look-through rules of section 904(d)(3) serve to determine the foreign tax credit limitation category into which income is placed, they do not change the geographic source of the income (that is, the income remains foreign-source income). Without any further restrictions, a U.S. corporation seeking to characterize income as foreign-source for purposes of the foreign tax credit limitation could loan money to a foreign-owned corporation and have the foreign corporation invest in U.S. securities. The dividend income earned by the foreign corporation could then be used to pay the interest on the loan. Even though the look-through rules would characterize this income as passive, it would still be foreign-source income.

To prevent such potential abuses of the source rules for purposes of the foreign tax credit limitation, Congress enacted section 904(g) in 1984 to re-source certain foreign distributions as U.S.-source income to the extent they are paid out of earnings and profits derived from U.S.-source income. These re-sourcing rules apply to (1) interest, dividends, and gross income included under subpart F (section 951(a)); (2) foreign personal holding company income (section 551); or (3) passive foreign investment company income (section 1293) paid or deemed paid by a United States-owned foreign corporation to a U.S. person.

A *United States-owned foreign corporation* is defined to be a foreign corporation owned 50 percent or more by U.S. persons (section 904(g)(6)). This definition includes controlled foreign corporations, but it also includes joint ventures that are foreign corporations and are 50-percent owned by U.S. persons. A special de minimis rule (section 904(g)(5)) allows the corporation to be exempt from the re-sourcing rules in any year in which the U.S.-source portion of earnings and profits for the year is less than 10 percent.

Interest. Interest is re-sourced only if it is paid to a "U.S. shareholder" (a 10-percent shareholder) or a related person to the U.S. shareholder

[43] Treas. Reg. Sec. 1.904-5(l), examples 8, 9, and 10.

(defined in section 267(b)). If the interest is *related-person interest* (as defined in Treas. Reg. Sec. 1.904-5(c)(2)(ii)), it is sourced as being from within the United States to the extent the foreign corporation has U.S.-source passive income. If the interest is less than or equal to passive income, the amount that is sourced within the United States is computed using a ratio of U.S.-source passive income to total passive income. Any related-person interest in excess of passive income and therefore allocated to other separate categories of income is sourced using either a gross income method or an asset method (see Treas. Reg. Sec. 1.904-5(m)(2)).

Example 7.18. Canco, a wholly owned foreign corporation of USCo, paid USCo 300u of interest during 1999. Canco had no other expenses. Canco has 3,000u of assets that generate 650u of foreign-source general limitation income and a 1,000u loan to an unrelated person that generates 20u of foreign-source passive income. Canco also has a 4,000u loan to an unrelated U.S. person that generates 70u of U.S.-source passive income and 4,000u of inventory that generates 100u of U.S.-source general limitation income. USCo uses the asset method to allocate interest expense. Canco's assets and income can be summarized as follows:

Assets:

	Foreign	*U.S.*	*Totals*
Passive	1,000u	4,000u	5,000u
General	3,000u	4,000u	7,000u
Total	4,000u	8,000u	12,000u

Income:

	Foreign	*U.S.*	*Totals*
Passive	20u	70u	90u
General	650u	100u	750u
Total	670u	170u	840u

Under Treas. Reg. Sec. 1.904-5(c)(2)(ii)(C), 90u of the 300u related-person interest payment from USCo to Canco is allocated to passive income. Under Treas. Reg. Sec. 1.904-5(m)(2), 70u is sourced as U.S. and 20u is sourced as foreign. The remaining 210u of interest expense is allocated to the general limitation category. Of this amount, 120u is sourced within the United States (4,000u/7,000u × 210u) and 90u is sourced outside the United States (3,000u/7,000u × 210u).[44]

[44]Treas. Reg. Sec. 1.904-5(m)(3), example 1.

Dividends. Dividends are sourced in proportion to the ratio of U.S.-source earnings and profits of the foreign corporation in the particular credit limitation category to the total earnings and profits of the foreign corporation in that separate category (section 904(g)(4) and Treas. Reg. Sec. 1.904-5(m)(4)). In the calculation of earnings and profits, related-person interest is allocated between U.S. and foreign earnings and profits using the rules of Treas. Reg. Sec. 1.904-5(m)(2), and other expenses are allocated using the rules of Treas. Reg. Sec. 1.904-5(c)(2)(ii).

> *Example 7.19.* Brazco, a wholly owned foreign corporation of USCo, has earnings and profits of 1,000u, of which 400u represents general limitation income and 600u represents passive income. The entire amount of the general limitation earnings and profits is from sources outside the United States. Earnings and profits from passive income is made up of 400u from sources outside the United States and 200u from sources within the United States. During the year, Brazco paid USCo a dividend of 500u. Of that amount, 300u is treated as passive income (600u/1,000u × 500u). Of this 300u, 100u is sourced within the United States (200u/600u × 300u) and 200u is sourced outside the United States (400u/600u × 300u). The remaining 200u of the dividend is sourced outside the United States and treated as general limitation income.[45]

Subpart F Inclusions. Income deemed to be distributed to a U.S. shareholder under section 951(a)(1) is sourced according to the underlying sources of the income constituting each separate category (section 904(g)(2) and Treas. Reg. Sec. 1.904-5(m)(5)).

> *Example 7.20.* Turko, a wholly owned CFC of USCo, reported 100u of subpart F foreign personal holding company income that is treated as passive limitation income. Of this amount, 40u is from sources within the United States. Turko also reported 50u of subpart F general limitation income, all of which is from sources outside the United States. USCo includes the 150u of subpart F income in gross income under section 951(a). Of this amount, 60u is treated as foreign-source passive income to USCo, 40u is treated as U.S.-source passive income, and 50u is treated as foreign-source general limitation income.[46]

Foreign Oil and Gas Limitations

Section 907 provides special rules for the treatment of taxes on foreign oil and gas income. These rules (1) relate to limitations on amounts allowed

[45] Treas. Reg. Sec. 1.904-5(m)(4)(iii), example.

[46] Treas. Reg. Sec. 1.904-5(m)(5)(ii), example.

as foreign taxes under section 901, (2) deal with foreign taxes on foreign oil-related income, (3) provide for recapture of foreign oil and gas extraction losses, and (4) describe the treatment of disallowed credits.

Oil and Gas Extraction Taxes. Section 907(a) establishes a limit on the amount of any oil and gas extraction taxes paid or accrued (or deemed to have been paid) that are taken into account for purposes of section 901. Taxes paid or accrued for purposes of section 901 must be reduced by the amount the taxes exceed foreign oil and gas extraction income for the taxable year, multiplied by the highest rate of tax under section 11(b) for a corporation, which currently is 35 percent. For an individual, the amount must be multiplied by a fraction: The numerator is the tax against which the regular foreign tax credit under section 901(a) is taken; the denominator is the taxpayer's entire taxable income.

Foreign oil and gas extraction income is income derived outside the United States from the extraction of minerals from oil or gas wells or the sale or exchange of assets used by the taxpayer in the trade or business of extracting minerals from oil or gas wells (section 907(c)(1)). It also includes certain dividends, interest, and partnership distributions (section 907(c)(3)). It does not include dividend or interest income (for example, interest on working capital) that would otherwise be passive income (as defined in section 904(d)(2)(A)).

Foreign Oil-Related Income. The term *foreign oil-related income* means the taxable income derived from sources outside the United States and its possessions from the following activities:

1. The processing of minerals extracted by the taxpayer or by any other person from oil and gas wells into oil or gas primary products;
2. The transportation of these minerals or primary products;
3. The distribution or sale of such minerals or primary products;
4. The disposition of assets used by the taxpayer in processing, transporting, or distributing these minerals or primary products (however, 50 percent or more of the income attributable to the asset for the three taxable years of the selling corporation immediately preceding the year of sale must be foreign base company oil nonextraction income); and
5. The performance of any other related service such as managerial services, accounting services, or insurance for oil extraction or nonextraction income (section 907(c)(2)).

Foreign oil-related income does not include dividend or interest income (for example, interest on working capital) that would otherwise be passive income (as defined in section 904(d)(2)(A)).

The following amounts are treated as foreign oil nonextraction income to the extent that they are attributable to foreign oil and gas nonextraction income:

1. Dividends and interest from a foreign corporation for which taxes are deemed paid by the taxpayer;
2. Dividends from a domestic corporation that are treated as income from sources outside the United States;
3. Amounts for which taxes are deemed paid under section 960; and
4. The taxpayer's distributive share of income of partnerships.

In addition, interest from a foreign corporation and dividends from a domestic corporation that are treated as foreign-source are foreign base company oil and gas nonextraction income to the extent attributable to foreign oil and gas extraction income. This means that such interest and dividends are oil nonextraction income even though foreign oil and gas extraction income is not foreign base company oil and gas nonextraction income.

Foreign Taxes on Foreign Oil-Related Income. Foreign income taxes otherwise creditable that are paid or accrued to any foreign country for foreign oil-related income are generally creditable against U.S. income taxes. Amounts are not creditable to the extent that the Secretary of the Treasury determines that the foreign law that imposes the tax is structured, or in fact operates, so that the amount imposed on foreign oil nonextraction income is in most cases materially greater than the amount generally imposed on income that is non-oil-related income. The amount not treated as a tax is treated as a deduction under the foreign law. Therefore, the excess amount is deductible for purposes of computing foreign income tax and for U.S. tax purposes.

This provision is meant to ensure that the rate of foreign tax on oil profits after the deduction does not exceed the rate of tax generally imposed by the country on other income. This amount must be computed algebraically by solving the following equations:

$$(1)\ Yf = Fo - (Tp - Tc)$$
$$(2)\ Tc = Yf \times Tr$$

where:

Fo = Foreign oil-related income
Tp = Oil taxes paid to a foreign jurisdiction
Yf = Foreign taxable income and U.S. taxable income
Tc = Foreign income tax for tax credit purposes
Tr = Generally applicable foreign income tax

The foreign income tax for tax credit purposes is computed by substituting Fo − (Tp − Tc) from equation 1 for Yf in equation 2.

$$(3)\ Tc = (Fo - [Tp - Tc])Tr$$

After solving for Tc in equation 3, equation 1 can be solved for Yf.

Example 7.21. A foreign country has a generally applicable income tax of 40 percent but imposes an additional "tax" on oil-related income that results in a total tax of 55 percent on such income. A company earning $100 of oil-related income on which it paid oil "taxes" of $55 is allowed $30 of the foreign tax as a credit against the precredit U.S. tax on taxable income of $75, computed as follows:

Tc = [$100 − ($55 − Tc)] × 40%
Tc = $30
Yf = $100 − ($55 − $30)
Yf = $75

The company is entitled to treat the remaining $30 of the foreign tax as a credit against the $25.50 precredit U.S. tax on the $75 taxable income; this leaves an excess credit of $4.50.

Foreign Oil Extraction Loss. A foreign oil extraction loss is the amount by which the taxpayer's gross income from activities giving rise to foreign oil and gas extraction income is exceeded by the sum of expenses, losses, and other deductions properly apportioned or allocated to that income and a ratable part of any expenses, losses, or other deductions that cannot be definitely allocated to some item or class of gross income (Treas. Reg. Sec. 1.907(c)-1(3)(i)). In the case of an affiliated group filing a consolidated return, if no overall foreign extraction loss has been sustained, then no foreign oil extraction loss is subject to recapture, even if a member of the group had an extraction loss and the member is subsequently sold or otherwise leaves the group.

In computing the amount of the foreign extraction loss, the net operating loss deduction under section 172(a), foreign expropriation losses (section 172(h)(1)), and an extraction loss arising from a casualty or

theft, to the extent not compensated for by insurance, are not taken into account. A taxpayer is treated as sustaining a foreign extraction loss whether or not a foreign tax credit is claimed for the year of the loss.

Recapture of Overall Foreign Extraction Loss. Section 907(c)(4) provides that when a taxpayer has an overall foreign extraction loss in a year that reduces nonextraction income, the loss is, in effect, recaptured in a subsequent year in which the taxpayer has overall foreign oil and gas extraction income. Section 907(c)(4) operates in substantially the same fashion as the overall foreign loss recapture provisions in section 904(f), by recharacterizing a portion of the foreign oil and gas extraction income earned in later years as foreign-source income that is not oil and gas extraction income. The amount of the foreign extraction income that is to be recharacterized as nonextraction income is equal to the amount of the extraction losses from prior years, to the extent that the losses have not been recharacterized in prior years. The taxpayer must recharacterize this income even though no tax benefits were obtained from the extraction losses.

Section 907(c)(4) may operate in conjunction with section 904(f) in cases in which the taxpayer has an overall foreign loss and part or all of the loss is a foreign extraction loss.

> *Example 7.22.* Gusher Corp. has an overall foreign extraction loss for the year of $100, foreign-source general limitation income of $75, and $100 of U.S. income. The extraction loss offsets first the $75 of foreign-source general limitation income and then $25 of U.S. income. In the subsequent year, Gusher Corp. has $100 of foreign oil extraction income. First, income of $25 would be recharacterized as U.S.-source income under section 904(f), and then $75 of foreign oil extraction income would be recharacterized as foreign-source general limitation income.

Any foreign income taxes imposed on the recharacterized extraction income are not recharacterized and always retain their character as extraction taxes.

Allocation of Taxes

In computing the separate foreign tax credit limitations, it is necessary to allocate foreign taxes paid to the separate income categories. The rules for making these allocations are found in Treas. Reg. Sec. 1.904-6. For purposes of the regulations, foreign taxes are characterized as (1) related to a separate category of income or (2) related to more than one separate category of income. Taxes are related to a separate category of income if

the income is included in the base on which the tax is imposed (for example, a withholding tax is generally related to the income from which it is withheld). A tax that is related to more than one category of income must be allocated to each separate income category based on the ratio of the *net income* subject to that foreign tax included in each separate category over the total net income subject to that foreign tax (Treas. Reg. Sec. 1.904-6(a)(1)(ii)).

In making the allocation of taxes, gross income is determined using the law of the foreign country to which the foreign taxes have been paid or accrued. Gross income in the passive limitation category is reduced by related-person interest allocated to the income under Treas. Reg. Sec. 1.904-5(c)(2)(ii)(C) (that is, the *netting rule*). Gross income in each category is then reduced by deducting expenses and losses that are specifically allocable to the gross income of each category under foreign law. Expenses not specifically allocated to gross income under foreign law are apportioned under the principles of foreign law. For example, if foreign law requires expenses to be apportioned using a gross income basis, then such expenses will be so apportioned. If foreign law does not provide for direct allocation or apportionment of expenses, the principles of Treas. Reg. Sec. 1.861-8 are applied. The taxes allocated to the passive limitation category must be further allocated to the "groups" of income within the passive category to determine whether any of the income is high-taxed income (Treas. Reg. Sec. 1.904-6(a)(iii)).

Example 7.23. USCo conducts business in foreign country X. USCo reported $400 of shipping income, $200 of general limitation income, and $200 of passive income for 1995. Under foreign law, none of USCo's expenses are directly allocated or apportioned to a particular category of income. Under the principles of Treas. Reg. Sec. 1.861-8, USCo allocates $75 of directly allocable expenses to shipping income, $10 of directly allocable expenses to general limitation income, and no such expenses to passive income. USCo also allocates expenses that are not directly allocable to a specific class of gross income—$40 to shipping income, $20 to general limitation income, and $20 to passive income. Net shipping income is $285 ($400 − $75 − $40) and net general limitation income is $170 ($200 − $10 − $20). The foreign country imposes a tax of $100 on a base that includes USCo's shipping income and general limitation income. The foreign country exempts passive income from tax. The tax is related to shipping income and general limitation income and must be allocated between the two categories on a net income basis as follows:

To shipping income: $100 × $285/($285 + $170) = $63

To general limitation income: $100 × $170/($285 + $170) = $37

None of the foreign country's tax is allocated to passive income.[47]

Additional Comments on the Limitation Formulas

Taxable income appears in the numerator and denominator of the separate income limitation formulas. The limitation formulas require that taxable income be calculated using U.S. tax-accounting principles. The sources of income and deductions are determined using the principles explained in chapter 5.

Taxable income for individuals, estates, and trusts is computed without considering personal exemptions (section 151) or the comparable exemption for estates and trusts (section 642(b)). The standard deduction is taken into consideration and is allocated between foreign- and domestic-source income to determine both the numerator and denominator. In the numerator, the appropriate percentage of the standard deduction is subtracted from foreign-source taxable income; in the denominator, the total standard deduction is subtracted from taxable income. Also allocated between foreign- and domestic-source income are itemized deductions not directly allocable to specific income items such as contributions and medical expenses.

The general limitation formula is as follows:

$$\frac{\text{Foreign-source taxable income less allocable standard deduction}}{\text{Taxable income before the deduction for exemptions}} \times \text{U.S. tax} = \text{Foreign tax credit limitation}$$

Example 7.24. Tim and Mary Jones are married and filed a joint return for 1998. They reported the following income and deductions:

Income subject to U.S. tax:	
U.S.-source	$36,000
Foreign-source general limitation	4,000
Gross income	$40,000
Less: Standard deduction	7,100
Taxable income before exemptions	$32,900
Less: Exemptions—(2 × $2,700)	5,400
Taxable income	$27,500
U.S. tax liability	$ 4,129

[47] Treas. Reg. Sec. 1.904-6(c), example 1. See also examples 2-8 for more complex situations involving high-taxed income and deemed-paid credits under sections 902 and 960.

In computing the foreign tax credit limitation, the standard deduction is allocated to foreign-source general limitation income by multiplying the amount ($7,100) times the ratio of foreign-source gross income to total gross income: $4,000/$40,000 × $7,100 = $710. The foreign tax credit limitation is computed as follows:

$$\frac{\$4{,}000 - \$710}{\$32{,}900} \times \$4{,}129 = \$413$$

All of the items in the calculation are with respect to the same taxable year.[48] The year is determined by the year in which the foreign taxable income (numerator) is subject to taxation by the United States. The U.S. taxes and total taxable income (denominator) are with respect to that same year. The limitation formula applies to the year in which the foreign income must be recognized. The year in which a credit can be taken against U.S. taxes is the year the foreign taxes are paid or accrued.

Treatment of Capital Gains for Purposes of the Foreign Tax Credit

The Tax Reform Act of 1976 added provisions altering the treatment of capital gains for purposes of the foreign tax credit. Under prior law, a taxpayer could increase foreign-source income by sales of assets giving rise to capital gains in a foreign country. The U.S. tax liability against which the ratio of foreign-source taxable income to total taxable income was applied was not adjusted to reflect the lower rate of U.S. tax applied to capital gains. In addition, foreign-source net capital gains or losses were not offset against domestic-source net capital gains or losses.

Section 904(b)(2) limits the gains from sales and exchanges of capital assets included in taxable income from foreign sources in a separate limitation category to the taxpayer's "foreign-source capital gain net income." Section 904(b)(3)(A) defines *foreign-source capital gain net income* as the lesser of (1) capital gain net income from foreign sources in the separate limitation category or (2) capital gain net income from all sources in that category. For purposes of this computation, capital gain net income includes net section 1231 gain.

Example 7.25. USCo had the following capital gains and losses for 1999 (assume all foreign income is general limitation income):

[48] *United States v. Betty Rogers (Extrx)*, 122 F.2d 485 (CA-9, 1941).

Foreign-source long-term capital gain	$10,000
Foreign-source long-term capital loss	(2,000)
Foreign-source capital gain net income	$ 8,000
U.S.-source long-term capital loss	7,100
Capital gain net income	$ 2,000

For purposes of computing the numerator (foreign taxable income) in the credit limitation formula for general limitation income, USCo includes foreign-source capital gain net income of $2,000 [the lesser of foreign-source capital gain net income ($8,000) and total capital gain net income].

If the taxpayer has a foreign-source net capital loss, such loss is deducted in computing foreign taxable income in a separate limitation category only to the extent the loss was taken into account in computing total capital gain net income in the same category (section 904(b)(2)(B)(iii)).

Example 7.26. USCo had the following capital gains and losses for 1999 (assume all foreign income is general limitation income):

Foreign-source long-term capital gain	$ 2,000
Foreign-source long-term capital loss	(10,000)
Foreign-source net capital loss	$(8,000)
U.S.-source long-term capital gain	12,100
Capital gain net income	$ 4,000

For purposes of computing the numerator (foreign taxable income) in the credit limitation formula for general limitation income, USCo deducts foreign-source net capital loss of $8,000.

In years during which capital gains are subject to a rate that is less than the highest marginal rate imposed on non-capital-gain income, the taxable income from sources outside the United States in the numerator of the foreign tax credit limitation formula includes foreign-source capital gains only in an amount equal to net income from such gains, reduced by the "rate differential" portion of foreign-source net capital gain (section 904(b)(2)(B)). The denominator of the formula (total taxable income) includes capital gain net income reduced by the rate differential portion of net capital gain. Any net capital loss from sources outside the United States, to the extent used to determine capital gain net income, is reduced by the rate differential portion of the excess of net capital gain from sources within the United States over net capital gain. The rate differential portion of foreign-source net capital gains, or the excess of net capital gain from sources within the United States over net capital gain,

is the excess of the highest marginal tax rate (section 1 or section 11(b)) less the alternative tax on net capital gain (section 1(h) or section 1201(a)) divided by the highest marginal tax rate. For 1999 the alternative tax on individual net capital gain was 20 percent and the highest marginal tax rate under section 1 was 39.6 percent. If an individual recognized net capital gain in 1999, the foreign-source net capital gain in the numerator and the denominator of the limitation formula would be limited to 20/39.6 of the total amount.

Overall Foreign Losses

U.S. taxpayers operating a foreign branch are able to deduct losses generated by the branch against U.S.-source income. Such a deduction reduces U.S.-source income subject to U.S. tax. To prevent a U.S. taxpayer from getting a "double benefit" when the branch eventually earns foreign-source income (that is, the loss was deducted against U.S. income and the subsequent tax on the foreign earnings was credited against U.S. tax), Congress enacted recapture rules for foreign losses in section 904(f) in 1976. Under this provision, foreign earnings of a branch are re-sourced as U.S.-source income for purposes of computing the foreign credit limitation to the extent that the branch had prior foreign losses that offset U.S.-source income.

Prior to the Tax Reform Act of 1986, the Treasury issued regulations under section 904(f), which required that a separate foreign loss be computed for each category of foreign tax credit limitation income. Due to vagueness in the wording of the regulations, U.S. taxpayers interpreted the regulations to allow an overall foreign loss (foreign-source income less allocated deductions) in one separate limitation category to offset U.S.-source income before offsetting any foreign-source income in another separate limitation category. This approach maximized the credit limitation in the current year and postponed the recapture of foreign income to future periods when the separate limitation category from which the loss arose had positive net income.

Congress "corrected" this ordering of foreign losses in the Tax Reform Act of 1986.[49] Under the revised rules, a foreign loss in one income limitation category reduces the income in other income limitation categories (on a pro rata basis) before offsetting U.S.-source income. In making this

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[49]See also Notice 89-3, 1989-1 C.B. 623.

computation, the taxpayer first determines the separate limitation income or loss in each income category. The separate limitation loss amounts are combined, as are the separate limitation income amounts. If the combined separate limitation loss for the current year is less than the combined separate limitation income for the year, a pro rata share of each separate limitation loss is allocated to each separate income category, using the ratio of the income in each specific category over the combined income of all categories with income.

If the combined separate limitation losses for the current year exceed the combined separate limitation income, the pro rata share of each separate limitation loss is allocated to each separate limitation income category, using the ratio of the loss in each specific category over the combined separate limitation losses from all categories with losses.

The excess of the combined separate limitation loss over the combined separate limitation income reduces U.S.-source taxable income to the extent possible (section 904(f)(5)(A)). Any excess of combined separate limitation loss over U.S.-source income is treated as a net operating loss deduction subject to the carryover or carryback rules of section 172.

Example 7.27. USCo has income from the following sources during 1999:

U.S.-Source	*General Limitation*	*Passive*	*Shipping*
$200	$50	$100	$(90)

USCo's combined foreign losses in separate limitation categories ($90) do not exceed combined foreign income in separate limitation categories ($150). As a result, USCo must allocate the foreign shipping loss pro rata against the general limitation income and the passive income. Using the allocation formula, $30 would be deducted against general limitation income ($90 × $50/$150) and $60 would be deducted against passive income ($90 × $100/$150).

Example 7.28. If USCo had a shipping loss of $200 in example 7.27, its combined foreign limitation losses ($200) would exceed its combined foreign limitation income ($150). As a result, the $200 shipping loss would reduce the passive income and general limitation income to $0, and the excess $50 loss would offset U.S.-source income.

If the credit limitation category that produced the loss has income in a subsequent year, that income is re-sourced according to the foreign-source limitation category or U.S.-source income it reduced in previous years. For purposes of this recapture of the previous loss deduction, the characterization of the income as U.S.-source takes priority.

The amount of foreign-source limitation income that is recaptured as U.S.-source in any year is limited to the lesser of (1) 50 percent of the combined foreign source taxable income in all limitation categories for the current year or (2) the amount of foreign loss remaining to be recaptured from the separate limitation category (section 904(f)(1)). The taxpayer may make an annual, irrevocable election to recapture a portion of the balance in an overall foreign loss account in excess of 50 percent of total foreign taxable income.

If income is reported in a separate limitation category and such category had a previous foreign loss, the income is recaptured as income from other separate limitation categories to the extent the previous loss was deducted against income in those categories (section 904(f)(5)(C)).

If the amount of income in a separate limitation category from which a previous-year loss was allocated to other separate limitation categories is not sufficient to recapture the entire amount of the loss, the income is recharacterized as other separate limitation income on a pro rata basis, using the ratio of income remaining to be recharacterized in each separate category over the total amount of income remaining to be recharacterized.

Example 7.29. Using the same facts as example 7.28, assume USCo had taxable income from the following sources in 2000:

U.S.-Source	*General Limitation*	*Passive*	*Shipping*
$100	$10	$20	$60

The $60 of shipping income is recharacterized according to the income against which the prior-year loss was offset, with the amount recharacterized as U.S.-source taking priority. Under section 904(f)(1), the amount of the shipping income that is recharacterized as U.S.-source is the lesser of (1) 50 percent of total foreign-source taxable income (50% × $90 = $45) or (2) the amount of shipping loss remaining to be recaptured ($50). In this case, USCo must recharacterize a minimum of $45 of shipping income as U.S.-source income in making the foreign tax credit limitation calculations. The taxpayer could elect to recharacterize the entire $50 of remaining unrecaptured shipping loss as U.S.-source. The remaining $15 of shipping income is recharacterized on a pro rata basis as general limitation income and passive income as follows:

General limitation income:

Lesser of (1) the amount remaining to be recaptured ($50) or (2) a pro rata amount of the shipping income to be recharacterized ($15 × $50/$150 = $5)

Passive income:

Lesser of (1) the amount remaining to be recaptured ($100) or (2) a pro rata amount of the shipping income to be recharacterized ($15 × $100/$150 = $10)

USCo would be treated as having $145 of U.S.-source taxable income, $15 of general limitation income, $30 of passive income, and no shipping income in computing its foreign tax credit limitation for each separate limitation category.

Even though income in a separate limitation category may be recharacterized for foreign tax credit limitation purposes, the foreign income tax paid or accrued with respect to the recaptured income is not recharacterized (section 904(f)(5)(C)).

A U.S.-source loss is allocated to the separate limitation categories on a pro rata basis. If a U.S.-source loss is carried forward or back to offset income in another year, such loss is first offset against U.S.-source income in that other year before it reduces foreign separate limitation income. U.S.-source income in subsequent years is not recharacterized as foreign-source income, however.

If a taxpayer has both a U.S.-source loss and a loss in a separate limitation category, the separate limitation loss is allocated against separate limitation income prior to the allocation of the U.S.-source loss (section 904(f)(5)(D)). The recharacterization rules are applied to any income remaining in a separate limitation category after deduction of any foreign limitation or U.S.-source loss.

Special recapture rules apply when a taxpayer has an overall foreign loss account from pre-1987 years (Treas. Reg. Sec. 1.904(f)-12). In general, the taxpayer recaptures the balance in the overall loss account from the separate limitation income category in effect after 1986 that is analogous to the income category from which the overall foreign loss account was established. For example, a foreign loss account from the prior nonbusiness interest category, as defined in prior section 904(d)(1)(A), is recaptured from the passive loss category after 1986. Overall foreign losses in the prior general limitation category must be recaptured from the post-1986 shipping income, financial services, dividends from each noncontrolled section 902 corporation, and general limitation categories on a pro rata basis unless the taxpayer can show that the loss was attributable to a specific income category. An overall foreign loss from pre-1987 years is recaptured before a post-1986 foreign loss.

Dispositions of trade or business property used predominantly outside the United States for the prior three years are subject to recapture rules if at the time of the disposition the taxpayer has an unrecaptured foreign loss account (section 904(f)(3)). In the case of such a disposition (defined as a sale, exchange, distribution, or gift of property), the taxpayer is deemed to have received and recognized foreign taxable income in the year of disposition in an amount equal to the lesser of (1) the excess of fair market value over adjusted basis or (2) the remaining amount of unrecaptured foreign loss. The taxpayer must treat 100 percent of the recognized foreign taxable income as U.S.-source income. This rule does not apply if the property was not a material factor in the production of income.

Carrybacks and Carryforwards of Excess Credits

Section 904(c) allows foreign taxes that are paid or accrued during the year, but that are not fully allowed as credits against U.S. income taxes because of the section 904(d) limitation, to be carried over to other taxable years and used as credits to the extent the taxes would have been allowed had they been paid or accrued in that year. An excess credit may be carried back two years and then carried forward for five years. The carryback is mandatory. The carrybacks and carryforwards are computed separately for each income limitation category.

Procedures for Carryover

A precise order must be followed for carrying the excess credits over: back to the second preceding year, back to the first preceding year, and then forward to each successive taxable year. Where excess credits from more than one year are carried over to the same year, the oldest credits (first-in, first-out) are used first.

For each year in the seven-year carryover period, the taxpayer must determine whether the year is one of an excess credit or an excess limitation. The excess limitation amount must be computed for each separate income category.

Example 7.30. USCo has the following foreign tax credit account for its general limitation income:

Year	*Limitation Amount*	*Foreign Taxes*	*Excess Limitation (Credit)*
19X1	$100	$ 75	$ 25
19X2	150	100	50
19X3	100	400	(300)
19X4	200	260	(60)
19X5	175	140	35
19X6	225	200	25
19X7	600	400	200
19X8	650	600	50

The 19X3 and 19X4 excess credits are carried to the other years in the following order:

19X3 excess credit ($300):

19X1	$ 25
19X2	50
19X5	35
19X6	25
19X7	165
	$300

19X4 excess credit ($60):

19X7	$35
19X8	25
	$60

A period of less than twelve months for which a return is filed is counted as one full year for purposes of determining the carryover period. In addition, excess credits cannot be carried over to years in which a deduction instead of a credit was taken for foreign taxes. A year in which a deduction is taken counts as a year used, and therefore an excess credit may not be carried to such a year even though a credit was not taken for that year.

Excess credits carried back give rise to a refund. The refund is claimed by filing Form 1120X (corporation) or Form 1040X (individual) and attaching a revised Form 1118 or 1116, respectively.

A foreign tax credit carryback that eliminates a tax deficiency from a prior year does not absolve the taxpayer from paying interest on the defi-

ciency from the due date of the return from such year to the due date of the return for the year in which the foreign tax credit carryback arose (section 6601(d)(2)).[50]

Restrictions on Carrybacks and Carryforwards

Section 904(c) states that excess credits cannot be carried over to years in which a deduction rather than a credit for foreign taxes was taken. A carryover also cannot be deducted in any year to which it carried, but may be used only as a credit. A carryover ready to expire cannot be taken as a deduction in a carryover year to prevent expiration. For open tax years, the election may be changed from credit to deduction by filing an amended return.

The Section 960 Credit

Subpart F income earned by a CFC is taxed to U.S. shareholders whether or not the income has been distributed (section 951(a)). Sections 960 and 962 allow deemed-paid credits to be taken by U.S. shareholders in the same year the undistributed income is taxed to them, similar to the deemed-paid credits allowed on regular dividend distributions from foreign corporations under section 902. This provision permits matching foreign tax credits with the related subpart F income.

The rules applicable to deemed-paid credits allowed under section 960 are, for the most part, identical to the rules under section 902. Section 960 applies only to domestic corporations, although section 962 allows individuals who are U.S. shareholders to elect to be subject to the corporate tax rates in exchange for being eligible for the section 960 credit on subpart F income. The deemed-paid credit under section 960 applies where a deemed distribution is made by a foreign corporation that is a member of a "qualified group" as defined in section 902(b) (section 960(a)(1)). That is, section 960 applies where section 902 would have applied if the deemed distribution was an actual dividend distribution (see the direct and indirect ownership rules discussed above under section 902). In addition, the deemed-paid credit under section 960 is computed

[50]Section 6601(d)(2) was enacted in 1997 and applies to foreign tax credit carrybacks arising in taxable years beginning after August 5, 1997. This statute codifies the court decisions in *Hallmark Cards, Inc.*, 111 T.C. 266 (1998), *Intel Corp.*, 111 T.C. 90 (1998), and *Fluor Corp. & Affiliates v. United States*, 126 F.3d 1397 (1997), *rev'g*. 35 Fed. Cl. 520 (1996).

before the deemed-paid credit under section 902 where a deemed dividend and an actual dividend are made in the same year (Treas. Reg. Sec. 1.960-1(i)(2)).

Example 7.31. USCo owns 100 percent of the voting stock of foreign corporation Franco. Franco owns 100 percent of the voting stock of foreign corporation Italco. Both Franco and Italco were formed in 1999. The results of their operations for 1999 follow. (For ease of illustration, it is assumed that all of the earnings and profits of Franco and Italco are general limitation income and the appropriate exchange rate is FC1: $1.)

Italco	
Pretax earnings and profits	FC100
Foreign income taxes (20%)	20
Earnings and profits	80
Amount required to be included in USCo's income	50
Dividends paid to Franco	None
Franco	
Pretax earnings and profits	FC200
Foreign income taxes (40%)	80
Earnings and profits	120
Amount required to be included in USCo's income	90
Dividends paid to USCo	None

For purposes of computing the section 960 credit on the subpart F inclusion from Italco, USCo makes the computation with regard only to Italco's post-1986 undistributed earnings and post-1986 foreign income taxes paid or accrued. Foreign taxes of FC20 are translated into U.S. dollars using the appropriate exchange rate (FC:$1). The section 960 credit with respect to Italco is $12.50, computed as (FC50/FC80 × $20). The section 960 credit on the subpart F inclusion from Franco is computed with regard only to Franco's post-1986 undistributed earnings and post-1986 foreign income taxes paid or accrued. The section 960 credit with respect to Franco is $60, computed as (FC90/FC120 × $80). In both cases, USCo increases the subpart F inclusion (deemed dividend) by the amount of deemed-paid credit using the gross-up rules of section 78.

Interrelation of Section 902 and Section 960 When Dividends Are Paid by First- Through Sixth-Tier CFCs

When a distribution is made from a lower-tier CFC to an upper-tier CFC, any tax attributable to that distribution may be treated as deemed-paid by the upper-tier CFC, for purposes of computing the section 902 deemed-

paid credit on a subsequent distribution from the first-tier CFC to a U.S. shareholder (Treas. Reg. Sec. 1.960-2). The dividend increases the earnings and profits of the upper-tier CFC, and the deemed-paid credit increases the pool of post-1986 foreign taxes paid or accrued. When a lower-tier CFC makes a distribution to an upper-tier CFC, the total amount of the distribution increases the earnings and profits of the upper-tier CFC. However, to the extent the dividend distribution has been included in the U.S. shareholder's gross income as a subpart F inclusion, only the portion of the dividend not previously included in the U.S. shareholder's gross income is eligible for the deemed-paid credit under section 902(b)(1). If the upper-tier CFC has subpart F income included in the U.S. shareholder's gross income, the upper-tier CFC's earnings and profits, for purposes of computing the section 902 credit with respect to the dividend received from the lower-tier CFC, is reduced by the net dividend (gross dividend less tax attributable to the dividend). The tax attributable to that portion of the dividend will not increase the upper-tier CFC's pool of post-1986 undistributed foreign taxes because they had been previously claimed as a credit.

Example 7.32. Assume in the previous example that Italco distributes a dividend of FC80 to Franco in 1999. The FC80 dividend from Italco to Franco is treated as FC50 from subpart F earnings and profits and FC30 from other earnings and profits. As previously computed, USCo has a section 960 credit with respect to the subpart F inclusion from Italco of $12.50. The section 960 credit on the subpart F inclusion from Franco is computed as follows:

Pretax earnings and profits:	
From operations	FC200
Italco dividend	80
Total	FC280
Foreign income taxes (40%)	112
Earnings and profits	FC168
Earnings and profits after exclusion of net dividend from Italco previously included in USCo's gross income (FC168 − [FC50 − (FC50 × 0.40)])	FC138
Subpart F inclusion from Franco to USCo	FC 90
Dividends paid to USCo	None
Foreign tax of Italco deemed paid by Franco under section 902(b)(1) ($20 × FC30/FC80)	$7.50

USCo's section 960 credit with respect to Franco consists of the tax actually paid by Franco on its income plus the deemed tax paid on that portion

of the dividend from Italco that was not included in USCo's gross income as subpart F income.

Tax actually paid by Franco:
FC90/FC168 × $112 = $60

Tax of Italco deemed paid by Franco under section 902(b)(1):
$90/$138 × $7.50 = $4.89

USCo's total section 960 credit with respect to Franco is $64.89.[51]

Distributions of Previously Taxed Subpart F Income

A problem that arises with subpart F income relates to distributions after the year in which the income is recognized by the U.S. shareholders and the foreign tax credit is taken. Section 959(a) provides that distributions of previously taxed subpart F income are treated as nontaxable. If additional foreign taxes are withheld on the distribution, under the usual foreign tax credit rules, the taxpayer's foreign-source income for purposes of the limitation formula might be zero. For example, if a wholly owned CFC had $100 of subpart F income on which $30 of tax was paid, the U.S. corporate shareholder would recognize $100 of income currently ($70 of subpart F income and a $30 gross-up under section 78) and have $30 of deemed-paid foreign taxes under section 960 ($30 × $100/$100). When the CFC distributes the $70 in a later year, the $70 will not be included in the U.S. shareholder's taxable income under section 959(a). The foreign country may impose a withholding tax on the distribution, however. If the U.S. shareholder has only U.S.-source income in the year the distribution is received, the withholding tax would not be allowed as a credit in the year paid because the numerator of the limitation ratio (foreign taxable income) would be zero.

To resolve this problem, section 960(b) provides for a special increase in the foreign tax credit limitation formula in the year of distribution of such previously taxed income. Section 960(b) requires each U.S. taxpayer to keep an "excess limitation account" for each separate foreign tax credit limitation category ("basket") of income. The excess limitation account is the accumulation of excess foreign tax credit limitations due

[51]Treas. Reg. Sec. 1.960-2(f), example 4. See also examples 5-10 for more complicated situations in which there are three tiers of CFCs and the first-tier CFC also makes a distribution to the U.S. shareholder.

to the inclusion in prior years of subpart F income under section 951(a). The amount added to the account each year is the excess of the increase in the foreign tax credit limitation (section 904(a)) due to the inclusion of the category of subpart F income, less the amount of any direct or deemed-paid foreign income taxes associated with such income allowable as a credit in the current year (section 960(b)(2)(B)). When previously taxed income is received under section 959(a), the current year's foreign tax credit limitation is increased by the lesser of the foreign income taxes imposed on the distribution, or the balance in the excess limitation account (section 960(b)(1)). The increase in the current year's foreign tax credit limitation due to this provision reduces the balance in the excess limitation account for future years. This "pooling approach" replaced the prior "separate item" approach, which required U.S. taxpayers to keep an excess foreign tax credit limitation "account" for each separate category of subpart F foreign tax credit limitation income on a CFC-by-CFC basis and on a year-by-year basis. The pooling approach was intended to reduce the administrative complexities associated with section 960(b) and reflect the multi-year pooling approach taken in 1986 to computing the deemed paid credit under section 902 and section 960(a).

Before section 960(b)(1) applies, the following requirements must be satisfied:

1. The taxpayer elected the foreign tax credit (or no creditable taxes were imposed) in the year in which the subpart F income was included in taxable income under section 951(a).
2. The taxpayer receives a distribution during the current year that is excluded from gross income under section 959(a), and the foreign tax credit is elected in the current year.
3. The taxpayer pays or accrues foreign income taxes on the section 959(a) distribution in the current year.

Example 7.33. USCo owns all of the stock of Belgico, a foreign corporation. For tax year 1999 USCo included in its gross income $70 of subpart F dividend from Belgico in addition to a gross-up of $30 under section 78 for deemed foreign taxes paid under section 960(a). The inclusion was categorized as general limitation income for foreign tax credit purposes. As a result of this income inclusion, USCo's foreign tax credit limitation under section 904(a) increased by $35 (assuming a marginal tax rate of 35 percent). Therefore, the entire deemed-paid credit under section 960(a) was allowed as a credit in 1996. USCo's excess limitation account would be credited with $5, the excess of the increase in the foreign tax credit limitation under section 904(a) over the foreign income taxes allowable as a credit.

In 2000, USCo included in its gross income $80 of subpart F dividend from Belgico in addition to a gross-up of $20 under section 78 for deemed foreign taxes paid under section 960(a). The inclusion was categorized as general limitation income for foreign tax credit purposes. As a result of this income inclusion, USCo's foreign tax credit limitation under section 904(a) increased by $35. The entire deemed-paid credit under section 960(a) was allowed as a credit in 2000. USCo's excess limitation account would be increased by $15, the excess of the increase in the foreign tax credit limitation under section 904(a) over the foreign income taxes allowable as a credit. The account balance at the end of 2000 would be $20.

In 2001, Belgico distributes $100 of previously taxed income to USCo, which was excluded from gross income under section 959(a). A withholding tax of $10 was imposed on the distribution by the foreign government. Under section 960(b), USCo can increase its foreign tax credit limitation for 2001 by the lesser of (1) the foreign withholding tax ($10) or (2) the balance in the excess limitation account ($20). The $10 increase in the foreign tax credit limitation reduces the balance in the excess limitation account to $10 ($20 – $10).

Deficits in Earnings and Profits and Deemed Distributions

The treatment of deficits in pre-1987 or post-1986 earnings and profits for distributions subject to section 902 is addressed in Treas. Reg. Sec. 1.902-2 and was discussed previously in this chapter. The treatment of deficits in pre-1987 or post-1986 earnings and profits (years beginning before March 4, 1997) for deemed distributions subject to section 960 is addressed in Notice 88-70.[52]

The procedures for handling deficits in separate categories of earnings and profits under sections 902 and 960 in years beginning after March 3, 1997 are discussed in Treas. Reg. Sec. 1.960-1(i)(4). A post-1986 accumulated deficit in a separate category must be allocated proportionately to reduce post-1986 undistributed earnings in the other separate categories. The allocated deficit does not permanently reduce earnings in the other separate categories, however. Rather, the separate limitation deficit is carried forward in the same separate category in which it was incurred after the deemed-paid taxes are computed. In no case can the numerator of the deemed-paid credit fraction (deemed inclusion from the separate category) exceed the denominator (post-1986 undistributed earnings in the separate category).

[52]1988-2 C.B. 369. See also Treas. Reg. Sec. 1.985-6(d)(2).

Example 7.34. Forco is a wholly owned CFC of USCo. In 1998, Forco earned 100u of non-subpart-F general limitation income, 100u of subpart F foreign personal holding company income categorized as passive income, and incurred a (50u) loss in shipping income. Forco's subpart F income of 100u does not exceed its earnings and profits of 150u, in which case the entire amount is included in USCo's gross income under section 951(a)(1)(A). The 100u is categorized as passive income for foreign tax credit limitation purposes. For purposes of computing post-1986 undistributed earnings with respect to the subpart F inclusion, the shipping limitation deficit of (50u) is allocated proportionately to reduce the general limitation earnings of 100u and the passive limitation earnings of 100u. After allocation, earnings in each category are 75u (100u/200u × (50u)). All of Forco's post-1986 foreign income taxes with respect to the passive limitation earnings are deemed paid by USCo under section 960 with respect to the 100u subpart F inclusion. The numerator in the section 960 calculation cannot exceed the denominator. After the computation, Forco has 100u of general limitation earnings, 0u of passive limitation earnings, and a (50u) deficit in shipping limitation earnings.[53]

Example 7.35. Assume the same facts as in Example 7.34. In 1999 Forco distributes 150u to USCo. Forco has 100u of previously taxed earnings and profits attributable to 1998, all of which is passive limitation earnings and profits. Under section 959(c), 100u is not included in USCo's gross income for 1999. The remaining 50u is treated as a taxable dividend paid out of Forco's general limitation earnings and profits. For purposes of computing the deemed-paid credit under section 902 with respect to the 50u dividend, the shipping limitation accumulated deficit of (50u) reduces the general limitation earnings and profits of 100u to 50u. As a result, 100 percent of Forco's post-1986 foreign income taxes with respect to general limitation earnings are deemed paid by USCo under section 902 with respect to the 1999 dividend of 50u. The numerator in the section 902 calculation cannot exceed the denominator. After the computation, Forco has 50u of general limitation earnings, 0u of passive limitation earnings, and a (50u) deficit in shipping limitation earnings.[54]

Miscellaneous Provisions

Consolidated Returns

The regulations for foreign tax credits do not provide special rules regarding affiliated corporations filing consolidated tax returns. Guidelines are

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[53]Treas. Reg. Sec. 1.960-1(i)(5), example 1.

[54]Treas. Reg. Sec. 1.960-1(i)(5), example 2.

provided in Treas. Reg. Sec. 1.1502-4. Under these regulations, affiliated corporations are treated as one taxpayer (1) for purposes of calculating the amount of foreign taxes eligible for credit or deduction, (2) for electing to take the foreign taxes as a credit or as a deduction, and (3) for purposes of the excess credit, carryback, or carryover to other years. These calculations are made using consolidated figures.

Allocations of deductions under Treas. Reg. Sec. 1.861-8 for purposes of calculating foreign-source taxable income are made on a consolidated basis using the rules of section 864(e). In addition, the parent corporation makes all foreign tax credit elections for the entire group, and the elections are binding on all the members of the group.

The principal advantage of filing a consolidated return for foreign tax credit purposes is that the consolidated return will average foreign taxes over a wider base (that is, over the income of all members of the group). This increases the likelihood that, if one company is in an excess credit position, the excess credit may be partially or fully offset against another company with excess foreign tax credit capacity.

Example 7.36. Parent Corp. and its wholly owned domestic subsidiary Subco report the following tax results on a separate return basis:

	Parent Corp.	*Subco*
Foreign income	$100	$100
Foreign taxes	20	40
U.S. tax	35	35
Credit limitation:		
$100/$100 × 35	35	—
$100/$100 × 35	—	35
Credit allowed	20	35

On a separate return basis, Parent Corp. has an excess limitation of $15 and Subco has an excess credit of $5. With separate returns these cannot be offset. If a consolidated return is filed, the foreign tax credit limitation becomes $70 ($200/$200 × $70) and total foreign taxes for the group are $60. On a consolidated basis, the entire amount of foreign taxes is creditable in the current year. The foreign taxes are in effect averaged between the two corporations.

The disadvantages of consolidation arise when a member of the affiliated group incurs foreign losses. Foreign tax credit limitations from filing a consolidated return can be reduced in this case.

Under Treas. Reg. Sec. 1.904(i), members of an "expanded" affiliated group are treated as members of the same consolidated group for pur-

poses of computing the foreign tax credit limitation. This provision was enacted in response to deconsolidation techniques used by consolidated groups to avoid the imposition of the foreign tax credit limitation (such as the interest allocation rules of section 864(e))

Alternative Minimum Tax and the Foreign Tax Credit

The foreign tax credit is available to reduce the alternative minimum tax (AMT) imposed under section 55 (section 59(a)(1)). The AMT foreign tax credit and its limitation are calculated in a manner similar to the regular income tax foreign tax credit, with several modifications. In particular, in computing the foreign tax credit limitation for each category of foreign-source income, the numerator of the limitation fraction is foreign-source alternative minimum taxable income for each income category and the denominator is total alternative minimum taxable income (section 59(a)(1)(B)). The categories of foreign-source income are the same as for the regular income tax except that the determination of whether passive income is high-taxed income uses the highest AMT rate rather than the highest marginal income tax rate (20 percent for corporations and 28 percent for individuals). The items included in alternative minimum taxable income under section 56(g) (adjusted current earnings) must be sourced into their respective foreign tax credit limitation categories (Treas. Reg. Sec. 1.904-4(k)).

The AMT foreign tax credit limitation ratios are applied to the tentative minimum tax (section 59(a)(1)(A)). In addition, the total AMT foreign tax credit generally cannot exceed 90 percent of the tentative minimum tax computed without any AMT net operating loss deduction (section 59(a)(2)(A)). The 90-percent limitation reflects Congress's intention in enacting the AMT that all taxpayers with economic income should pay some amount of tax to the United States. The Tax Court has held that this provision overrides treaties predating its enactment.[55] Excess AMT foreign tax credits are subject to the carryback and carryforward provisions of section 904(c).

[55]*Lindsey*, 98 T.C. 672 (1992). The taxpayer unsuccessfully argued that the 90-percent limitation violated the prohibition against double taxation in the U.S.-Swiss Confederation Income Tax Treaty.

Statute of Limitations for Treatment of Foreign Taxes

The amount of foreign taxes credited in a particular taxable year may subsequently turn out to be incorrect in a later year. This difference may occur if (1) the taxes accrued in an earlier year differ from the amount actually paid in a later year (the liability was incorrectly estimated), (2) the taxes paid in the later year are later determined to be too much or too little, (3) the foreign government assesses more taxes retroactively, (4) a contested tax liability is settled with a foreign government, or (5) some refund is made by the foreign government.

If foreign taxes claimed in one year subsequently increase (for example, due to an audit adjustment), a U.S. taxpayer has ten years from the due date of the original return to file an amended return and claim any additional U.S. tax refund (section 6511(d)(3)(A)). The Claims Court has held that the ten-year period begins with the due date of the taxable year to which the excess foreign tax is carried and provides a tax benefit.[56]

Section 905(c) states that when accrued taxes differ from the amounts claimed as credits or if any tax paid is refunded in whole or in part, the commissioner of internal revenue must be notified of the amount of change. The commissioner will then redetermine the amount of tax due for the year or years affected. The statute of limitations does not begin until such a notice is given.[57]

Section 905(c) also provides that no interest will be assessed or collected on any amount of tax due on the redetermination resulting from a refund to the taxpayer, for any period before the receipt of such refund, except to the extent interest was paid by the foreign country on the refund.

Section 6689 provides that a taxpayer who fails to notify the Secretary of the Treasury of a foreign tax redetermination is subject to a civil penalty unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The penalty is 5 percent of the deficiency if the failure is for not more than one month, with an additional 5 percent of the deficiency for each month the failure continues. The maximum penalty amount is 25 percent of the deficiency.

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[56] *Ampex Corporation v. United States*, 620 F.2d 853 (Ct. Cl. 1980).

[57] Rev. Rul. 71-454, 1971-2 C.B. 294.

8

Rules for Controlled Foreign Corporations

Foreign corporations are the predominant vehicles through which U.S. multinational corporations conduct their international operations.[1] The primary tax advantage of operating abroad through a foreign corporation is that foreign-source income earned by the corporation is generally not taxed by the United States until the income is distributed to the U.S. shareholders. This deferral of U.S. taxation has been allowed from a policy standpoint on the grounds that it encourages investment in foreign countries so that U.S.-owned businesses are able to compete in foreign markets.

In 1961 President John F. Kennedy delivered a tax message to Congress in which he asked, in part, that the tax-deferral benefit for all U.S.-owned firms operating through foreign subsidiaries be entirely eliminated. This request represented a major shift in U.S. tax policy and was

[1]The Statistics of Income branch of the Internal Revenue Service reported that for 1994, the most current year for which data are available, U.S. corporations with $500 million or more in total assets controlled over 31,000 foreign corporations. See Ruth Schwartz, "Controlled Foreign Corporations, 1994," *Statistics of Income Bulletin* (Summer 1998): 109–130.

prompted by a need to raise revenues, to offset a deteriorating balance-of-payments situation, and to achieve equity in the tax treatment of domestic companies and foreign subsidiaries.

Strong opposition to this proposal was expressed by the business community. After extensive congressional hearings and considerable negotiation and compromise, the proposal was modified and adopted by Congress in the Revenue Act of 1962 to tax only certain types of income and investments of U.S.-controlled foreign corporations. The result was subpart F of chapter N of the Internal Revenue Code (sections 951–964), which contains some of the most complex sections of the code. The objective of subpart F is to tax U.S. shareholders currently on their pro rata share of selective types of income earned by the foreign corporation, principally passive income and income earned in tax haven countries.

The 1962 legislation provided several exceptions to the subpart F rules. In 1986 Congress perceived that these exceptions were excessively broad and allowed U.S. taxpayers to defer U.S. taxation on foreign income that was portable, passive in nature, and subject to low foreign tax rates. In the Tax Reform Act of 1986, Congress moved to strengthen the subpart F provisions by (1) expanding the definition of a U.S.-controlled foreign corporation, (2) increasing the categories of income that are taxed currently, (3) decreasing the thresholds at which subpart F becomes operative, and (4) restricting the use of deficits in earnings and profits to offset subpart F income. The U.S. Treasury is currently revisiting the subpart F regime and is expected to release a "white paper" report on subpart F.

The subpart F rules become operative where a controlled foreign corporation (CFC) exists. Subpart F requires that U.S. persons who are "United States shareholders" (as defined in section 951(b) and discussed below) of the CFC on the last day of the CFC's taxable year include in their income, as a dividend, their pro rata share of certain types of income earned by the CFC (subpart F income), investments made by the CFC in U.S. property, and certain previously excluded income. In so requiring, subpart F eliminates the tax-deferral benefits otherwise enjoyed by the CFC's U.S. shareholders on foreign-source income that is not repatriated. The CFC itself is not subject to U.S. taxation except on income earned in the United States or effectively connected with the operation of a U.S. trade or business.

U.S. shareholders of a CFC may also be subject to the foreign personal holding company rules (sections 551–558) and the passive foreign investment company rules (sections 1291–1297). These rules are discussed in chapters 9 and 10, respectively.

A CFC triggers several possible tax disadvantages, some of which are not limited to subpart F:

1. Loss of tax deferral on subpart F income;
2. Loss of tax deferral on earnings and profits invested in U.S. property (regardless of how earned); and
3. Characterization of certain gains on the sale or redemption of stock or gains on liquidation of a CFC as dividend income rather than as capital gain (section 1248).

A CFC may also provide tax advantages, especially when a corporate shareholder has excess foreign tax credits. Generating foreign-source income that is taxed at an effective foreign rate lower than the U.S. rate may permit use of foreign tax credits that might otherwise expire unused.

This chapter discusses (1) the criteria that determine when a foreign corporation is a CFC, (2) the criteria that determine if and when U.S. shareholders of a CFC are subject to the provisions of subpart F, (3) the various types of income that may be currently includable in taxable income, including subpart F income, and (4) some of the more important exceptions, exclusions, and limitations that apply to subpart F and other types of currently includable income.

A summary of the amounts that must be included in the gross income of U.S. shareholders under section 951 is shown in figure 8.1.

Definition of a Controlled Foreign Corporation

A *controlled foreign corporation* is any foreign corporation in which U.S. shareholders own more than 50 percent of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of such corporation (section 957(a)). An analysis of this definition follows.

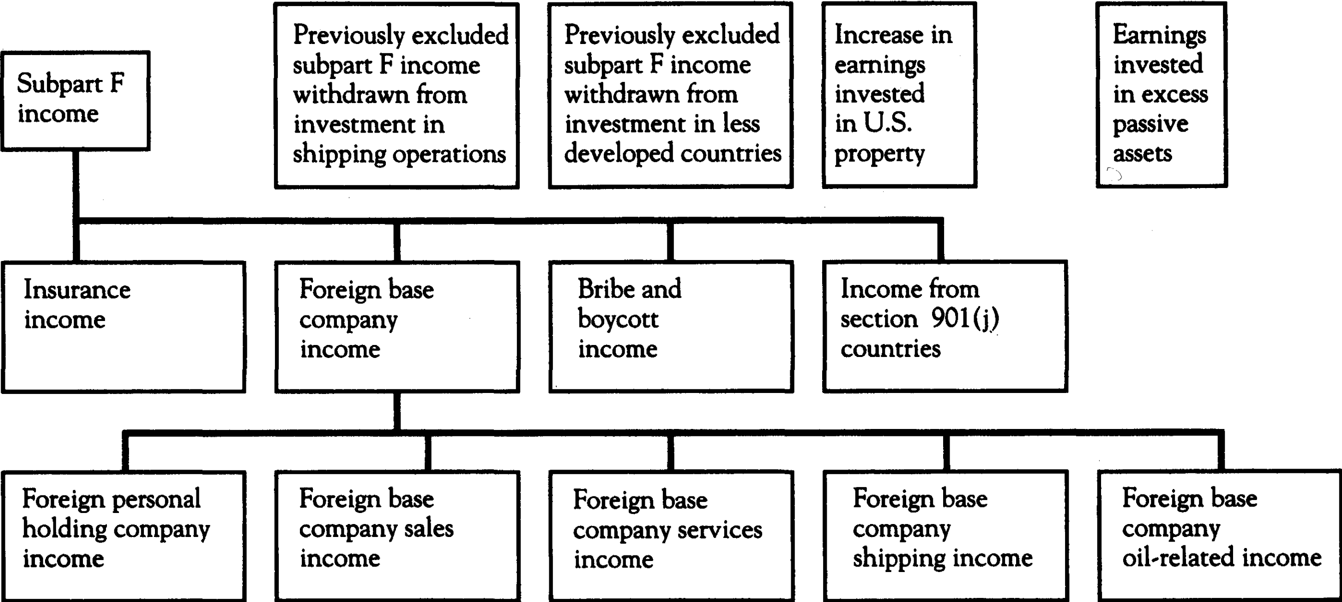
Foreign Corporation

As defined in section 7701(a)(5), a foreign corporation is any corporation that is not domestic. Section 7701(a)(4) states that the term *domestic* when applied to a corporation means "created or organized in the United States or under the law of the United States or of any State." (see also Treas. Reg. Sec. 301.7701-1(d)). The term *corporation* is not limited to the legal corporate entity; it also includes associations, joint-stock

(continued on page 271)

Figure 8.1

Amounts to Be Included in Gross Income Under Section 951



companies, insurance companies, state-chartered banks, business entities wholly owned by a state or any political subdivision thereof, trusts treated as associations because of their nature or activities, and certain foreign entities (Treas. Reg. Sec. 301.7701-2(b)).

Check-the-Box Regulations. In December 1996, the Treasury issued final "check-the-box" regulations under Treas. Reg. Sec. 301.7701-3 that replaced the prior "formalistic" entity classification rules with a "simpler approach that generally is elective."[2] The rules became effective on January 1, 1997, regardless of an entity's tax accounting year and apply to both U.S. and foreign entities.

Under Treas. Reg. Sec. 301.7701-3(a), a business entity that is not classified as a corporation under Treas. Reg. Sec. 301.7701-2(b)(1), (3)-(8) can elect its classification for federal tax purposes. Such an entity is referred to as an eligible entity. An entity is defined under federal tax law (not local law) and must carry on a trade, business, financial operation, or venture (that is, an undertaking to share expenses in not an entity) (Treas. Reg. Sec. 301.7701-1(a)(1) and (2)). A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded. If the entity is disregarded, it is treated in the same manner as a sole proprietorship, branch, or division of the owner (Treas. Reg. Sec. 301.7701-3(a)). Certain foreign entities (called per se *corporations*) are automatically treated as corporations for federal tax purposes. The list of per se corporations is found in Treas. Reg. Sec. 301.7701-2(b)(8) and includes any Canadian corporation and company, French *Société Anonyme*, German *Aktiengesellschaft*, Japanese *Kabushiki Kaisha*, Netherlands *Naamloze Vennootschap*, and United Kingdom Public Limited Company.

The election to treat an eligible entity as either a corporation or a flow-through entity for federal income tax purposes is made by "*checking*

[2]Under prior Treas. Reg. Sec. 301.7701-2, characteristics that determined corporate status for income tax purposes included (1) associates, (2) an objective to carry on business and divide the gains, (3) continuity of life, (4) centralization of management, (5) liability for debts limited to corporate property, and (6) free transferability of interests. An association or limited liability company was deemed to be a corporation for federal income tax purposes if it had more corporate characteristics than partnership characteristics, after disregarding those characteristics common to both entities (that is, associates and a profit objective). For an example of this process, see Rev. Rul. 88-8, 1988-1 C.B. 403.

the box" on Form 8832 (Treas. Reg. Sec. 301.7701-3(c)(1)(i)). All of the members at the time of the election must sign the election (an officer can sign on behalf of the members if she or he has the proper authorization) (Treas. Reg. Sec. 301.7701-3(c)(2)). To relieve entities of the election process, the regulations provide default classification rules as follows: (1) if all members of a foreign entity have limited liability, the entity will be treated as an association taxed as a corporation; (2) if a foreign entity has two or more members, and at least one member has unlimited liability, the entity will be classified as a partnership (if it has a single owner with unlimited liability, it will be disregarded as a separate entity) (Treas. Reg. Sec. 301.7701-3(b)(2)(i)). Limited liability is defined as a member not having personal liability for the debts of or claims against the entity by reason of being a member (Treas. Reg. Sec. 301.7701-3(b)(2)(ii)).

If an eligible entity makes an election to change its classification, the entity cannot change its classification again during the sixty months succeeding the effective date of the election (Treas. Reg. Sec. 301.7701-3(c)(1)(iv)). The Commissioner of Internal Revenue can permit the entity to change its classification within the sixty-month period if more than 50 percent of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons not owning any interests in the entity on the filing date or on the effective date of the entity's prior election.

U.S. taxpayers already operating through an entity that they have treated as a partnership or disregarded entity for U.S. tax purposes can continue to treat is as such if the following conditions are met: (1) the entity was in existence on May 8, 1996; (2) the entity was relevant for U.S. tax purposes (that is, its classification affects the tax liability of anyone); and (3) no person for whom the entity's classification was relevant treats the entity as a corporation (Treas. Reg. Sec. 301.7701-2(d)).

Ownership Tests

For a foreign corporation to be a CFC, U.S. shareholders must own more than 50 percent of the combined voting power of all classes of stock entitled to vote or the total value of the stock of such corporation on any day during the CFC's tax year (section 957(a)). For purposes of subpart F, a *U.S. shareholder* is any U.S. person who owns or is deemed to own 10 percent or more of all classes of stock entitled to vote (section 951(b)). Note that the value-of-stock test is applied only to determine if a foreign

corporation is a CFC. This provision was added in the Tax Reform Act of 1986 to combat situations in which U.S. shareholders effectively avoided the subpart F rules by sharing voting stock evenly with non-U.S. persons (primarily foreign banks) while retaining the majority of the value of the foreign corporation through ownership of nonvoting preferred stock or other securities. The retention of a voting-power test only for defining who is a U.S. shareholder reflects Congress's feeling that only shareholders who can influence dividend policy should be subject to the nondeferral rules.

U.S. Person. The term *U.S. person* means a citizen or resident of the United States, a domestic partnership, a domestic corporation, or any nonforeign estate or trust (section 7701(a)(30)), but excludes certain residents of U.S. possessions (section 957(c)).

Constructive Ownership. The constructive ownership rules of section 958(b) are used in the calculation of both the 50-percent test for determining CFC status and the 10-percent test for determining who is a U.S. shareholder. These constructive ownership rules are a modification of the attribution rules found in section 318.

In the case of attribution from members of a family, an individual is considered to own the stock owned directly or indirectly by or for his or her spouse, children, grandchildren, and parents (Treas. Reg. Sec. 1.958-2(b)). An adopted child is treated as a child by blood. Relatives such as brothers and sisters, aunts and uncles, and nieces and nephews are not included in these rules. Section 958 modifies the section 318 family attribution rules by excluding stock owned by a family member who is a nonresident alien (Treas. Reg. Sec. 1.958-2(b)(3)).

Stock owned directly or indirectly by or for a partnership, estate, or trust is considered to be owned proportionally by the partners or beneficiaries. Thus, an individual with a 20-percent interest in a partnership is deemed to own 20 percent of any stock owned by the partnership. Stock owned directly or indirectly by or for a trust is considered owned by its beneficiaries in proportion to the actuarial interest of the beneficiaries in the trust. Stock owned by a grantor trust is considered owned by the grantor or others treated as substantial owners (Treas. Reg. Sec. 1.958-2(c)(1)(ii)).

A shareholder is deemed to own a *pro rata* share of any stock owned by a corporation, but only if the shareholder owns directly or indirectly

10 percent or more of the total value of the corporation's stock (section 958(b)(3)). The proportion of stock deemed owned by the shareholders is the ratio that their shares bear to the total value of all shares of stock in the domestic corporation (Treas. Reg. Sec. 1.958-2(c)(1)(iii)).

A partnership or estate is deemed to own all of the stock owned directly or indirectly by its partners or beneficiaries (Treas. Reg. Sec. 1.958-2(d)(1)(i)). A trust is considered to own all of the stock owned by beneficiaries who have more than a 5-percent actuarial interest in the trust (Treas. Reg. Sec. 1.958-2(d)(1)(ii)(a)). Stock owned by an individual considered an owner under the grantor trust rules is considered owned by the trust (Treas. Reg. Sec. 1.958-2(d)(1)(ii)(b)). A corporation is treated as owning all of the stock owned directly or indirectly by any shareholder who owns, directly or indirectly, 50 percent or more in value of the corporation's stock (Treas. Reg. Sec. 1.958-2(d)(1)(iii)). Attribution from an individual to an entity does not apply if the attribution would cause a U.S. person to be deemed to own stock of a non-U.S. person (section 958(b)(4) and Treas. Reg. Sec. 1.958-2(d)(2)).

If a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote, such entity is considered to own 100 percent of the stock entitled to vote (section 958(b)(2)).

> *Example 8.1.* Alpha, a domestic corporation, owns 60 percent of Beta Ltd., a foreign corporation. For purposes of the constructive ownership rules of section 958(b)(2), Alpha is deemed to own 100 percent of Beta Ltd. Beta Ltd. meets the definition of a CFC. If Beta Ltd. owns 60 percent of Delta Ltd., a foreign corporation, Alpha is also deemed to own 100 percent of Delta Ltd. This results because Alpha is first treated as owning 100 percent of Beta Ltd. Using the rules of Treas. Reg. Sec. 1.958-2(d)(1)(iii), Alpha is deemed to own all of Beta Ltd.'s stock in Delta Ltd. Alpha's indirect ownership of 60 percent of Delta Ltd. is increased to 100 percent under section 958(b)(2). Delta Ltd. is also considered a CFC. If Beta Ltd. and Delta Ltd. were domestic corporations, Alpha would be considered to own 60 percent of Beta Ltd. and 36 percent (60% × 60%) of Delta Ltd. (section 318(a)(2)(C)).

Finally, any person with an option to purchase stock is considered as owning such stock (Treas. Reg. Sec. 1.958-2(e)). This provision can unexpectedly result in CFC status, or U.S. shareholder status, for foreign joint ventures (for example, a buy-out option included in a shareholder agreement).

The 10-Percent Test. The stock ownership tests for determining CFC status include only stock owned directly, indirectly, or constructively by U.S. shareholders. *U.S. shareholder* is a term of art used in subpart F and is limited to those U.S. persons who own 10 percent or more of the total combined voting power of all classes of stock entitled to vote in the foreign corporation. For purposes of determining whether the 10-percent test is met, the direct and indirect ownership rules of section 958(a) and the constructive ownership rules of section 958(b) are used. A U.S. person is considered to be a U.S. shareholder if he or she meets the ownership requirement at any time during the tax year.

Voting power is defined as the ability to elect members of the board of directors (Treas. Reg. Sec. 1.957-1(b)). If only one class of voting stock is outstanding, each shareholder's voting power percentage is calculated by dividing the number of shares owned directly, indirectly, or constructively by the total number of outstanding voting shares.

If more than one class of stock is outstanding, a U.S. person who can elect or appoint 10 percent or more of the board of directors is considered a U.S. shareholder (Treas. Reg. Sec. 1.951-1(g)(2)). The percentage of total combined voting power owned by a U.S. person is computed by multiplying the total percentage of the board of directors that each class of stock can elect or appoint by the percentage of each class of stock the U.S. person owns, and then adding the individual percentages.

> *Example* 8.2. Foreign corporation Alpha has two classes of stock outstanding, consisting of 1,000 shares of class A stock and 1,000 shares of class B stock. Class A shareholders are entitled to elect eight of the ten corporate directors, and the owners of class B stock are entitled to elect the other two directors. Ponson, a U.S. citizen, owns 200 shares of class A stock and 100 shares of class B stock. Ponson's combined voting power is computed by multiplying the percentage of the board of directors that owners of each class of stock are entitled to elect times the percentage of stock she owns in each class of stock. Ponson owns 20 percent of the class A stock (200/1,000), which as a class can elect 80 percent of the board of directors. Her class A voting percentage is 16 percent (20% × 80%). Ponson owns 10 percent of the class B stock (100/1,000), which as a class can elect 20 percent of the board of directors. Her class B voting percentage is 2 percent (10% × 20%). Ponson's combined voting percentage is 18 percent, making her a United States shareholder.

In addition, U.S. persons are deemed to meet the 10-percent test if they own directly, indirectly, or constructively 20 percent or more of the

total number of shares of a class of stock that possesses one or more of the following powers: (1) the power to elect a majority of any body that controls the foreign corporation in lieu of the directors; (2) the power to cast a deciding vote in the event of a deadlock of the regular governing body; or (3) the power to appoint a person who exercises the powers ordinarily exercised by a board of directors (Treas. Reg. Secs. 1.951-1(g)(2) and 1.957-1(b)(1)).

The More-Than-50-Percent Test. For a foreign corporation to be a CFC, U.S. shareholders must collectively own more than 50 percent of its total combined voting power or total value of its stock on any day during the corporation's taxable year. Inasmuch as only those U.S. persons who own 10 percent or more of the voting power of a foreign corporation are included in the 50-percent test, a foreign corporation can be 100-percent owned by unrelated U.S. persons and not be a CFC because no one U.S. person owns 10 percent of the corporation.

Control of a foreign corporation will be deemed to exist in cases in which the mechanical 50-percent requirement is not met but in which U.S. shareholders have (1) the power to elect, appoint, or replace a majority of that body of persons exercising the powers ordinarily exercised by the board of directors of a domestic corporation; (2) the power to elect one-half of the governing body and to cast a deciding vote in the event of a deadlock of the regular governing bodies; or (3) the power to elect, appoint, or replace a person who exercises the powers ordinarily exercised by a board of directors (Treas. Reg. Sec. 1.957-1(b)(1)).

Any arrangement to shift voting power away from U.S. shareholders will not be given effect if, in reality, voting power is retained. Furthermore, any agreement, whether expressed or implied, to vote stock in a specified manner or not to vote at all or any facts indicating that the votes are not independent will be considered in determining whether or not control by U.S. shareholders does exist (Treas. Reg. Sec. 1.957-1(b)(2)). Consideration will be given to all the facts and circumstances in each case (Treas. Reg. Sec. 1.951-1(g)(2)). In summary, the test for control is based more on the reality of voting power than on the mechanical tests of stock ownership. It is interesting to note that in the House of Representatives version of the Tax Reform Act of 1986, the more-than-50-percent test would have been replaced by a 50-percent-or-more test. Congress did not make this change because, in part, it felt the Internal Revenue Service (IRS) could use the "effective control test" in Treas. Reg. Sec. 1.957-1(b) in situations in which the circumstances were appropriate.

It may be unwise to consider relinquishing voting control to avoid being classified as a CFC for tax-planning purposes. An optimal solution, although difficult to achieve, would be to acquire effective control in some way but also avoid statutory control. There are a few suggested methods for gaining effective control while avoiding statutory control.

Effective control by dispersion of ownership is one method. A foreign corporation could be organized with the majority U.S. taxpayer owning less than 50 percent of the voting stock. The remaining stock could be owned by unrelated U.S. persons (to avoid the attribution rules of section 958), none of whom owns 10 percent of the stock (to avoid the U.S. shareholder 10-percent test). Instead of ownership by U.S. persons, the stock could also be owned by foreign persons in order to avoid the 10-percent U.S. shareholder test.

Expansion overseas on a joint ownership basis with foreign persons is another method, although the U.S. shareholders must be careful to relinquish voting control. To date, there have been five court cases in which taxpayers attempted to use voting preferred stock as a decontrol device.[3] Common stock was issued to the U.S. shareholders and voting preferred stock to the non-U.S. shareholders. In each of the five cases, the preferred stock had voting power of at least 50 percent. (In *Koehring Co. v. United States*, the voting power was 55 percent.) In four of the five cases the foreign corporation was deemed a CFC based on facts and circumstances because in reality voting power remained with the common shareholders. In CCA *Inc.*, the Tax Court found that there was an actual divestiture of control. U.S. shareholders must now also consider the value test in any plan to avoid CFC status.

Another way to decontrol a CFC might be through a dividend or spin-off of the CFC stock to the shareholders of the domestic corporation. If the domestic corporation has dispersion of ownership such that the 50-percent and 10-percent ownership requirements are not met, the foreign corporation will lose its CFC status. Prior to the Tax Reform Act of 1984, U.S. corporate shareholders of foreign corporations used stapled, or paired, stock as a means of accomplishing the spin-off without risking the loss of effective management control. Under these arrangements, the distributed shares of the foreign corporation could only be transferred

[3]*Garlock, Inc. v. Comm.*, 489 F.2d 197 (CA-2, 1974), *aff'g*. 58 T.C. 423, *cert. denied*, 417 U.S. 911; *Hans P. Kraus v. Comm.*, 490 F.2d 898 (CA-2, 1974), *aff'g*. 56 T.C. 681; *Estate of Edwin C. Weiskopf*, 64 T.C. 78 (1975), *aff'd*. without opinion, 76-1 U.S.T.C. (CCH) para. 9387 (CA-2, 1976); *Koehring Co. v. United States*, 583 F.2d 313 (CA-7, 1978); CCA, *Inc.*, 64 T.C. 137 (1975).

together with the stock of the U.S. parent. To combat this strategy, Congress enacted section 269B in 1984, which treats the stapled foreign corporation as a U.S. corporation. Such treatment subjects the foreign corporation to U.S. taxation on its worldwide income. The "conversion" of the foreign corporation to a domestic corporation is treated as a reorganization taxable under section 367.[4] Even though the foreign corporation is treated as a U.S. corporation for tax purposes, it is not treated as a U.S. corporation for purposes of filing a consolidated tax return (that is, losses incurred by the foreign corporation cannot be used to offset income of the U.S. corporation).[5]

Use of nonvoting stock to effectively control the foreign corporation while at the same time not violating the mechanical 50-percent test is no longer feasible if the U.S. shareholders own more than 50 percent of the total value of the corporation's stock.

Indirect Ownership. In contrast to the constructive ownership rules of section 958(b), section 958(a) attributes stock ownership to a U.S. person if the stock is owned directly or indirectly through a foreign entity. If a U.S. person has ownership in a foreign corporation, foreign partnership, or estate, or a beneficial interest in a foreign trust that in turn owns stock of another foreign corporation, the U.S. person is considered to own proportionally the stock owned by the foreign entity. The rule creates a chain of ownership through attribution, which stops with the first U.S. person in the chain. The determination of CFC and U.S. shareholder status is made using both the section 958(a) and section 958(b) attribution rules. The determination of the amount of subpart F income included in a U.S. shareholder's gross income is determined using only the section 958(a) attribution rules.

> *Example 8.3.* Alpha, a domestic corporation, owns 60 percent of Beta Ltd., a foreign corporation. Beta Ltd. owns 60 percent of Delta Ltd., a foreign corporation. For purposes of the constructive ownership rules of section 958(b), Alpha is deemed to own 100 percent of Beta Ltd. and 100 percent of Delta Ltd. (see example 8.2). For purposes of section 958(a), Alpha is deemed to own 60 percent of Beta Ltd. (direct ownership only) and 36 percent of Delta Ltd. (60% × 60%). Beta and Delta both meet the definition of a CFC because of the section 958(b) attribution rules. If Beta has $1,000 of subpart

[4]Rev. Rul. 89-103, 1989-2 C.B. 65.

[5]Notice 89-94, 1989-2 C.B. 416.

F income, Alpha will be required to report $600 currently ($1,000 × 60%). If Delta has $1,000 of subpart F income, Alpha will be required to report $360 currently ($1,000 × 36%).

Amounts Included in Gross Income of U.S. Shareholders

Section 951(a) requires that U.S. shareholders of a CFC include in gross income their pro rata share of the CFC's (1) subpart F income, (2) previously excluded subpart F income withdrawn from investment in shipping operations, (3) previously excluded subpart F income withdrawn from investment in less developed countries, and (4) increase in earnings invested in U.S. property during the current year. Subpart F income includes income derived from the insurance of risks located outside the country in which the CFC is created or organized, foreign base company income, bribe and boycott income, and income earned in designated (section 901(j)) foreign countries. The rules of subpart F apply only in years in which a foreign corporation is a CFC for an *uninterrupted period* of *thirty days* or more during its taxable year, and only to U.S. shareholders who own stock in the CFC on the last day in the taxable year on which the corporation is a CFC.

Income From Insurance of Risks Located Outside the Country in Which the CFC Is Created or Organized

U.S. tax law does not allow a deduction for reserves for self-insurance. When premiums are paid to another company, however, the payments can be deductible, even if that other company is an affiliate of the payor. In the case of payments to an affiliated, or captive, insurance company, the courts look to whether the subsidiary faces some hazard if a loss event occurs, whether the insurance contract involves risk shifting and risk distribution, and whether the insurance meets "commonly accepted" notions of insurance.[6] *Risk shifting* involves the transfer of an identifiable

[6] *Humana, Inc.*, 881 F.2d 247 (CA-6, 1989), *aff'g., rev'g., and rem'g.* 88 T.C. 197 (1987); AMERCO, *Inc.*, 979 F.2d 162 (CA-9, 1992), *aff'g.* 96 T.C. 18 (1991); *The Harper Group*, 979 F.2d 1341 (CA-9, 1992), *aff'g.* 96 T.C. 45 (1991); *Sears, Roebuck & Co.*, 972 F.2d 858 (CA-7, 1992), *aff'g., rev'g., and rem'g.* 96 T.C. 61 (1991); *Ocean Drilling and Exploration Co.*, 988 F.2d 1135 (CAFC, 1993), *aff'g.* 24 Cl. Ct. 714 (1992); *Malone & Hyde, Inc.*, 66 T.C.M. 1551 (1993).

risk from the insured to the insurer. *Risk distribution* looks to the insurer to determine whether the transferred risk is shifted to a broader group of individuals. Premiums paid to wholly owned insurance subsidiaries are generally deductible if the subsidiary insures a substantial amount of risks for parties other than the U.S. parent and its affiliates.

Prior to the enactment of subpart F in the Revenue Act of 1962, a useful tax device was to establish a foreign insurance company for the purpose of insuring one's own U.S. risks and foreign risks. There were tax advantages in that the U.S. company was able to deduct for U.S. tax purposes the insurance premiums paid to the affiliate, which in turn paid no U.S. tax on its income. If the insurance affiliate was established in a tax haven country, foreign taxes could be avoided or minimized as well. Section 953, as originally enacted, curtailed the use of this practice by requiring the U.S. shareholders of a CFC to include income earned by the CFC from the insurance or reinsurance of U.S. risks. Congress expanded section 953 in the Tax Reform Act of 1986 to treat as subpart F income all income arising from the insurance of risks outside the country in which the insurer is created or organized. This change was made because Congress felt that insurance income was highly movable and in response to aggressive promotions by tax haven countries (primarily in the Caribbean), which encouraged U.S. companies to set up offshore insurance companies for tax-avoidance purposes. Proposed regulations under section 953, issued in 1991, have still not been finalized.

The amount of insurance income treated as subpart F income is the amount that would have been taxable if the CFC was a domestic corporation, subject to certain modifications (sections 953(a) and (b)). Section 957(b) treats a foreign corporation as a CFC for purposes of taking into account insurance income if U.S. shareholders directly, indirectly, or constructively own more than 25 percent of the corporation's voting power or total value on any day of its taxable year. This special rule applies only if more than 75 percent of the foreign corporation's gross premiums are from reinsurance contracts or the issuance of insurance or annuity policies for other than same-country risks.

Prop. Treas. Reg. Sec. 1.953-6(f)(1) states that a CFC is not excluded from these provisions simply because it is not an insurance company taxable under subchapter L of the Internal Revenue Code or because its primary and predominant business activity is not the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Any CFC may be subject to section 953. Such

corporations, however, are subject to special rules in calculating their taxable incomes (Prop. Treas. Reg. Sec. 1.953-6(f)(2)).

Insurance Income. Section 953(a) defines *insurance income* as it relates to subpart F as income attributable to the issuing (or reinsuring) of any insurance or annuity contracts in connection with property in, liability arising out of activity in, or in connection with the lives or health of residents of a country other than the country in which the CFC is created or organized. Such income includes both premium and investment income.

Section 953(a) insurance income is bifurcated into two categories: *related-person insurance income* (RPII category) and *not-related-person insurance income* (non-RPII category). Income that is derived from issuing or reinsuring insurance or annuity contracts in the CFC's "home country" is referred to as *same-country insurance* (SCI). SCI is generally not subpart F income, but may be foreign personal holding company (FPHC) income under sections 954(a)(1) and (c).

Under Prop. Treas. Reg. Sec. 1.953-1(b), the following procedures must be used to determine if a CFC has section 953 insurance income:

1. Determine if the insurance income is section 953 insurance income or SCI income by determining the location of the risks under contract;
2. Determine whether the premiums that are section 953 insurance are RPII or non-RPII;
3. Allocate and apportion investment income to the RPII, non-RPII, and SCI categories; and
4. Allocate and apportion deductions to the RPII, non-RPII, and SCI categories (both premiums and investment income).

Location of Property Risks. Prop. Treas. Reg. Sec. 1.953-2(e)(1) states the general rule that risks associated with property (tangible and intangible) covered by insurance are located where the property is located during the period or periods of coverage applicable to the taxable year. Where property is located is a facts-and-circumstances determination. Prop. Treas. Reg. Sec. 1.953-2(e)(2) provides specific rules for locating certain types of property. For *commercial transportation property* (ship, boat, railroad car, motor vehicle, aircraft), the premiums are allocated based on where the property is located during the period of coverage. In cases in which the property is located in and outside the home country, the premiums are

allocated based on any reasonable basis, such as time or mileage. In the case of *noncommercial transportation property,* the risk is considered located outside the home country if the property is registered in a country other than the home country or if the owner is a citizen or resident of other than the home country. Premiums related to risks in connection with *property exported by ship or aircraft* are located based on where the risks related to the transportation of the property commence or terminate. If the risks commence when the exported property is placed aboard the ship or aircraft, the premiums associated with such risks are treated as located outside the home country. A similar rule applies to premiums associated with risks in connection with property imported by ship or aircraft. If the insured risks terminate when the imported property is unloaded at the home country port of entry, the premiums related to such risks are treated as located outside the home country.

Location of Risks in Connection With Liability Arising Out of Activity. An insurance risk is treated as in connection with an "activity" if the insured is covered against liability resulting from the actions of a person or juridical entity, including actions that result in a tort, violation of contract, violation of property rights, or any other cause of action pursuant to the operation of law (Prop. Treas. Reg. Sec. 1.953-2(f)(1)). The general rule is that a risk in connection with an activity is located where the activity that could give rise to a liability or loss is performed. Where an activity is performed is a facts-and-circumstances determination, but factors to be considered include the location of the assets associated with the activity, the place where services comprising the activity are performed, the place where activities intended to result in a sale occur, and the place where sales actually occur.

Special rules are provided for certain types of activities (Prop. Treas. Reg. Sec. 1.953-2(f)(3)). Premiums under an insurance contract that insures a person who *manufactures, produces, constructs, or assembles property* against claims arising from the consumption or use of the property are treated as located where the consumption or use of the property takes place. If that place cannot be determined, the premium is treated as located where the property is manufactured, produced, constructed, or assembled. Premiums arising from insurance contracts related to risks from operating transportation property (motor vehicle, ship or boat, aircraft, or railroad, or railroad car) are located based on where the property is located. Premiums from insurance related to *selling activities* are treat-

ed as located based on where the selling activity takes place (that is, where the advertising, negotiating, and distributing takes place).

Location of Risks in Connection With Life or Health. Premiums related to insurance issued in connection with risks related to the insured's life or health (including accidents) are treated as located in the country where the person with respect to whom the risk is insured (the determining life) is resident (Prop. Treas. Reg. Sec. 1.953-2(g)(1)). The insured's residence is presumed to be the last address given by the person to the CFC as such person's residence. The determination of residency is made at the time the insurance contract is approved.

Risks Deemed to Be Located Outside the Home Country. Section 953(a)(1)(B) covers risk-swapping arrangements in which a CFC insures same-country risks of another corporation in return for which the other corporation receives a substantially equal amount of premiums for insuring the CFC's other-country risks. Premiums from insurance of same-country risks under this type of "artificial arrangement" are treated as insurance income from other-country risks and are included as subpart F insurance income.

Captive Insurance Income. Section 953(c) provides that U.S. shareholders must include in gross income their pro rata share of "related person insurance income" of certain "captive insurance companies." *Related person insurance income* is defined to be any section 953(a) insurance income (investment income or premiums) earned from the insurance or reinsurance of a "U.S. shareholder" of the foreign corporation or a "related person" to such shareholder (section 953(c)(2)). For purposes of this provision, the definition of a U.S. shareholder includes *any* U.S. person who owns stock in the foreign corporation using the attribution rules of section 958(a). In addition, the foreign corporation will be a CFC if the U.S. shareholders (as modified) own 25 percent or more of either the voting power or value of the foreign corporation (section 953(c)(1)(B)).

The definition of a related person to the U.S. shareholder is determined using the rules of section 954(d)(3). As so defined, a *related person* is an individual, corporation, partnership, trust, or estate that controls, or is controlled by, the U.S. shareholder. Control for this purpose is defined to be direct or indirect ownership of more than 50 percent of the total voting power or total value of the stock of the U.S. shareholder.

There are several exceptions to the captive insurance company rules. The rules do not apply to any foreign corporation if at all times during its taxable year less than 20 percent of the combined voting power and total value is directly or indirectly owned by persons who are insured under policies issued by the foreign corporation or who are related persons to such persons (section 953(c)(3)(A)). The rules also do not apply if the foreign corporation's gross related-person insurance income is less than 20 percent of its gross insurance income for the year (including excluded same-country risk income) (section 953(c)(3)(B)).

A corporation that is a CFC solely by virtue of these captive insurance rules may avoid the special section 953(c) rules by electing to treat its related person insurance income as income effectively connected with the conduct of a U.S. trade or business subject to corporate tax under section 882 and by waiving any treaty benefits available to such income. Making this election will also avoid the excise tax imposed by section 4371 on insurance premiums paid to foreign insurers. The administrative details for making this election are found in Notice 87-50[7] and Notice 88-111[8] and in Prop. Treas. Reg. Sec. 1.953-7(c). Losses incurred by foreign corporations making this election are treated as dual consolidated losses and are not deductible against the income of a U.S. corporate shareholder's consolidated group (section 953(d)(3)).

The captive insurance company rules apply to both stock and mutual insurance companies (section 953(c)(4)). Although such rules have the potential to adversely affect foreign mutual insurance companies that insure a significant number of U.S. persons (who will also be stockholders), the Joint Committee on Taxation notes in its *General Explanation of the Tax Reform Act of 1986* that these rules will not apply if the company maintains a permanent establishment in the United States and is thus treated as generating U.S. effectively connected income subject to tax under section 882. Such income is precluded from the definition of subpart F income by virtue of section 952(b).[9]

Congress enacted the captive insurance company provisions to limit the ability of U.S. taxpayers to avoid the subpart F rules by forming an offshore insurance company and dispersing the ownership in a manner

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[7]1987-2 C.B. 357.

[8]1988-2 C.B. 447.

[9]Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (H.R. 3838), 99th Cong., 2d sess., 1987 Committee Print, 981.

sufficient to avoid the mechanical ownership tests (so-called dispersed ownership captive insurance companies).

Foreign Base Company Income

Foreign base company income includes foreign personal holding company (FPHC) income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income (section 954(a)). U.S. shareholders of a CFC that operates as a base company may be required to recognize income from such operations.

The foreign base company rules are designed to prevent tax avoidance through the formation of a foreign corporation in a tax haven from which investments, sales, services, shipping operations, or oil-related activities in other countries are conducted.

Three sets of regulations apply to determine foreign base company income and foreign personal holding company income: (1) Treas. Reg. Sec. 1.954-0 through 1.954-2 apply to a CFC's tax years beginning after November 6, 1995 (although taxpayers can elect to apply these regulations to tax years beginning after 1986); (2) Treas. Reg. Sec. 4.954-0 through 4.954-2 apply to a CFC's tax years beginning after 1986 and on or before November 6, 1995; and (3) Treas. Reg. Sec. 1.954A-1 and 1.954A-2 apply to a CFC's tax years beginning before 1987.

Foreign Personal Holding Company Income. In the amazing patchwork of tax laws that have been directed toward domestic taxpayers, some of the most complicated (and perhaps convoluted) are those involving FPHC income. There are three types of taxable entities that can generate FPHC income: a foreign personal holding company (FPHC), a CFC, and a passive foreign investment company (PFIC). The tax treatment of a FPHC and its shareholders (sections 551-558) is discussed in chapter 9. The tax treatment of a PFIC and its shareholders (sections 1291–1297) is discussed in chapter 10. The subpart F rules take precedence over the FPHC rules (section 951(d)) and the PFIC rules (section 951(f)).

Prior to the enactment of the Tax Reform Act of 1986, FPHC income for subpart F purposes was defined by reference to the FPHC rules of section 553, with special modifications added by subpart F. This reference approach was removed in 1986, and FPHC income for subpart F purposes is now defined in section 954(c). The definition of FPHC income for subpart F purposes was expanded in the Tax Reform Act of 1986 to

impose current taxation on additional types of income that Congress perceived to be portable and susceptible to jurisdiction shifting to reduce the taxpayer's U.S. tax liability. The types of income added to the definition of FPHC income for subpart F purposes include (1) net gains on sales of foreign property that does not generate active income; (2) net income from certain commodities transactions; (3) net foreign currency exchange rate gains; (4) certain dividends, interest, and securities gains of banking and insurance business; and (5) income equivalent to interest. Congress added two new categories of FPHC income in 1997, net income from a notional principal contract and payments in lieu of dividends (both of these new rules apply only to tax years beginning after August 5, 1997).

A more detailed discussion of the components of FPHC income follows.

Dividends, Interest, Royalties, Rents, and Annuities. Dividends, interest, royalties, rents, and annuities are considered FPHC income under section 954(c)(1)(A). For CFC tax years beginning after March 3, 1997, tax-exempt interest of a CFC under section 103 is included in foreign personal holding company income (Treas. Reg. Sec. 1.954-2(b)(3). The definition of FPHC income is subject to many exceptions.

Export financing interest derived in the conduct of a banking business is excluded from FPHC income (section 954(c)(2)(B)). The definition of export financing interest is the same as for foreign tax credit limitation purposes (section 904(d)(2)(G)). Section 904(d)(2)(G) defines *export financing interest* as any interest derived from financing the sale for use or consumption outside the United States of any property (1) that is manufactured, produced, grown, or extracted in the United States by the taxpayer or a related person and (2) not more than 50 percent of the fair market value of the property is attributable to products imported into the United States. Treas. Reg. Sec. 1.954-2(b)(2)(iii) provides that export financing interest is considered derived in the conduct of a banking business if, in connection with the financing from which the interest is derived, the CFC, through its own officers or employee, engage in all the activities in which banks customarily engage in issuing and servicing a loan.

Example 8.4. CFC1 manufactures Product X in Country A from component parts that were manufactured by U.S. Corporation (USCo) in the United States. CFC2 provides loans to unrelated persons in Country A for the pur-

chase of Product X from CFC1. CFC2 engages in all activities in which banks customarily engage in issuing and servicing these loans. Because Product X is manufactured outside the United States, CFC2's interest income will not be treated as export financing interest for purposes of the exception found in section 954(c)(2)(B) and will be included in foreign personal holding company income.[10]

FPHC income does not include dividends and interest received from a related person (as defined in section 954(d)(3)) that (1) is a corporation created or organized in the same country as the CFC and (2) has a substantial part of its trade or business assets located in that same country (section 954(c)(3)(A)(i)). A "substantial" part means that for each, the average value of assets used in the related person's trade or business located in its country of incorporation exceeds 50 percent of the average value of all of the related person's assets (including assets not used in a trade or business) (Treas. Reg. Sec. 1.954-2(b)(4)(iv)). Average value is determined by averaging the value of assets at the close of each quarter of the taxable year. Allocations are required when the property is located partly in the related person's country of incorporation during the year or, in the case of same-country inventory, when activities connected with the production and sale or purchase and resale take place in the country of incorporation and other countries. The "same-country dividend rule" does not apply to dividends that are paid out of earnings and profits that were accumulated during periods when the recipient (CFC) did not hold the stock directly or indirectly through a chain of one or more subsidiaries (section 954(c)(3)(C)).

Rents and royalties may be excluded from FPHC income in two ways. FPHC income does not include rents or royalties derived in the active conduct of a trade or business and received from a person who is not a related person (section 954(c)(2)(A). Rents and royalties are derived in the active conduct of a trade or business only if the provisions of Treas. Reg. Sec. 1.954-2(c) or (d) are met (Treas. Reg. Sec. 1.954-2(b)(6)). Rents are considered derived in the active conduct of a trade or business if the CFC leases personal property that it regularly manufactures or produces (or if acquired, has added substantial value to), or, if realty, the CFC regularly performs active and substantial management and operational functions during the lease period (Treas. Reg. Sec. 1.954-2(c)). Royalties are considered derived in the active conduct of a trade or business if the

[10]IRS TAM 199925041 (April 29, 1999), Scenario #2.

CFC licenses property that it developed, created, or produced (Treas. Reg. Sec. 1.954-2(d)).

Example 8.5. Beta Ltd., a CFC, produces office machines, which it sells or leases to others and services. The rental income from the leases is derived from the active conduct of a trade or business and is not FPHC income.[11]

Example 8.6. Delta Ltd., a CFC, owns a complex of apartment buildings that it acquired by purchase. Delta Ltd. engages a real estate management firm to lease the apartments, manage the buildings, and pay over the net rents to Delta Ltd. The rental income from such leases is not derived in the active conduct of a trade or business and is FPHC income.[12]

Rents or royalties received from a corporation that is a related person for the use of, or privilege of using, property within the country in which the CFC is created or organized are also not FPHC income (section 954(c)(3)(A)(ii)).

The exclusion for interest, rents, and royalties received from same-country related persons does not apply if the payment reduces the payor's subpart F income (section 954(c)(3)(B)). Interest is not excluded from FPHC income to the extent the deduction for interest is allocated under Treas. Reg. Sec. 1.954-1(a)(4) and (c) to the payor's adjusted gross foreign base company income, adjusted gross insurance income, or any other subpart F income. (Treas. Reg. Sec. 1.954-2(b)(4)(ii)(B)(1)).

Finally, payments of interest, rents, or royalties by a partnership with one or more corporate partners may be treated as having been made by the corporations themselves for purposes of the related person exemption rule (section 954(c)(3)(A)).

Certain Property Transactions. FPHC income includes the excess of gains over losses from property transactions described in section 954(c)(1)(B). The transactions described in section 954(c)(1)(B) are those involving (1) property that gives rise to dividends, interest, rents, royalties, or annuities; (2) property that is an interest in a partnership, trust, or REMIC; and (3) property that does not give rise to income. Property excluded from "property that does not give rise to income" includes intangible property, goodwill, or going concern value to the extent used or held for use in the CFC's trade or business (Treas. Reg. Sec. 1.954-2(e)(3)(iv)).

[11]Treas. Reg. Sec. 1.954-2(c)(3), example 1.

[12]Treas. Reg. Sec. 1.954-2(c)(3), example 3.

Gain from the sale of such intangibles is excluded only if the intangible property is disposed of in connection with the disposition of the CFC's entire trade or business (Treas. Reg. Sec. 4.954-2(e)(3)(vi)).

For tax years beginning after August 5, 1997, net income from all notional principal contracts is included in FPHC income (section 954(c)(1)(F)). For prior years, notional principal contracts are excluded from the definition of "property that does not give rise to income" (Treas. Reg. Sec. 1.954-2(e)(3)(v)). Income, gain, deduction, or loss from a notional principal contract that is entered into to hedge income in another FPHC income category is income in that category.

Regular dealers of property that would otherwise give rise to FPHC income are exempt from these rules. Gains from the sale or exchange of inventory are not subject to these rules, nor are gains on the sale of property used by the seller in an active trade or business at the time of sale (section 954(c) and Treas. Reg. Sec. 1.954-2(e)(1)(ii)). Income from a notional principal contract used to hedge inventory is excluded from FPHC income. Property converted to such use just prior to sale may still be considered as generating FPHC income when sold. Gains from the disposition of dual-character property must be bifurcated between FPHC income and non-FPHC income based on a method that most reasonably reflects the relative users of the property (for example, the physical division of the property). If a CFC owns a building that it uses 60 percent in its business and rents the other 40 percent, then 40 percent of the gain on the sale of the building should be treated as FPHC income (Treas. Reg. Sec. 1.954-2(e)(1)(iv)).

Commodities Transactions. Net gains (but not losses) from commodity transactions are treated as FPHC income (section 954(c)(1)(C)). For purposes of this provision, a commodity includes tangible personal property of a kind that is actively traded or with respect to which contractual interests are actively traded (Treas. Reg. Sec. 1.954-2(f)(2)(i)). Nonfunctional currency is a commodity if it is actively traded or if contractual interests in the currency are actively traded. The term *commodity transaction* is defined in Treas. Reg. Sec. 1.954-2(f)(2)(ii) and includes a futures or forward contract in a commodity.

Gains and losses from "active qualified sales" and "qualified hedging transactions" are excluded from the definition of FPHC income. An *active qualified sale* means the sale of commodities in the active conduct of a commodity business as a producer, processor, merchant, or handler of

commodities if substantially all of the CFC's business is as an active producer, processor, merchant, or handler of commodities (Treas. Reg. Sec. 1.954-2(f)(2)(iii)(A)). This exception is not intended to apply to CFCs that are engaged primarily in such financial transactions as the trading of futures. A CFC is considered to be engaged in the active conduct of a commodities business if it holds the commodities as inventory and if it incurs substantial expenses from (1) engaging in the production of commodities (for example, planting or harvesting crops, raising or slaughtering livestock, or extracting minerals), (2) the processing of commodities prior to sale (for example, concentrating, refining, mixing, crushing, aerating, or milling), or (3) the moving, handling, and storage of commodities (for example, preparing contracts and invoices; arranging freight, insurance, or credit; arranging storage or warehousing; owning warehouse or storage facilities; or arranging vessels or vehicles for transportation). (Treas. Reg. Sec. 1.954-2(f)(2)(iii)(B)).

A *qualified hedging transaction* means a bona fide hedging transaction that is (1) reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which such business is customarily and usually conducted by others; (2) entered into to reduce the risk of price change (but not the risk of currency fluctuations); and (3) clearly identified on the CFC's records before the close of the fifth day after the day during which the hedging transaction was entered into and at a time when there was a reasonable risk of loss (Treas. Reg. Sec. 1.954-2(f)(iv)).

Foreign Currency Gains. FPHC income includes the excess of foreign currency gains over losses (as defined in section 988(b)) attributable to any "section 988 transactions" (section 954(c)(1)(D)). Such foreign currency gains or losses are excluded from FPHC income if they are directly related to the business needs of the corporation.

A foreign currency gain or loss is directly related to the corporation's business needs if (1) it can be clearly determined that it arises from a transaction entered into or properly used in the normal course of the corporation's trade or business and the transaction does not give rise to subpart F income; or (2) if it arises from a bona fide hedging transaction with respect to such a transaction or property (Treas. Reg. Sec. 1.954-2(g)(2)(ii)(B)). In the case of a bona fide hedging transaction, the gain or loss attributable to the hedging transaction must also be clearly identifiable on the CFC's records (Treas. Reg. Sec. 1.954-2(g)(2)(ii)(B)(2)).

Income Equivalent to Interest. Income that is deemed to be equivalent to interest is treated as FPHC income (section 954(c)(1)(E)). This would include (1) investments in which payments, net payments, cash flows, or return predominantly reflect the time value of money and (2) transactions in which payments are, in substance, for the use or forbearance of money but that are not generally treated as interest (Treas. Reg. Sec. 1.954-2(h)(2)). This category would include commitment fees for the actual lending of money, service fees, discount income, certain factoring income, and imputed interest on delayed payments on the performance of services.

Income equivalent to interest does not include income attributable to notional principal contracts such as interest rate swaps, currency swaps, interest rate floor agreements, or similar contracts except to the extent that such contracts are part of an integrated transaction that gives rise to income equivalent to interest (Treas. Reg. Sec. 1.954-2(h)(3)(ii)).

Payments in Lieu of Dividends. For tax years beginning after August 5, 1997, payments in lieu of dividends derived from equity securities lending transactions pursuant to section 1058 are now treated as a new category of FPHC income (section 954(c)(1)(G)).

Regular Dealer Exception. For tax years beginning after August 5,1997, the "regular dealer exception" previously applied to sellers of property now applies to any transaction (including a hedging transaction) entered into in the ordinary course of a CFC's business as a regular dealer in property, forward contracts, options, notional principal contracts, or similar financial instruments (including instruments referenced to commodities).

Income Derived From the Active Conduct of a Banking, Financing, or Similar Business. For tax years beginning in 1999 only, FPHC income does not include income from the active conduct of a banking, financing, or similar business (section 954(h)). For this exception to apply, the CFC must be "predominantly engaged" in the active conduct of such business, which is satisfied if more than 70 percent of the CFC's gross income is derived from the active conduct of a lending or finance business (section 954(h)(2)(B)). A lending or finance business includes making loans, purchasing or discounting accounts receivable, engaging in leases, issuing letters of credit or providing guarantees, providing charge and credit card services, and rending services or making facilities available in connection

with the previous activities (section 954(h)(4)). Section 954(h)(3)(B) adds an additional requirement that more than 30 percent of the CFC's (or a qualified business unit of the CFC) gross income must be derived directly from the active and regular conduct of a lending or financing business with unrelated customers located in the CFC's home country.

Members of Congress have offered bills that would extend, or make permanent, this exception, which has been extremely controversial.

Foreign Base Company Sales Income. In general, *foreign base company sales income* is income derived from the sale or purchase of personal property to (or from) a related person where the property is manufactured and sold outside the country of incorporation (section 954(d)). Foreign base company sales income can arise in the following four types of transactions:

1. The purchase of personal property from a related person and its sale to any person;
2. The purchase of personal property from any person and its sale to a related person;
3. The sale of personal property to any person on behalf of a related person;
4. The purchase of personal property from any person on behalf of a related person (section 954(d)(1) and Treas. Reg. Sec. 1.954-3(a)(1)(i)).

The term *related person* is defined in section 954(d)(3) to mean (1) an individual, corporation, partnership, trust, or estate that controls or is controlled by the CFC or (2) a corporation, partnership, trust, or estate that is controlled by the same person or persons who control the CFC.

Control is defined to be the direct or indirect ownership of stock possessing more than 50 percent of the combined voting power or total value of stock of the CFC. In the case of a partnership, trust, or estate, the ownership test is applied to the value of the person's beneficial interest in the partnership, trust, or estate. The attribution rules of section 958 apply in determining indirect ownership.

Foreign base company sales income arises only on the disposition of personal property; income from the disposition of real property is excluded. Neither the Code nor the regulations define personal property for purposes of the foreign base company sales income determination, except that personal property does not include agricultural commodities that are

not grown in the United States in commercially marketable quantities. The regulations under section 1.954-3(a)(1)(ii) list the agricultural commodities grown in the United States in commercially marketable quantities. Under section 954(d)(4), enacted in the 1993 Tax Act, subpart F foreign base company sales income includes income derived in connection with the sale of any unprocessed timber that is softwood and was cut from an area located in the United States or the milling of such timber outside the United States.

Personal property must be sold for use, consumption, or disposition outside the country of incorporation. The test is not based on where the sale is made or where title passes, but rather on where the goods are used, consumed, or disposed. This also applies when the CFC does not take title (not a sale) but acts on a fee or commission basis.

Treas. Reg. Sec. 1.954-3(a)(3)(ii) sets forth criteria for determining the country of use (consumption or disposition). These criteria, referred to as the *destination test*, operate in the following manner. With respect to a sale to an unrelated person, the destination of the property sold (where shipped to buyer) determines the country of use unless, at the time of sale, the seller knew, or should have known, that the property would not be used, consumed, or disposed of in the country of destination (shipment). In that case, the seller must determine the ultimate destination, or it will be presumed to be outside the country in which the CFC is organized. For this test, it is nebulous as to how knowledgeable the seller must be or how obvious a situation must be to constitute "or should have known." Apparently, a taxpayer must determine what an unrelated purchaser intends to do with the product. Regarding a sale to a related person, it is presumed that the destination for use is outside the country in which the CFC is organized, unless the CFC can substantiate differently. This latter test places the responsibility on the seller for following through on a sale to a related person to determine where the product is used.

Furthermore, foreign base company sales income does not include income of a CFC derived in connection with the sale of personal property manufactured, produced, or constructed by the CFC from personal property it has purchased (Treas. Reg. Sec. 1.954-3(a)(4)(i)).

Example 8.7. Beta Ltd., a CFC incorporated under the laws of country M, is a wholly owned subsidiary of domestic corporation Alpha. Beta Ltd. purchases from Alpha, a related person, electric motors manufactured in the United States and sells the motors, in the form in which they were pur-

chased from Alpha, to Omega Inc., an unrelated corporation, for delivery and use in country P. Gross income of Beta Ltd. derived from the purchase and sale of the motors to Omega Inc. is foreign base company sales income.[13]

Example 8.8. Beta Ltd., in example 8.7, also purchases from Omega Inc. stereo equipment manufactured in country P and sells the equipment in the form in which it was purchased to Theta Corp., a related person, for use in country W. The gross income of Beta Ltd. derived from the purchase and sale of the equipment is foreign base company income.[14]

Example 8.9. Beta Ltd., in example 8.7, is paid a commission by Alpha of 6 percent of the gross selling price of all motor sales solicited by Beta Ltd. and sold in country F. Alpha ships the motors, which are manufactured in the United States, directly to the purchaser in country F. Beta Ltd. does not take title to the property. Gross commissions received by Beta Ltd. from Alpha on sales to country F of such property constitute foreign base company sales income.[15]

Treas. Reg. Sec. 1.954-3(a)(4)(iii) gives guidelines to identify what constitutes *manufacturing*. Property is manufactured (produced, grown, or extracted) if it is substantially transformed prior to sale by a corporation or if the operations are substantial in nature and are generally considered to constitute the manufacture, production, or construction of property (such as the assembling of component parts). If, in connection with such property, conversion costs (direct labor plus factory burden) account for 20 percent or more of the total cost of goods sold, the operation is substantive.[16] The regulations prescribe, however, that in no event will packaging, repacking, labeling, or minor assembly operations constitute substantive operations (Treas. Reg. Sec. 1.954-3(a)(4)(iii)). The 20-percent rule may be criticized because it does not consider situations in different industries and different products. In a recent case, the Tax Court held that assembly (of sunglasses) could constitute "manufacturing" if the company's investment in human, rather than physical, capital was "substantive."[17]

[13]Treas. Reg. Sec. 1.954-3(a)(1)(iii), example 1.

[14]Treas. Reg. Sec. 1.954-3(a)(1)(iii), example 2.

[15]Treas. Reg. Sec. 1.954-3(a)(1)(iii), example 3.

[16]Treas. Reg. Sec. 1.954-3(a)(4)(iii). See also *Dave Fischbein Manufacturing Company*, 59 T.C. 338 (1972).

[17]*Bausch & Lomb, Inc.*, 71 T.C.M. 2031 (1996).

Example 8.10. Beta Ltd., a CFC incorporated under the laws of country M, is a wholly owned subsidiary of domestic corporation Alpha. Beta Ltd. sells industrial engines for use, consumption, and disposition outside country M. Beta Ltd. performs machining and assembly operations in connection with the sale of the engines. Beta Ltd. purchases components manufactured in the United States from Alpha, a related person, and Gamma Inc., an unrelated person. On a per-unit basis, Beta Ltd.'s selling price and costs of such engines are as follows:

Selling price			$400
Cost of goods sold:			
Material:			
Acquired from Alpha	$100		
Acquired from Gamma Inc.	40		
Total material		$140	
Conversion costs (direct labor and factory burden)		70	
Total cost of goods sold			210
Gross profit			$190
Administrative and selling expenses			50
Taxable income			$140

The conversion costs incurred by Beta Ltd. are more than 20 percent of the total cost of goods sold ($70/$210 or 33 percent). Although the product sold, an engine, is not sufficiently distinguishable from the components to constitute a substantial transformation of the purchased parts, Beta Ltd. meets the 20-percent test and will be considered to have manufactured the product it sells. Gross income on sales outside of country M will not be foreign base company income.[18]

Example 8.11. Assume in example 8.10 that Beta Ltd. added only $10 of conversion costs to the motors and therefore failed the 20-percent test. Also assume that 50 percent of the sales were made to unrelated persons in country M (Beta Ltd.'s country of incorporation) and 50 percent were made to unrelated persons in Country F. Gross income from sales is computed as follows:

(continued)

[18]Treas. Reg. Sec. 1.954-3(a)(4)(iii), example 1.

Selling price			$400
Cost of goods sold:			
Material:			
Acquired from Alpha	$100		
Acquired from Gamma Inc.	40		
Total material		$140	
Conversion costs (direct labor and factory burden)		10	
Total cost of goods sold			150
Gross profit			$250
Gross income from sales:			
For use within country M			$125
For use outside country M			$125

Foreign base company income is computed by multiplying the gross income from sales outside country M by the ratio of purchases from related persons ($100) over total purchases of all components ($140). Foreign base company income is $89.29 ($125 × $100/$140).[19]

A CFC that is a partner in a partnership that sells or purchases property from a person related to the CFC will have foreign base company sales income to the extent of its distributive share of gross income that would have been foreign base company sales income had the CFC engaged in the transaction directly (Treas. Reg. Sec. 1.701-2(f)). For example, consider a CFC organized in country M that is a 25-percent partner in foreign partnership GBP, which is organized in country L. GBP purchases machines from domestic corporation USCo, the 100-percent shareholder of the CFC, for sale and use in country L. The CFC's distributive share of partnership income that represents gross income from the purchase of machines from USCo and the sale or use of such machines in country L will be foreign base company income to the CFC.[20]

Miscellaneous exclusions to foreign base company sales income provided by the regulations include the sale to an unrelated person of tangible personal property after substantial use has been made of the property by the CFC in its business and the sale of substantially all the property of a corporation pursuant to a plan for discontinuation of business (Treas. Reg. Sec. 1.954-3(a)(1)(i)). This does not include stock in trade or prop-

[19]Treas. Reg. Sec. 1.954-3(a)(5), example 1.

[20]See also *Brown Group, Inc. & Subs.*, 77 F.3d 217 (CA-8, 1996), vacating and remanding 104 T.C. 105 (1995). The Treasury Department is expected to issue regulations that adopt the "aggregate" approach in determining a partner's share of a partnership's subpart F income in the latter part of 1999.

erty held primarily for sale. Income that constitutes *foreign trade income*, as defined in section 923(b), is also not included in foreign base company sales income (section 951(e)).

The Branch Rule. In some cases, a branch of a CFC will be treated as a separate corporation for determining foreign base company sales income (section 954(d)(2)). A branch will be treated as a separate corporation if a CFC carries on purchasing or selling activities by or through a branch located outside the country of incorporation of the CFC, and the use of the branch has substantially the same tax effect as if the branch were a wholly owned subsidiary.

Without the branch rule it would be possible, for example, for a CFC to manufacture in the country of its incorporation and establish a sales branch in a country with low or no taxes. The manufacturing activities in the country of incorporation would preclude U.S. foreign base company sales income treatment. On the other hand, if the country in which the CFC was incorporated did not tax branch profits, the sales income might escape taxation altogether.

If the country in which the CFC is incorporated does not tax branch profits, and if the effective tax rate on branch profits in the country of operations is less than 90 percent of, and at least five percentage points below, the effective rate of tax that would apply to that income under the laws under which the CFC is incorporated, the branch will be treated as a separate CFC for foreign base company sales income purposes (Treas. Reg. Sec. 1.954-3(b)(1)(i)(b)).

For a buying or selling branch, if the tax rates in the country in which the branch is located are less than 90 percent of, and at least five percentage points below, the effective rate of tax had the income been earned in the country in which the home office is located, the branch rule becomes operative. (This is sometimes referred to as the *sales branch rule*.) For a manufacturing branch with a selling home office, the test is reversed (Treas. Reg. Sec. 1.954-3(b)(1)(ii)). If the tax rate in the country in which the CFC is organized is less than 90 percent of, and at least five percentage points below, what it would be had the income been earned in the country in which the manufacturing branch is located, the branch rule becomes operative. (This is sometimes referred to as the *manufacturing branch rule*.)

Example 8.12. Delta Ltd., a CFC incorporated in country Y, manufactures in country Y and sells in country Z through a sales office (branch) located in country Z. Country Y levies an effective income tax rate of 40 percent, treats the branch as a separate corporation, and levies no tax on branch profits.

Country Z levies an effective income tax rate of 10 percent. The branch is treated as a wholly owned separate corporation. The 10-percent tax rate of country Z is less than 90 percent of country Y's tax rate (90% × 40% = 36%) and is more than five percentage points below country Y's tax rate (40% − 5% = 35%). As a result, the branch located in country Z will be treated as a CFC for purposes of computing foreign base company sales income on sales made by the branch outside of country Z.

The term *branch* is not defined in the regulations or the statute. Although the IRS has attempted to give the term its broadest meaning, the U.S. Tax Court has construed the term more narrowly, stating that a "branch" should be given its ordinary meaning in a business and accounting sense.[21]

Establishing a branch in a low-tax jurisdiction may benefit the U.S. taxpayer who is in an excess foreign tax credit position. Because the branch will be treated as a separate CFC, the subpart F income earned through the branch and the low taxes thereon may be used to absorb excess foreign tax credits associated with other foreign-source income.

Contract Manufacturing. In Rev. Rul. 75-7[22] the Internal Revenue Service held that the manufacture of goods by a *contract manufacturer* of the CFC could be attributed to the CFC for purposes of determining whether gross profit from sales of the goods was FBC sales income. Under a typical contract manufacturing arrangement, a low-tax foreign subsidiary (CFC) of USCo owns and manages the business of producing a product, owns the intangibles associated with manufacturing the product, and takes the risks and retains the benefits with respect to the manufacturing activities. The contract manufacturer, usually located in a high-tax country, provides manufacturing services and earns a fee for its services (for example, cost plus 5 percent).

Under the foreign base company sales rules, if the contract manufacturer was a subsidiary of USCo, sales by the CFC outside its country of incorporation would be foreign base company sales income. By treating the unrelated contract manufacturer's activities as being conducted by the CFC, the sales outside the CFC's country of incorporation would not be foreign base company sales income. The Internal Revenue Service also held in Rev. Rul. 75-7 that the contract manufacturer would be consid-

[21] *Ashland Oil, Inc.*, 95 T.C. 348 (1990); *Vetco, Inc.*, 95 T.C. 529 (1990). *Ashland Oil Co.* presents a summary of the legislative history of the branch rule.

[22] 1975-1 C.B. 244.

ered a "branch" of the CFC, in which case the *manufacturing branch* rules of section 954(d)(2) could apply if the contract manufacturer was located in a country with a tax rate in excess of the tax rate imposed by the country in which the CFC was located. After losing the extension of a branch to include a contract manufacturer in *Ashland Oil, Inc.* and *Vetco, Inc.*, the Internal Revenue Service revoked Rev. Rul. 75-7 in Rev. Rul. 97-48.[23] Under Rev. Rul. 97-48, the Internal Revenue Service stated that it will not attribute the operations of a contract manufacturer to a CFC for purposes of determining if the CFC "manufactures" the product sold under §954(d)(1). The Service will allow U.S. taxpayers to rely on Rev. Rul. 75-7 for years beginning before 1998 provided they are willing to accept the Service's position that the contract manufacturer is a branch, even though this approach was rejected by the Tax Court in *Ashland Oil, Inc.* and *Vetco, Inc.* Absent this agreement, Rev. Rul. 75-7 is revoked retroactively.

Foreign Base Company Services Income. The treatment of foreign base company services income as subpart F income is intended to deny tax deferral when services activities are separated from manufacturing or selling activities primarily to obtain a low rate of tax for the services income. The policy is similar to that for foreign base company sales income. For example, if a parent or a related company sells a product that requires continuous maintenance and servicing, a service company could be established in a tax haven country, and the income from servicing is thereby subject to a lower tax rate than if the parent or related company had performed its own servicing. As a further example, a parent or related company could bid on a contract to build a dam in country X and organize a base company in country Y to construct the dam in country X rather than do the construction itself. The income so derived from services such as these can constitute foreign base company services income.

Foreign base company services income is a term that encompasses the performance of personal services by a CFC for or on behalf of a related person outside the country in which the CFC is organized (section 954(e)). More specifically, the personal services include technical, managerial, engineering, architectural, scientific, industrial, commercial, or the like. The income from these services can be in the form of compensation, commissions, fees, or otherwise. Some kinds of services that can constitute foreign base company services income are (1) drilling an oil

[23]1997-49 I.R.B. 5.

well, (2) constructing a dam, (3) constructing a highway, (4) installing, repairing, and maintaining machinery, (5) furnishing skilled laborers for a job, (6) drafting plans and specifications, and (7) performing research activities for a company's product development and testing.

Because the services must be performed outside the country of incorporation, the place where the services are rendered must be accurately determined. There is no difficulty in determining where a dam is built or an oil well drilled or machinery serviced in one country only, but a question arises when the base company services several countries with a staff of traveling technicians.

The regulations state that the place in which services will be considered performed will depend on the facts and circumstances of each case (Treas. Reg. Sec. 1.954-4(c)). The general rule is that services are performed where the persons performing the services are physically located when they perform their duties. When a CFC performs services in more than one country, its gross income must be apportioned between that which is foreign base company services income and that which is not. The apportionment of the income is to be based on time spent on the various jobs in each country. The apportionment is to be adjusted further for the value of the services. That is, clerical workers who spend 500 hours in country X will ordinarily be assigned little value, whereas skilled technicians who spend 500 hours in that country will be assigned greater values in relation to the type of function performed by each individual (Treas. Reg. Sec. 1.954-4(c)).

Even though income from performing services for, or on behalf of, a related person outside the country of incorporation of the CFC is usually foreign base company services income, there are exceptions. When the related person does nothing more than act as guarantor on the contract and does not perform any services or pay the CFC for performing the services, the income from the services is excluded from foreign base com-pany services income (Treas. Reg. Secs. 1.954-4(b)(2) and (3), example 6).

> *Example 8.13*. A domestic parent corporation enters into a contract with an unrelated person to construct a highway in a foreign country. The parent corporation immediately assigns the entire contract to its wholly owned foreign corporation, incorporated outside the country in which the construction takes place. The income earned by the CFC from the construction is foreign base company services income. If the parent did nothing but guarantee the contract and the CFC acquired the contract, performed the work without the assistance of its related parent, billed the customer, and collected the receivable, then the income would not be foreign base company services income.

If the CFC is not performing services for a related person and later requires the assistance of a related person, the income from a contract can be considered foreign base company services income. The regulations state that certain assistance by a related person will taint the income. For these purposes, assistance is defined as follows:

1. Assistance in the form of know-how, supervision, direction, and services will not be considered assistance on the contract unless it is substantial and directly assists in the performance of the contract. *Substantial assistance* is defined as being a principal element in producing the income—the costs equaling 50 percent or more of the total costs of the CFC for the job.
2. Assistance in the form of financial help, equipment, material, or supplies will be considered assistance on the contract only if it is substantial, as defined above. For purposes of the 50-percent test for substantial assistance, the amounts to be included are only the excess of the arm's-length charges for these items, less the consideration actually paid by the CFC for them (Treas. Reg. Sec. 1.954-4(b)(2)(ii)).

If a related parent corporation acquires a contract to build a highway with the stipulation that the buyer will use the CFC for all the servicing and maintenance of the highway, the income received from this maintenance is normally treated as foreign base company services income because the CFC is considered to be performing the service on behalf of the parent corporation. However, an example cited in the regulations states that if the situation is such that there are numerous persons qualified and available to perform such services (with no agreement as to who is to perform services) and the buyer chooses the CFC from this group, the income is not foreign base company services income (Treas. Reg. Sec. 1.954-4(b)(3), example 10).

Section 954(e)(2) provides an exception from the definition of foreign base company services income for income from services that are directly related to the sale or exchange by a CFC of property manufactured, produced, grown, or extracted by it, and that are performed prior to the time of the sale or exchange or from services directly related to an offer or effort to sell or exchange such property.

Foreign Base Company Shipping Income. The fourth category of foreign base company income is foreign base company shipping income (section 954(f)). Under Treas. Reg. Sec. 1.954-6(b)(1), foreign base company shipping income includes—

1. Gross income derived from, or in connection with, the performance of services directly related to the use of any aircraft or vessel in foreign commerce. This type of income includes two subcategories: (a) intragroup services (which includes income from terminal services, stevedoring, and maintenance and repairs) and (b) services for passengers, the consignor, or the consignee (such as rental of staterooms, furnishing of meals, demurrage, dispatch, and dead freight).
2. Incidental income derived in the course of the active conduct of foreign base company shipping operations. Examples of incidental income include amounts derived from temporary investments, income from granting concessions to others aboard aircraft or vessels used in foreign commerce, and income from stock and currency futures.
3. Gross income derived from the sale or exchange or other disposition of any aircraft or vessel used in foreign commerce.
4. Dividends and interest received from a foreign corporation and gain recognized from the sale, exchange, or other disposition of stock or obligations of a foreign corporation, but only if the foreign base company would be deemed under section 902(b) to pay taxes with respect to another foreign corporation and only to the extent that the dividends, interest, and gains are attributable to foreign base company shipping income.
5. A distributive share of the gross income of any partnership and any amounts includable in gross income under Code provisions related to income for trusts to the extent that such items would have been includable in foreign base company shipping income had they been realized by the CFC directly.
6. Exchange gains to the extent that such gains are allocable to foreign base company shipping income.
7. Income derived from a space or ocean activity that is subject to the sourcing rule of section 863(d).

Foreign base company shipping income does not include income from the operation of a vessel between two points within the foreign country in which the corporation is created or organized and the aircraft or vessel used is registered (section 954(b)(7)).

To prevent any amounts from being included in foreign base company income twice, section 954(b)(6)(A) provides that if income is

determined to be foreign base company shipping income, that income is not also considered to fall into any of the other three categories of foreign base company income. Dividend and interest income that is also FPHC income will be treated as FPHC income (section 953(f)). This generally applies to interest and dividends related to working capital. In addition, if a CFC distributes foreign base company shipping income as a dividend through a chain of ownership to another CFC, that distribution will generally be excluded from the foreign base company income of the recipient CFC (section 954(b)(6)(B)).

Congress significantly increased the potential amount of shipping income included in subpart F income in the Tax Reform Act of 1986. Under prior law, a U.S. shareholder could exclude from subpart F income any increase in the CFC's qualified investment in foreign base company shipping operations during the taxable year. This reinvestment exclusion was not available for any other foreign base company income. Congress viewed shipping income as highly movable between jurisdictions and likely not to be taxed by a foreign jurisdiction. In addition, Congress felt that allowing deferral for reinvestment in foreign-flag shipping operations promoted investment in such operations and questioned whether this was in the best interests of the United States.

Foreign Base Company Oil-Related Income. The term *foreign base company oil-related income* means income from nonextraction activities from sources outside the United States (section 954(g)(1)). The activities include processing minerals extracted from oil or gas wells into their primary products and distributing oil or gas minerals or their primary products. For example, a CFC located in country X that purchased oil from the government of Y and sold the oil to an unrelated corporation in country Z would have foreign base company oil-related income.

Income from the performance of services related to oil and gas extraction or nonextraction activities is oil-related income if the person performing the services or a related person is engaged in oil and gas extraction activities. Services include transportation, managerial services, accounting services, and insurance for oil extraction or nonextraction assets.

The term *foreign oil-related income* (FORI), also called "foreign base company oil nonextraction income," means the taxable income derived from sources outside the United States and its possessions from the following activities:

1. The processing of minerals extracted by the taxpayer or by any other person from oil and gas wells into their primary products (section 907(c)(2)(A));
2. The transportation of these minerals or primary products (section 907(c)(2)(B));
3. The distribution or sale of such minerals or primary products (section 907(c)(2)(C));
4. The disposition of assets used by the taxpayer in processing, transporting, or distributing these minerals or primary products; however, 50 percent or more of the income attributable to the asset for the three taxable years of the selling corporation immediately preceding the year of sale must be foreign base company oil nonextraction income (section 907(c)(2)(D)); and
5. The performance of any other related service, such as managerial services, accounting services, or insurance for oil extraction or non-extraction income (section 907(c)(2)(E)).

The following amounts are treated as foreign oil-related income to the extent that they are attributable to foreign oil-related income:

1. Dividends and interest from a foreign corporation for which taxes are deemed paid by the taxpayer under section 902;
2. Amounts for which taxes are deemed paid under section 960(a); and
3. The taxpayer's distributive share of income of partnerships (section 907(c)(3)).

In addition, interest from a foreign corporation and dividends from a domestic corporation that are treated as foreign-source are FORI to the extent attributable to foreign oil and gas extraction income. This means that such interest and dividends are FORI even though foreign oil and gas extraction income is not FORI (section 907(c)(3)).

Items that are not considered FORI include—

1. FORI derived from sources within a foreign country in connection with oil and gas that is extracted by anyone from an oil or gas well in that foreign country (for example, income derived in a foreign country by a subsidiary from the purchase and sale of oil extracted in that country (section 954(g)(1)(A)).
2. FORI derived from sources within a foreign country in connection with oil or gas or a primary product of oil or gas that is sold by that

person or by a related person for use or consumption in that country. Fuel transferred into the fuel tank of a vessel or an aircraft for consumption by that vessel or aircraft is considered to be consumed in the country in which that transfer occurs (section 954(g)(1)(B)).

3. All FORI is exempted from foreign base company oil-related income treatment if the aggregate average daily production of foreign crude oil and natural gas by the foreign corporation and related person for any taxable year is less than 1,000 barrels per day (or its equivalent in gas) (section 954(g)(2)).
4. FORI does not include interest or dividends that are FPHC income (section 954(g)(1)). This provision eliminates interest and dividends from working capital from being cross-credited with other FORI.

Exclusion From Foreign Base Company Income. There are several exceptions that serve to exclude all or a portion of a CFC's subpart F income from current taxation to the U.S. shareholders. Section 954(b)(3)(A) provides a de minimis rule that excludes all gross income from being treated as foreign base company income or insurance income if the sum of the CFC's gross foreign base company income and gross insurance income is less than the lesser of 5 percent of gross income or $1 million. Conversely, section 954(b)(3)(B) provides a "full inclusion" rule whereby all of the CFC's gross income will be treated as foreign base company income or insurance income if more than 70 percent of the CFC's gross income is foreign base company income and insurance income. The full inclusion rule does not apply to captive insurance companies that are treated as CFCs under the reduced threshold test of section 953(c). Related party factoring income (described in sections 864(d)(1) and (d)(6)) is taxed currently to U.S. shareholders without regard to the de minimis rule.

To prevent abuses that might arise through the use of multiple corporations to avoid the $1 million threshold test, Treas. Reg. Sec. 1.954-1(b)(4) requires that income of two or more CFCs be aggregated and treated as a single corporation if one principal purpose for the separate corporations is to avoid the de minimis rule or the full inclusion rule. The regulation creates a presumption that this purpose exists if the CFCs are related persons (as described in section 267(b)) and meet one of three descriptions. The presumption applies if (1) the multiple CFCs carry on the same activities or use substantially the same assets as a prior single CFC and the U.S. shareholders of the multiple CFCs are substantially the

same as the U.S. shareholders of the prior single CFC; (2) the CFCs carry on a business, financial operation, or venture as partners in a partnership that is a related person; or (3) the activities carried on by the CFCs would constitute a single branch operation under Temp. Treas. Reg. Sec. 1.367(a)-6T(g)(2) if carried on directly by a U.S. person (Treas. Reg. Sec. 1.954-1(b)(4)(ii)).

Example 8.14. USP is the sole shareholder of three controlled foreign corporations: CFC1, CFC2, and CFC3. The CFCs are partners in a foreign partnership through which the CFCs generate all of their income that is not foreign base company income. The CFCs generate foreign base company income jointly through the foreign partnership and separately. Gross income for the current year for each CFC is—

	CFC1	*CFC2*	*CFC3*
Gross income	$4,000,000	$8,000,000	$12,000,000
5 percent of gross income	200,000	400,000	600,000
Foreign base company income	199,000	398,000	597,000

The CFCs separately meet the 5-percent de minimis test. If the foreign base company income is aggregated, however, it exceeds $1 million. If the antiabuse rule applies, the U.S. shareholders of each CFC will be taxed currently on the CFC's foreign base company income.[24]

The current de minimis test was enacted in the Tax Reform Act of 1986. Under prior law, the de minimis test was based on a 10-percent-of-gross-income test without a total foreign base company income threshold. In addition, insurance income was not included in the de minimis or full-inclusion tests because it was subject to separate tests (which were repealed by the Tax Reform Act of 1986). Congress saw no sound policy basis for distinguishing tax haven insurance income from foreign base company income for purposes of either test.

A second exception to current taxation of subpart F income to U.S. shareholders applies to foreign base company income (other than foreign oil-related income) and insurance income that is subject to an effective income tax rate imposed by a foreign country that is greater than 90 percent of the maximum U.S. income tax rate imposed under section 11 (section 954(b)(4)). For years beginning after 1992, this comparison rate would be 31.5 percent (90 percent × 35 percent). Also, if more than 90 percent of the adjusted gross foreign base company and adjusted gross

[24]Treas. Reg. Sec. 1.954-1(b)(4)(iv).

insurance income qualifies for the high tax exception, the full inclusion rule will not apply to income that would otherwise be included in gross income under the rule (Treas. Reg. Sec. 1.954-1(d)(6)).

The high tax exception is determined for each "item" of net foreign base company income or net insurance income (Treas. Reg. Sec. 1.954-1(d)(1)). An item of net foreign base company income (other than foreign personal holding company income that is passive income) or net insurance income is defined to be income that falls within a single category of net foreign base company income or net insurance income and also falls within a single separate foreign tax credit limitation category for purposes of sections 904(d) and 960 (Treas. Reg. Sec. 1.954-1(c)(1)(iii)). In the case of FPHC income that is passive income for foreign tax credit purposes, an item of net FPHC income is the amount of such income that falls within a single category of passive income for foreign tax credit purposes. (Examples would include passive income, high withholding tax interest, high-tax income, and financial services income.)

The amount of foreign taxes paid for purposes of computing the effective tax rate is considered to be the amount of foreign taxes that would be deemed paid under section 960 with respect to the item of income if that item was included in the gross income of a U.S. shareholder under section 951(a)(1)(A).

The exclusion of high-tax-exception income from foreign base company income or insurance income is made at the election of the controlling U.S. shareholders. A statement to this effect must be attached to the shareholders' returns.

The high tax exception replaced the prior law "formed or availed of" test. Under this subjective test, a CFC was not subject to subpart F if the location of the CFC was not motivated by a "significant" purpose to substantially reduce income taxes. A number of factors were used to determine if the lack of a tax-avoidance motivation existed. Congress replaced this subjective test with an objective test in order to provide greater certainty for both taxpayers and the Internal Revenue Service. However, given that the required effective rate calculation under current law is "inherently factual," the Internal Revenue Service will not issue a ruling on whether the 90-percent test is met.[25]

[25]Rev. Proc. 99-7, 1999-1 I.R.B. 226.

Net Foreign Base Company Income. Gross foreign base company income, after adjustment for the de minimis and full-inclusion rules, is further reduced by deductions properly allocable to such categories of income (Treas. Reg. Sec. 1.954-1(a)(4)). The resulting amount is referred to as "net foreign base company income." Net foreign base company income is adjusted to take into account any items of net foreign base company income for which the high tax exception is elected. The remaining amount, termed adjusted net foreign base company income, is the amount subject to inclusion in the U.S. shareholder's gross income as subpart F income (Treas. Reg. Sec. 1.954-1(a)(5)).

In the computation of net foreign base company income, expenses, taxes, and other deductions are first allocated to items or categories of gross income to which they directly relate (Treas. Reg. Sec. 1.954-1(c)). Expenses, taxes, and other deductions that cannot definitely be allocated to some category of gross income are ratably apportioned among all items or categories of gross income. No expense, tax, or other deduction is allocated to an item or category of income to which it clearly does not apply. The allocation and apportionment of expenses must be consistent with the allocation and apportionment of expenses for purposes of the foreign tax credit limitation calculations under section 904(d).

Example 8.15. Gamma Ltd., a wholly owned CFC of Alpha, reports the following items of income and expense:

Gross income:	
Foreign base company income	$ 600
Other gross income	400
	$1,000
Expenses:	
Expenses directly related to—	
Foreign base company income	200
Other gross income	150
Expenses not directly related to a particular category of gross income	300
Taxable income	$ 350
Income taxes at a 20-percent rate	70

The gross income and expenses are allocated as follows:

	FBC Income	*Other*	*Total*
Gross income	$600	$400	$1,000
Directly related expenses	200	150	350
	400	250	650

	FBC Income	*Other*	*Total*
Allocable expense*	180	120	300
	220	130	350
Income tax†	44	26	70
Net income	$176	$104	$280

*Allocated on the basis of gross income in the absence of a more reasonable allocation method.
†The 20-percent rate was applied to each category of income in the absence of special foreign tax treatment of a category of income.

Gamma Ltd.'s net foreign base company income is $176 and would constitute subpart F income to Alpha. Because the effective tax rate imposed on Gamma Ltd.'s net foreign base company income is less than 90 percent of the highest U.S. rate (90% × 35% = 31.5%), the high tax exception is not available. Therefore, Gamma Ltd.'s adjusted net foreign base company income is also $176. The amount included in Alpha's gross income as a dividend will be the $176 plus the $44 in foreign taxes attributable to the income ($220). Alpha is entitled to a deemed-paid foreign tax credit under section 960 for the $44, subject to any limitations.

Other Subpart F Income

Subpart F income also includes boycott income, illegal bribes or other payments made to officials of foreign governments, income from countries during periods to which the country is subject to section 901(j) previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for prior taxable years or from investments in less developed countries, and any increase in the CFC's non-subpart F (tax deferred) earnings invested in U.S. property.

International Boycott Income. U.S. shareholders of a CFC are currently taxed on income earned as a result of participation in or cooperation with an international boycott (section 952(a)(3)). The amount of boycott income is determined by multiplying the income of the CFC not already treated as subpart F income times the international boycott factor, which is defined in section 999. The list of countries that may require cooperation with international boycotts includes Bahrain, Iraq, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates, and the Republic of Yemen.

Illegal Foreign Bribes. Subpart F income includes payments of illegal bribes, kickbacks, or other payments paid by or on behalf of the CFC directly or indirectly to an official, employee, or agent of a foreign gov-

ernment. The types of payments included in this definition are those specified in section 162(c).

Income From Section 901(j) Countries. Section 952(a)(5) provides that subpart F income includes all income derived from a foreign country during any period during which section 901(j) applies to such country. Section 901(j) disallows foreign tax credit for taxes paid to countries with which the U.S. government has severed relations. Countries currently subject to section 901(j) are Cuba, Iran, Iraq, Libya, North Korea, Sudan, and Syria.

Withdrawal of Previously Excluded Subpart F Income From Qualified Investment. Section 955 provides that a U.S. shareholder of a CFC must include in gross income the amount of previously excluded subpart F income withdrawn from either investment in foreign base company shipping operations made in years prior to 1987 or investments in less developed countries made in years prior to 1976. The amount of income to be included from the withdrawal from investment in foreign base company shipping operations is the lowest of the following three amounts:

1. The decrease in qualified investments in foreign base company shipping operations less any loss on disposal of such assets;
2. The sum of amounts excluded from foreign base company income for all prior taxable years less the sum of amounts of previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for all prior taxable years; and
3. Earnings and profits accumulated after December 31, 1975.

The decrease in qualified investments in foreign base company shipping operations is calculated by subtracting the amount of qualified investments in foreign base company shipping operations at the close of the taxable year from the qualified investment amount at the close of the preceding taxable year. The decrease is taken into account only to the extent of earnings and profits accumulated after December 31, 1975, and through tax years beginning before 1987, and to the extent that the amount of previously excluded subpart F income invested in less developed countries is attributable to earnings and profits accumulated for taxable years beginning after December 31, 1962. In addition, the decrease is reduced by an amount equal to the extent that losses exceed gains on dispositions during the year.

The Tax Reform Act of 1986 eliminated the exclusion for reinvestments in qualified shipping operations for years beginning after December

31, 1986. All foreign base company shipping income is taxed currently to U.S. shareholders, subject to previously mentioned exclusions. Decreases in qualified investments in foreign base company shipping operations related to this income will not be taxed currently to U.S. shareholders.

Prior to the enactment of the Tax Reduction Act of 1975, a CFC could exclude from subpart F income certain income derived from investments in less developed countries. The Tax Reduction Act of 1975 repealed this exclusion for tax years beginning after December 31, 1975, but amounts previously excluded must be included in income when they are withdrawn from investments in less developed countries (Treas. Reg. Sec. 1.955-1).

Exclusion of U.S. Income. Subpart F income does not include any income from sources within the United States that is effectively connected with the conduct of a trade or business within the United States unless the income is exempt from taxation or is subject to a reduced rate pursuant to a U.S. treaty obligation (section 952(b)).

Investment in U.S. Property

To prevent tax avoidance through indirect repatriation of foreign earnings, section 956 provides that U.S. shareholders are taxed currently on earnings of the CFC that are invested in "United States" property. In essence, earnings brought back to the United States are taxed to the shareholders on the grounds that this investment is substantially equivalent to payment of a dividend. It should be noted that the amount of the constructive dividend is dependent on how earnings are invested, not how they are earned. Thus any earnings of a CFC are subject to inclusion in income by U.S. shareholders under section 956.

U.S. Property. In general, *U.S. property* means (1) tangible property located in the United States, (2) stock of a domestic corporation, (3) an obligation of a U.S. person, or (4) any other right to use in the United States a copyright, patent, invention, model, design, formula, process, or similar property right acquired or developed by the CFC for use in the United States (section 956(c)(1)). A CFC is considered to hold an obligation of a U.S. person if the CFC is pledgor or guarantor of such an obligation (section 956(d)). Rev. Rul. 82-171[26] also holds that a loan by a CFC to a foreign corporation that is treated as a domestic subsidiary of

[26]1982-2 C.B. 161.

the U.S. corporate shareholder pursuant to an election under section 1504(d) is an investment in U.S. property.

Under section 956(d) a pledge or guarantee by a CFC of an obligation of a U.S. person is considered an acquisition of the underlying obligation. Therefore, the CFC is considered to have invested in U.S. property. The status of indirect pledges or guarantees is somewhat nebulous. In Rev. Rul. 76-125[27] the Internal Revenue Service interpreted the intent of section 956(d) as including indirect pledges and held that the pledge of stock of a CFC by its U.S. shareholder is considered an investment in U.S. property. In *Daniel K. Ludwig*,[28] a case that involved a pledge of CFC stock as collateral for a loan, the Tax Court rejected the Internal Revenue Service position expressed in Rev. Rul. 76-125 because the CFC did not promise to pay the U.S. shareholder's obligation and had no obligation to pay the obligation if the debtor did not pay it.

Treas. Reg. Sec. 1.956-2(c)(2) attempts to clarify the treatment of indirect pledges and guarantees. The Treasury perceives indirect pledges and guarantees as "loopholes" created by the absence of their specific mention in section 956(d) and the rejection of Rev. Rul. 76-125 in the *Ludwig* case.

Treas. Reg. Sec. 1.956-2(c)(2) requires that if the assets of a CFC serve at any time, either directly or indirectly, as security for the performance of an obligation of a U.S. person, the CFC will be considered a pledgor or guarantor of that obligation. For this purpose, a CFC stock pledge will be considered an indirect pledge of assets if at least two-thirds of the total combined voting power of all classes of stock is pledged and if the stock pledge is accompanied by certain other restrictions. These regulations contain an example with facts that are similar to the facts in *Ludwig*.

Under Temp. Treas. Reg. Sec. 1.956-2T(d)(2), the term *obligation of a United States person* includes all evidences of debt except for indebtedness arising out of involuntary conversion of non-U.S. property and obligations arising out of the provision of services by the CFC to the U.S. person to the extent the amount does not exceed what would be ordinary and necessary to carry on the business of the CFC or the U.S. person if they were unrelated. Obligations payable within sixty days are considered as meeting the ordinary-and-necessary test.

[27]1976-1 C.B. 204.

[28]68 T.C. 979 (1977), *nonacq*. 1978-2 C.B. 4.

The temporary regulations eliminated a prior exception from the definition of U.S. property for obligations not exceeding one year for loans made on or after June 14, 1988 (Temp. Treas. Reg. Sec. 1.956-2T(d)(2)(ii)). This exception was eliminated to prevent rollovers of short-term obligations to avoid having the obligation treated as U.S. property. In September 1988 the IRS issued Notice 88-108,[29] in which it announced that the final regulations under section 956 would exempt from the definition of U.S. property obligations held at year-end that are collectible within thirty days. The exclusion will not apply to obligations held by the CFC for sixty or more calendar days during the taxable year (120 for the taxable year that includes June 14, 1988) that would otherwise constitute U.S. property if held at the end of the CFC's quarter or taxable year.

The IRS followed Notice 88-108 with Rev. Rul. 89-73,[30] in which it took the further position that obligations of the U.S. shareholder that were held by the CFC during the year and were redeemed before the CFC's year-end, and then reloaned shortly after the CFC's new taxable year began, could be treated as outstanding at the CFC's year-end if the time lapse between the redemption and the reloan was not "sufficient." The objective of Rev. Rul. 89-73 is to limit a common planning technique in which the U.S. shareholder borrowed money from the CFC early in the year and then repaid the loan prior to the CFC's tax year-end.[31] The IRS held that a repayment of a $200X loan from a CFC on November 15 and a reloan of $225X on January 15 of the following year was not a sufficient time lapse and thus the $200X loan would be deemed outstanding at year-end. If the loan was repaid on June 15 and then reloaned on January 15, the IRS held that sufficient time had elapsed and the form of the transactions would be respected.

Under section 956(c)(2), U.S. property does not include investments in—

1. Obligations of the U.S. government, money, or deposits with persons carrying on a banking business in the United States.
2. Property located in the United States that is purchased there for export to, or use in, foreign countries.

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[29]1988-2 C.B. 445.

[30]1989-1 C.B. 258.

[31]For an example of this strategy, see *Jacobs Engineering Group, Inc.*, 168 F.3d 499 (CA-9, 1999), *aff'g*. 97-1 U.S.T.C. para. 50,340 (C.D. Cal, 1997).

3. Any obligation of a U.S. person arising in connection with the sale or processing of property. The amounts of these obligations cannot exceed the amounts that would be ordinary and necessary to carry on a trade or business between unrelated parties (but see *Sherwood Properties, Inc.*[32] for an example of the difficulty in making this determination).
4. Any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in foreign commerce and used predominantly outside the United States.
5. Certain insurance company reserves.
6. Stock or obligations of certain domestic corporations. To qualify for this exception, the acquired stock may not be (a) in a domestic corporation that is a U.S. shareholder of the CFC or (b) in a corporation in which immediately after the acquisition a U.S. shareholder of the CFC owns, under the ownership rules of section 958(b), 25 percent or more of the total combined voting power of such domestic corporation.
7. Any movable property, except a vessel or aircraft, that is used for exporting, developing, removing, or transporting resources from the U.S. continental shelf.
8. An amount of assets of the CFC equal to earnings and profits accumulated after December 31, 1962, and excluded from subpart F income under section 952(b) (income already subject to the regular U.S. corporate income tax).
9. Property held by a foreign sales corporation (FSC) that would otherwise be U.S. property and that is related to the export activities of the FSC.

Notwithstanding the foregoing exceptions (other than exception 8), U.S. property includes trade or service receivables acquired from a related person (within the meaning of section 864(d)) and the obligor of such receivables is a U.S. person (section 956(b)(3)). A *trade receivable* is defined as arising from the sale of property described in section 1221(1) (that is, stock in trade, inventory, and property held for sale to customers in the ordinary course of business).

[32] 89 T.C. 651 (1987).

Computation of Includable Income. For CFC taxable years beginning after September 30, 1993, the section 956 amount included in gross income is the lesser of two amounts. The first amount is the excess of the U.S. shareholder's pro rata share of the average of U.S. property held by the CFC at the close of each quarter less the U.S. shareholder's pro rata share of the CFC's earnings and profits previously included in gross income under section 956 (section 956(a)(1)). The second amount is the U.S. shareholder's pro rata share of the applicable earnings of the CFC (section 956(a)(2)). Applicable earnings is defined in sections 956(b)(1) and 956A(b) as the CFC's current and accumulated earnings and profits less current year distributions and less amounts previously included in the U.S. shareholder's gross income under section 956. A deficit in accumulated earnings and profits is ignored in computing applicable earnings. In addition, U.S. property acquired by the foreign corporation prior to becoming a CFC is ignored in computing the section 956 inclusion amount (the amount ignored cannot exceed the corporation's earnings and profits accumulated before becoming a CFC).

Example 8.16. Calvert Ltd., a foreign corporation, is a wholly owned CFC of Brooks Corporation, a domestic corporation. For its taxable year ending in 1999, Calvert had an average quarterly investment in U.S. property of $200. No prior investment in U.S. property was made before 1999. Current and accumulated earnings and profits (applicable earnings) were $400. For 1999, the amount included in gross income under section 956(a) is $200, the lesser of $200 or $400. For 2000, the average quarterly investment in U.S. property was $500. Current earnings were $300, and no distributions were made. Applicable earnings for 2000 are $500 ($400 + $300 − $200). The amount included in gross income under section 956(a) is $300, the lesser of (1) $500 − $200 = $300 or (2) $500. Effectively, these rules cause the U.S. shareholder to include in income an amount that represents the CFC's increase in U.S. property holdings to the extent such an amount would have been a dividend if distributed.

A U.S. shareholder may prefer to have its CFC invest in U.S. property (for example, by making a loan to the U.S. parent corporation) rather than have the CFC remit profits by means of a dividend because foreign withholding taxes may be avoided. (Some foreign jurisdictions will recharacterize the investment as a dividend and subject it to withholding tax.) This will produce a lower effective foreign tax rate until an actual dividend is paid, thereby possibly alleviating an excess foreign tax

credit problem. Furthermore, by investing in U.S. property, the U.S. shareholder causes the income to skip over higher-tier corporations, which could not be done if a dividend from the lower-tier corporation was desired (this is often referred to as the *hopscotch rule*). The U.S. shareholder might therefore be able to repatriate earnings with the desired effective foreign tax rate. It is possible, however, that the IRS may treat the investment as a constructive dividend from the lower tier to a higher tier, coupled with an investment in U.S. property by the higher-tier corporation.

One should also note that the inclusion of income from increases in earnings invested in U.S. property under section 956 is not subject to either the de minimis rule or the full-inclusion rule otherwise applicable to foreign base company income under section 954.

Deemed and Actual Distributions of CFC Income

A U.S. shareholder of a CFC must include in gross income deemed distributions under section 951. In addition, a U.S. shareholder may also be required to include in gross income amounts received as distributions from a CFC.

Deemed Distributions From a CFC

Ownership Requirements. A foreign corporation must be a CFC for an uninterrupted period of thirty days during its taxable year before the U.S. shareholders of that foreign corporation are subject to the subpart F provisions (section 951(a)(1)). The thirty-day requirement must be met each year.

A U.S. shareholder who owns stock in a foreign corporation on the last day of the taxable year during which the corporation is a CFC is treated as receiving a deemed dividend from the CFC equal to the shareholder's pro rata share of section 951 income. A U.S. shareholder's pro rata share of subpart F income is computed using the following formula:

$$\text{Pro rata share of subpart F income to U.S. shareholder (before limitations)} = \text{Percent of stock owned at year-end} \times \text{Subpart F income} \times \frac{\text{Number of days the corporation was a CFC}}{\text{Total number of days in the year}}$$

The U.S. shareholder's percent of stock owned includes stock owned directly and indirectly through other foreign corporations using the indirect ownership rules of section 958(a). Again it is noted that for purposes of determining if a U.S. shareholder is subject to subpart F, the attribution rules of section 958(b) apply. For determining the amount of subpart F income attributable to this stock, however, only the rules of section 958(a) apply.

> *Example 8.17.* Gamma Company, a domestic corporation, owns 51 percent of Omega Ltd., a foreign corporation, which in turn owns 51 percent of Xeno Ltd., a foreign corporation. Under the ownership rules of section 958(b), Omega Ltd. and Xeno Ltd. are both CFCs because Gamma Company is considered to own 100 percent of Omega Ltd. and 100 percent of Xeno Ltd. If Xeno Ltd. has $10,000 of subpart F income, Gamma Company will be required to include $2,601 in gross income attributable to stock owned under section 958(a) ($10,000 × 51% × 51%).

If the corporation was controlled for less than the entire year (but for at least thirty consecutive days), subpart F income is reduced to the shareholders on a pro rata basis for every day it was not so controlled. The calculation is based on the year's entire subpart F income. As a result, if a foreign corporation is controlled for only two months of the year, the corporation must still account for subpart F income for the full twelve months. For example, if the corporation was controlled for the first six months of the year and the total year's subpart F income was $1,000, then $496 ($1,000 × 181/365) would be treated as subpart F income on a pro rata basis.

The pro rata share that must be recognized by a U.S. shareholder is not to exceed a pro rata share of earnings and profits of the CFC. Earnings and profits are reduced for blocked income (that is, amounts that may not be paid out because of legal restrictions).

A U.S. shareholder owning CFC stock at year-end is liable for the CFC's entire year's subpart F income. However, relief is provided in situations in which stock is acquired sometime during the year. A dividend paid during the year to a previous shareholder reduces the amount of subpart F income that the present shareholder must recognize. The reduction is limited to the lesser of the following two amounts: (1) the dividend paid to the previous shareholder during the year, or (2) the previous shareholder's pro rata portion of the CFC's subpart F income for the period during which the shareholder owned the CFC stock (Treas. Reg. Sec. 1.951-1(b)).

Example 8.18. Alpha Ltd., a foreign corporation, has $1,000 of subpart F income during the taxable year. Beta Co., a domestic corporation, purchased 100-percent of Alpha from foreign corporation Zeta on March 14 of the taxable year. Alpha was a CFC for 292 days during the year. A dividend of $350 was paid prior to March 14. Beta's pro rata share of Alpha's subpart F income would be $600, computed as follows:

1. Total subpart F income for the entire year	$1,000	
2. Beta's interest in Alpha	× 100%	
3. Beta's pro rata share of total subpart F income	$1,000	
4. Percentage of days in year Alpha was a CFC (292/365)	× 0.80	
5. Subpart F income included in gross income by Beta before reduction of dividends paid to prior shareholders		$800
Less the lesser of:		
6. Dividends paid to prior shareholders	$350	
7. Beta's pro rata share of subpart F income for the entire year	$1,000	
Number of days in the year the stock was not held by Beta (73/365)	× 0.20	
	$200	
8. Lesser of line 6 or line 7		$200
9. Beta's pro rata share of subpart F income (line 5 less line 8)		$600

For tax years beginning after August 5, 1997, if a U.S. shareholder (10-percent shareholder) purchases CFC stock from another U.S. shareholder, the purchaser can reduce its pro rata share of the CFC's subpart F income by the amount of dividend income recognized by the seller under §1248 (section 951(a)(2)(B)). The amount by which the purchaser reduces its subpart F dividend in the year of purchase cannot exceed the seller's pro rata share of the subpart F income for the portion of the year during which the seller owned the CFC stock.

Example 8.19. Alpha Ltd., a foreign corporation, has $1,000 of subpart F income during the taxable year. Beta Co., a domestic corporation, purchased a 100-percent interest in Alpha on March 14 of the taxable year from USCo. Alpha was a CFC for the entire year. USCo recognized a dividend under section 1248 on the sale of the Alpha stock of $500. Beta's pro rata share of Alpha's subpart F income would be $800, computed as follows:

1. Total subpart F income for the entire year	$1,000
2. Beta's interest in Alpha	×100%

3. Beta's pro rata share of total subpart F income	$1,000	
4. Percentage of days in year Alpha was a CFC	×100%	
5. Subpart F income included in gross income by Beta before reduction of dividends paid to prior shareholders		$1,000
Less the lesser of:		
6. Section 1248 dividend recognized by USCo	$500	
7. Beta's pro rata share of subpart F income for the entire year	$1,000	
Number of days in the year the stock was not held by Beta (73/365)	× 0.20	
	$200	
8. Lesser of line 6 or line 7		$200
9. Beta's pro rata share of subpart F income (line 5 less line 8)		$800

The total current earnings and profits of a CFC must be converted to a pro rata share of earnings and profits for each U.S. shareholder.

Blocked Income. Treas. Reg. Sec. 1.964-2 provides that any amount of earnings and profits of a CFC subject to a currency or other restriction imposed under the laws of any foreign country on distributions to shareholders will not be included in earnings and profits for purposes of subpart F, withdrawal of previously excluded subpart F income from investment in foreign shipping operations or less developed countries, and investment of earnings in U.S. property.

Income is considered to be blocked only when it is subject to a currency or other restriction throughout a 150-day period beginning ninety days before the close of the taxable year, and ending sixty days after the close of such taxable year.

A valid restriction or limitation occurs only when payment of dividends to U.S. shareholders is prevented or the ready conversion of currency into U.S. dollars is prevented. A currency restriction will not be considered to exist unless export restrictions are also imposed. Such restrictions must prevent the exportation of property (of a type normally owned by the CFC in the operation of its business) that could be readily converted into U.S. dollars. A currency restriction will not be considered to exist unless the U.S. shareholders have exhausted all available procedures for distribution.

Earnings and profits can be reduced for mandatory reserves placed on a CFC by the laws of a foreign country. Upon removal of the restrictions,

the income previously deferred from taxation is taxable subject to the limits of Treas. Reg. Sec. 1.964-2(c).

Reduction of Earnings and Profits for Deficits. Prior to the enactment of the Tax Reform Act of 1986, a CFC could use a current deficit in earnings and profits in any income category (including nonsubpart F income categories) to offset positive current earnings and profits and thereby reduce the currently taxable distributed subpart F income. In addition, deficits in earnings and profits from prior years could be used to offset current-year earnings and profits (the *accumulated deficit rule*). If the CFC was part of a chain of CFCs, the deficit in earnings and profits of one CFC could be used to offset the earnings and profits of another CFC in the chain (the *chain deficit rule*).

Congress repealed the chain deficit rule for taxable years beginning in 1987 except in limited cases involving mergers and acquisitions. Preacquisition deficits of an acquired corporation may be used to offset postacquisition earnings and profits of the acquiring corporation only to the extent the U.S. shareholders of the acquiring corporation had ownership interests in the acquired corporation when the deficits arose and the acquired corporation was a CFC in that year.

Congress also restricted the use of the accumulated deficit rule (section 952(c)). For taxable years beginning in 1987 and thereafter, only accumulated deficits in foreign base company shipping income, foreign base company oil-related income, subpart F insurance income, or foreign personal holding company (FPHC) income of a CFC may be used to offset the current year's earnings and profits. Such deficits may only be offset against the current earnings and profits relating to the same category of income. (A deficit in FPHC income may be used only to offset current earnings and profits relating to FPHC income.) Deficits arising from insurance income may be carried forward only if the CFC is predominantly engaged in the active conduct of an insurance business in both the year in which the deficit arose and the year to which it is carried. The accumulated deficit rule applies to FPHC income only if the CFC is predominantly engaged in the active conduct of a banking, financing, or similar business.

> *Example* 8.20. In 1999, Theta Corporation, a CFC that is wholly owned by USCo, incurred a $100 deficit in current earnings and profits, $60 of which was due to foreign base company shipping activities and $40 of which was related to foreign base company oil-related activities. In 2000, Theta earned $90 of foreign base company shipping income, $20 of foreign oil-related

income, and $10 of foreign base company services income. Under section 952(c)(2)(B), Theta may offset the full $60 accumulated deficit from foreign base company shipping income against the current earnings and profits from foreign base company shipping income (assumed here to be $90). Only $20 of the accumulated deficit from foreign oil-related activities may offset the $20 of current earnings and profits from foreign base company oil-related income, leaving an accumulated deficit carryforward of $20. None of the accumulated deficit may be used to offset the earnings and profits from foreign base company services income.[33]

Current deficits in earnings and profits of any category of income may be used to offset current earnings and profits from subpart F income. However, section 952(c)(2) recharacterizes any excess current earnings and profits over subpart F income in future years as subpart F income to the extent prior-year deficits reduced subpart F income. Recapture rules similar to the loss recapture rules for the foreign tax credit separate limitation categories are applied to subpart F income recapture (Treas. Reg. Sec. 1.952-1(f)).

Example 8.21. Assume Theta Corporation has a (150u) deficit in its non-subpart F general limitation E&P category in 1999. Theta also has 200u of current E&P in its passive limitation category and 100u of foreign base company sales general limitation income. The passive income qualifies as FPHC income and is subject to subpart F, as is the foreign base company sales income. Theta offsets the 150u deficit in its general limitation nonsubpart F E&P against the 100u of subpart F general limitation income and 50u against the 200u passive E&P. Subpart F income included in the U.S. shareholder's gross income is 150u [limited to total earnings and profits (E&P)]. If in 2000, Theta reports 200u of income in its general limitation nonsubpart F E&P, Theta must recharacterize 100u of the general limitation E&P as subpart F general limitation income and 50u as subpart F passive (FPHC) E&P.[34]

Distributions From a CFC

When a CFC repatriates earnings to its U.S. shareholders, the earnings and profits (E&P) out of which the distribution is made may be comprised of two types of earnings: (1) income not previously taxed to the CFC's U.S. shareholders (that is, non-subpart-F income), or (2) income

[33]This example is taken from the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 985-86.

[34]See Treas. Reg. Sec. 1.952-1(f)(4) for more complex examples.

that has previously been taxed to the CFC's U.S. shareholders under section 951. Section 951 income includes subpart F income and earnings invested in U.S. property. Income that has previously been taxed to the CFC's U.S. shareholders is not included in these shareholders' incomes a second time when distributed or when invested in U.S. property or excess passive assets (section 959(a)). A withholding tax may be imposed by the foreign government on the actual distribution. Special provisions are necessary to allow a foreign tax credit for withholding taxes imposed on distributions of such "previously taxed income" (PTI) (section 960(b)). The objective of section 959 is to prevent the double taxation of a CFC's earnings by the United States.

Maintenance of E&P Accounts. A CFC must maintain separate E&P accounts for each foreign tax credit (FTC) limitation category of income (for example, general limitation, passive, high withholding tax interest). Each E&P account maintained by the CFC is divided into three pools (section 959(c)). These three pools consist of (1) E&P attributable to earnings invested in U.S. property (section 956(a)(2)) and included in shareholder income under section 951(a)(1)(B) and E&P attributable to earnings invested in excess passive assets and included in shareholder income under section 951(a)(1)(C) (the section 959(c)(1) pool); (2) E&P attributable to earnings included in shareholder income as subpart F income under section 951(a)(1)(A) (the section 959(c)(2) pool); and (3) E&P attributable to earnings that have not been subject to U.S. taxation at the shareholder level (the section 959(c)(3) pool). These E&P accounts must be maintained at the shareholder level (only one E&P account must be maintained for each FTC limitation category if the CFC is a wholly owned subsidiary of a U.S. corporation). A CFC may elect to combine its two E&P accounts that contain PTI (the section 959(c)(1) and section 959(c)(2) pools).

Distributions From the E&P Pools. Distributions from a CFC are taxable only to the extent they are paid out of the section 959(c)(3) E&P pool. A CFC distribution is treated as paid from the current and accumulated E&P from one E&P pool before it is treated as paid from a second E&P pool. The E&P pools from which a distribution is deemed paid are ordered as follows: (1) section 959(c)(1) E&P is distributed first; (2) section 959(c)(2) E&P is distributed second; and (3) section 959(c)(3) E&P (taxable distributions) is distributed last. Previously taxed income (the section 959(c)(1) and section 959(c)(2) pools) is treated as distributed

on a last-in, first-out (LIFO) basis. Section 959(c) states that "section 316 shall be applied by applying paragraph (2) thereof, and then paragraph (1)." If more than one E&P account is maintained (that is, the CFC has income in more than one foreign tax credit limitation basket), a previously taxed income distribution is treated as paid pro rata from each account. Distributions from the section 959(c)(3) pool are eligible for the section 902 credit, and the E&P pool is maintained on a cumulative basis (that is, the E&P and foreign taxes are "pooled" within the pool).

Example 8.22. Fortuna PLC, a wholly owned subsidiary of Bonanza Corporation, a U.S. corporation, reported the following amounts in its general limitation E&P account (assume this is the only E&P account):

	Classification of E&P (in u)		
Year	*(c)(1)*	*(c)(2)*	*(c)(3)*
1996	-0-	300	200
1997	-0-	400	500
1998	100	200	600
1999	200	100	300
	300	1,000	1,600

During 1999, Fortuna made a distribution of 900u to Bonanza Corporation. The distribution is deemed to be paid out of the following E&P pools:

Amount	*Year*	*E&P Pool*
200	1999	(c)(1)
100	1998	(c)(1)
100	1999	(c)(2)
200	1998	(c)(2)
300	1997	(c)(2)
900		

The entire distribution is treated as previously taxed income because it is deemed paid from the section 959(c)(1) and section 959(c)(2) pools. Fortuna's remaining balances in its E&P pools are as follows:

Year	*(c)(1)*	*(c)(2)*	*(c)(3)*
1996	-0-	300	200
1997	-0-	100	500
1998	-0-	-0-	600
1999	-0-	-0-	300
	-0-	400	1,600

Distributions of PTI Through CFC Tiers. When previously taxed income (PTI) of a lower-tier CFC is distributed to a higher-tier CFC or to the U.S. shareholder, such income is not taxed a second time to the U.S. shareholders (section 959(b)). Under section 959(b), PTI retains its section 959(c) characteristics when it is distributed from a lower-tier CFC to a higher-tier CFC. Previously taxed subpart F income (section 959(c)(2) E&P pool) distributed from a second-tier CFC to a first-tier CFC is added to the first-tier CFC's section 959(c)(2) E&P pool. The PTI is added to the "layer" (year) in the section 959(c)(2) E&P pool in which the subpart F income was included in the U.S. shareholder's income (Treas. Reg. Sec. 1.959-3(b)(3)). PTI of a lower-tier CFC in a higher-tier CFC's E&P pool is considered paid to the U.S. shareholder before the PTI of the higher-tier CFC.

Example 8.23. Gemini corporation, a U.S. corporation, owns 100 percent of Castor Corporation, a foreign corporation. Castor Corporation owns 100 percent of Pollux Corporation, also a foreign corporation. Castor and Pollux have the following amounts in their general limitation E&P accounts (in u):

Castor Corporation

Year	*(c)(1)*	*(c)(2)*	*(c)(3)*
1996	-0-	300	200
1997	-0-	400	500
1998	100	200	600
1999	200	100	300
	300	1,000	1,600

Pollux Corporation

Year	*(c)(1)*	*(c)(2)*	*(c)(3)*
1996	-0-	100	400
1997	-0-	200	300
1998	100	300	200
1999	200	400	100
	300	1,000	1,000

During 1999, Pollux Corporation distributed 1,200u to Castor Corporation. The distribution is deemed to be paid out of the following E&P pools:

Amount	*Year*	*E&P Pool*
200	1999	(c)(1)
100	1998	(c)(1)

Amount	*Year*	*E&P Pool*
400	1999	(c)(2)
300	1998	(c)(2)
200	1997	(c)(2)
1,200		

The entire distribution would be treated as a distribution of Pollux's PTI and would be added to Castor's layers of E&P in the same pools out of which the distribution was deemed paid. Castor's E&P balances would now be as follows:

Year	*(c)(1)*	*(c)(2)*	*(c)(3)*
1996	-0-	300	200
1997	-0-	600	500
1998	200	500	600
1999	400	500	300
	600	1,000	1,600

Any withholding taxes paid by Castor on the receipt of the distribution reduce the amount of the distribution included in the E&P categories (it is not offset by a section 78 gross-up). Such taxes increase Castor's pool of post-1986 foreign taxes paid for purposes of any deemed-paid credits on distributions to Gemini Corporation.

Exchange Gain or Loss on PTI Distributions. A U.S. shareholder may be required to recognize an exchange gain or loss (ordinary income or loss) due to exchange rate fluctuations between the time of the deemed distribution and the time of the actual distribution (section 986(c)). The exchange gain or loss is computed from the total pool of E&P even though PTI is treated as distributed on a year-by-year basis. In order to compute exchange gain or loss, PTI must be maintained in the CFC's functional currency and in U.S. dollars. When PTI is distributed, the CFC must calculate the "dollar basis" attributable to that PTI from the pool of post-1986 E&P from which it is distributed. The dollar basis of the PTI distributed is computed as follows:

$$\begin{array}{c}\text{Dollar basis of post-}\\ \text{1986 PTI less the}\\ \text{dollar basis of prior-}\\ \text{year distributions of}\\ \text{post-1986 PTI}\end{array} \times \frac{\text{Units of PTI distributed in functional currency}}{\begin{array}{c}\text{Total units of PTI for post-1986}\\ \text{years less prior distributions}\\ \text{of post-1986 PTI}\end{array}}$$

The exchange gain or loss is the difference between the dollar value of the actual PTI distribution (translated at the spot rate at the date of dis-

tribution) and the dollar basis attributed to the PTI distribution (computed above).

Example 8.24. Calliope Corporation is a 100%-owned foreign subsidiary of Muse Corporation, a U.S. corporation. Calliope Corporation's section 959(c)(2) E&P pool for its general limitation income is as follows:

Year	*Functional Currency (u)*	*U.S. Dollars*
1999	1,000	$ 2,000 (1u:$2.00)
1998	2,000	3,500 (1u:$1.50)
1997	4,000	7,000 (1u:$1.75)
1996	1,000	1,500 (1u:$1.50)
	8,000	$14,000

During 1999, Calliope Corporation made a 4,000u distribution to Muse Corporation out of its section 959(c)(2) E&P at a time when the exchange rate was 1u:$1.85. In dollars, the distribution is $7,400. The dollar basis attributable to the PTI distribution is computed as follows: $14,000 × 4,000u/8,000u = $7,000. Even though the PTI distribution is nontaxable, Muse Corporation must recognize an exchange gain under section 986(c) of $400 ($7,400 − $7,000) on the actual distribution (this is treated as ordinary income).

If there exists more than one category of FTC income, the exchange gain or loss must be computed separately for each income category. PTI is treated as distributed pro rata out of the E&P of each separate FTC category using the following formula:

$$\text{Distribution of PTI attributable to the taxable year} \times \frac{\text{PTI in each separate category for that year}}{\text{Total PTI in all separate categories for that year}}$$

Example 8.25. Assume in the previous example that Calliope had two FTC categories of section 959(c)(2) E&P: general limitation and passive. The account balances are as follows:

General Limitation

Year	*Functional Currency (u)*	*U.S. Dollars*
1999	1,000	$ 2,000 (1u:$2.00)
1998	2,000	3,500 (1u:$1.50)
1997	4,000	7,000 (1u:$1.75)
1996	1,000	1,500 (1u:$1.50)
	8,000	$14,000

Passive

Year	*Functional Currency (u)*	*U.S. Dollars*
1999	1,000	$ 2,000 (1u:$2.00)
1998	2,000	3,500 (1u:$1.50)
1997	-0-	-0- (1u:$1.75)
1996	1,000	1,500 (1u:$1.50)
	4,000	$ 7,000

During 1999, Calliope Corporation made an 8,000u distribution to Muse Corporation out of its section 959(c)(2) E&P at a time when the exchange rate was 1u:$1.85. In dollars, the distribution is $14,800. The dollar basis attributable to the PTI distribution must be allocated between general limitation and passive income as follows:

Year	*General Limitation*	*Passive*
1999	1,000	1,000
1998	2,000	2,000
1997	2,000	-0-
	5,000	3,000

The dollar basis attributable to the PTI distribution from general limitation income is computed as follows: $14,000 × 5,000u/8,000u = $8,750. The dollar basis attributable to the PTI distribution from passive income is computed as follows: $7,000 × 3,000u/4,000u = $5,250. Muse Corporation recognizes an exchange gain of $500 on the distribution from the general limitation category as follows: $9,250 ($1.85 × 5,000u) − $8,750 = $500. Muse Corporation recognizes an exchange gain of $300 on the distribution from the passive limitation category as follows: $5,550 ($1.85 × 3,000u) − $5,250 = $300. This exchange gain is included in Muse Corporation's FTC basket for general limitation income ($500) and passive income ($300).

Election by Individuals to Be Subject to Tax at Corporate Rates

Section 962 provides that U.S. shareholders of a CFC who are individuals, trusts, or estates may elect to be taxed on undistributed section 951(a) income at domestic corporate rates. This election is made by filing a statement with the U.S. shareholder's return (Treas. Reg. Sec. 1.962-2(b)). Section 962 provides a second temporary benefit to electing taxpayers by allowing a deemed-paid foreign tax credit to be taken for foreign income taxes paid by a CFC. Individuals are not ordinarily allowed to take a deemed-paid foreign tax credit.

Section 962(c) provides that each electing U.S. shareholder is allowed to use the corporate graduated rate brackets only once. If a U.S. shareholder has section 951 income from more than one CFC, all such income must be combined for tax computation purposes.

The deemed-paid credit allowed to individuals is only temporarily allowed. When the previously taxed income (under section 962) is later distributed, the distribution must be recognized as income to the extent that earnings and profits (E&P) of the CFC exceed the income taxes paid by such a shareholder (section 962(d)). In other words, the only benefit allowed for taxes previously paid under this election is a deduction, not a credit.

The election achieves a deferral from U.S. taxation, the value of which depends on the marginal tax bracket of the U.S. shareholder and the length of deferral (time value of temporary savings).

Adjustments to the Basis of Stock in a CFC

Section 961 provides that the basis of a U.S. shareholder's stock in a CFC is increased by the amount required to be included in gross income under section 951(a). In the case of a U.S. shareholder who has elected to be taxed as a corporation under section 962, the increase in basis cannot exceed an amount equal to the amount of tax paid with respect to the section 951(a) income (Treas. Reg. Sec. 1.961-1(a)(2)).

Distributions that are excluded from gross income under section 959(a) reduce the basis of a U.S. shareholder's stock (Treas. Reg. Sec. 1.961-2(a)(2)). A U.S. shareholder who has elected to be taxed as a corporation under section 962 cannot reduce the basis of stock by an amount exceeding the amount excluded from gross income under section 959(a) after section 962(d) is applied.

Tax Years of Controlled Foreign Corporations

Section 898 requires that certain CFCs (a "specified foreign corporation") adopt the same tax year as their majority U.S. shareholder. CFCs are subject to this rule when a U.S. shareholder owns, on each "testing day," more than 50 percent of the total voting power or the total value of stock of the CFC. The testing days are either (1) the first day of the CFC's taxable year; or (2) the days during a representative period prescribed by

regulations. The CFC may elect a taxable year that begins one month earlier than the tax year of the majority U.S. shareholder. Tax year conformity is only required if the specified foreign corporation generates includable subpart F or foreign personal holding company (FPHC) income (Prop. Treas. Reg. Sec. 1.898-1(c)(1)).

Estimated Taxes

U.S. shareholders must include, on a current basis, their share of subpart F income in the calculation of estimated taxes using the annualization method. Subpart F income must be taken into account for estimated tax purposes in a manner similar to the manner in which partnership income is taken into account. Foreign tax credits allocable to includable subpart F income are to be taken into account in making the estimated tax computation. A safe harbor is provided for corporate taxpayers that own directly or indirectly more than 50 percent of the corporation's stock (vote or value). Such taxpayers can elect to pay annualized estimated taxes based on 115 percent of the corporation's "relevant prior-year inclusions." The relevant prior year is the second preceding year for first- and second-quarter installment payments and the first preceding year for third- and fourth-quarter payments. For all other shareholders, the safe harbor is reduced to 100 percent of the relevant prior-year inclusions.

9

Rules for Foreign Personal Holding Companies

Ever since the corporation has been a separate taxable entity, shareholders have attempted to accomplish certain tax savings by using the corporation as a tax shelter. Congress has enacted several laws to prevent corporations from being used for nonbusiness and tax-avoidance purposes. In 1921 Congress passed the accumulated earnings tax to encourage the payment of dividends by corporations with accumulations beyond "reasonable needs." The imposition of this tax is based on a subjective requirement that the government show that the corporation was "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders" (section 532(a)).

In 1934 Congress passed the personal holding company provisions, which took a more objective approach to curtailing shareholder abuse of corporate entities. The provisions established mechanical tests that, when met, assessed a penalty tax to a corporation on its undistributed personal holding company income. These provisions, however, did not effectively reach and curtail abuses in U.S. taxpayers' use of foreign corpora-

tions to accomplish similar U.S. tax savings. Foreign corporations provided opportunities such as the following:

- Sheltering passive income (such as interest or dividends) from high U.S. individual taxes (that is, "incorporated pocketbooks")
- Holding appreciated property, which on a subsequent sale could realize a gain outside the United States and, therefore, not be subject to current U.S. taxation
- Generating deductions against U.S. taxable income that amounted to little more than shifting funds (for example, borrowing from a foreign corporation and paying interest to that corporation)
- Assigning income from personal services so that it would be taxed at lower foreign income tax rates
- Leaving accumulations in a foreign corporation until death, with ownership being transferred to the heirs at a new stepped-up fair market value basis
- Converting the accumulations in foreign corporations from ordinary income into long-term capital gains by liquidation of the foreign corporation or sale of its stock rather than by dividend distributions

In 1937 Congress passed the foreign personal holding company (FPHC) provisions, presently constituting sections 551 through 558, to curb tax avoidance through foreign corporations. Under these provisions, U.S. shareholders are taxed by the United States on their pro rata share of the undistributed FPHC income of a foreign corporation that is an FPHC. The income is taxed as if the foreign corporation paid out a dividend to a U.S. shareholder who, in turn, made a subsequent capital contribution to the foreign corporation. Unlike the regular personal holding company provisions (sections 541-547), the *U.S. shareholders* are taxed instead of the corporation. Jurisdictional and enforcement problems are the principal reasons for taxing the U.S. shareholders of the foreign corporation. Similar to the personal holding company, an FPHC is not subject to the accumulated earnings tax (section 532(b)(2)).

A foreign corporation may be a personal holding company or an FPHC. If the requirements for FPHC provisions are not met, the corporation may still be treated as a personal holding company, in which case its undistributed U.S.-source income may be subject to the penalty tax of 39.6 percent (see section 542(c)(5), which excludes an FPHC from the definition of a personal holding company). An FPHC may also be subject to U.S. withholding tax imposed by sections 881 and 882.

In addition, if income is taxed to shareholders under both the subpart F and the FPHC provisions, the subpart F rules take precedence over the FPHC rules with respect to that income (section 951(d)).

Statutory Requirements

An FPHC is a foreign corporation that satisfies the following requirements:

1. At any time during the year, more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote, or more than 50 percent of the value of stock, is owned, directly or indirectly, by or for not more than five individuals who are U.S. citizens or residents (stock ownership requirement).
2. At least 50 percent (60 percent for the initial year of qualification) of its gross income is FPHC income (gross income requirement).

Section 552(b) states that the FPHC provisions apply to any foreign corporation except the following: (1) a corporation exempt from tax under subchapter F, which, listed at sections 401(a) and 501(c) and (d), includes nonprofit organizations such as private foundations, farmers' cooperatives, civic leagues, business leagues, fraternal beneficiary societies or orders, teacher retirement fund associations, and pension plan trusts; and (2) a banking corporation, provided it can show it was not formed or availed of for the purpose of evading or avoiding U.S. income taxes on its shareholders. The regulations (Treas. Reg. Sec. 1.552-4) contain the procedures for making such attestations.

Stock Ownership Requirement

For a foreign corporation to be considered an FPHC, more than 50 percent of the total value or total combined voting power of its outstanding stock must be owned, directly or indirectly, by or for not more than five *individuals* who are citizens or residents of the United States (these persons are referred to as the "United States group"). This requirement is met if such ownership exists at any time during the taxable year. All forms and classes of outstanding stock are taken into account for these purposes. In the FPHC provisions, the stock ownership rules are used—

- To determine if a foreign corporation's stock ownership is such (more than 50 percent) that it is an FPHC (section 552(a)(2)).

- To determine if personal service contract income (25 percent or more) and rents from certain shareholders (25 percent or more) are to be included as FPHC income (sections 553(a)(5) and 553(a)(6)).
- To determine who is to recognize dividend income from an FPHC and the amount of dividend income (section 551(a)).

Five or Fewer Individuals

In determining whether the foreign corporation is an FPHC, the statute and regulations confine the stock ownership requirement to the stock held directly or indirectly by U.S. citizens and residents who are individuals (section 552(a)(2)). Stock owned by other entities (corporations, partnerships, estates, and trusts) may be attributed to individuals using the constructive ownership rules of section 554. At least one court interpreted the term *individual* as it was used in the 1939 Code FPHC stock requirement provisions to include domestic corporations.[1] Once FPHC status is reached, the U.S. shareholders who are deemed to receive undistributed FPHC income are expanded to include domestic corporations, partnerships, estates, and trusts (section 551(a)).

Value or Voting Power

The stock ownership tests are based on the total value or combined voting power of the stock. The regulations state that value is to be determined based on the company's net worth, earning and dividend-paying capacity, appreciation of assets, plus all other factors bearing on the value of the stock (Treas. Reg. Sec. 1.552-3(c)). Treasury stock is not included in the value tests. This approach places a value on total shares of stock outstanding. Difficulties arise when different classes of stock are outstanding, and in such cases, value must be allocated among them. Further guidelines for determining value have been established by the courts and by Rev. Rul. 59-60.[2] The voting-power test was added by the Tax Reform Act of 1986 to make the FPHC stock ownership requirement test consistent with the controlled foreign corporation stock ownership tests found in section 957. As with other voting-power tests, voting power is generally determined by the shareholders' ability to elect members of the board of directors.

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[1] *Rodney, Inc. v. Hoey*, 53 F. Supp. 604 (S.D.N.Y. 1944).

[2] Rev. Rul. 59-60, 1959-1 C.B. 237. See *Mariani Frozen Foods, Inc.*, 81 T.C. 448 (1983).

Stock Owned Directly or Indirectly

For purposes of determining whether the more than 50-percent stock ownership requirement of section 552(a)(2) and the 25-percent stock ownership thresholds of sections 553(a)(5) and 553(a)(6) are met, an individual must take into account shares of stock that are constructively owned under the rules of section 554. Shares can be constructively owned through other entities (corporation, partnership, estate, or trust), family members, and options. Section 554 does not apply in determining the amount of dividend income a U.S. shareholder reports from an FPHC under section 551(b); only direct ownership is applicable in making that determination.

Corporation, Partnership, Estate, or Trust. Stock of a foreign corporation owned by a corporation, partnership, estate, or trust is considered owned proportionally by the respective shareholders, partners, or beneficiaries (section 554(a)(1)). Stock of a corporation is attributed to the shareholders regardless of their ownership percentage in the corporation. Although no specific mention is made about how different classes of stock are to be taken into account, Treas. Reg. Sec. 1.544-1(c) states that "all forms and classes of stock, however denominated . . . shall be taken into consideration in applying the constructive ownership rules." Stock from a trust or estate is attributed to the present and future beneficiaries in proportion to their actuarial interests.[3]

> *Example 9.1.* An individual owns 100 percent of a domestic corporation, which owns 40 percent of a foreign corporation. The shareholder of such domestic corporation is deemed to own 40 percent of the foreign corporation under section 554(a)(1).

Family and Partnership Ownership. An individual is deemed to own the shares of stock owned, directly or indirectly, by or for his or her partners, brothers and sisters (whether by whole or half blood), spouse, ancestors, and lineal descendants (section 554(a)(2)). Stock owned by aunts and uncles is not attributed to an individual.[4]

> *Example 9.2.* Mary McArdle owns 100 shares of Beta Corporation, a foreign corporation. Mary's great-grandson also owns 10 shares of Beta Corporation.

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[3]Rev. Rul. 62-155, 1962-2 C.B. 132.

[4]Rev. Rul. 59-43, 1959-1 C.B. 146.

Mary is deemed to own 110 shares for purposes of the stock ownership test in determining if Beta Corporation is an FPHC.

There are two exceptions to the family and partnership ownership rule. Stock owned by a nonresident alien (other than a foreign trust or estate) is not attributed to family members listed in section 552(a)(2) who are U.S. citizens or resident aliens and who do not own shares of stock in the foreign corporation, either directly or through attribution (other than family attribution) (section 554(c)(1)). A U.S. citizen or resident alien spouse of a nonresident alien is deemed to own the nonresident alien's shares through family attribution. Prior to this change, which was enacted in the Tax Reform Act of 1984, the Tax Court had held that attribution of stock owned by two Canadian sisters should not be made to their brother, who was a U.S. citizen and owned no stock in the foreign corporation.[5]

Example 9.3. Jon and Cosette Valjean, both of whom are nonresident aliens, own 60 percent and 40 percent, respectively, of Javert Sarl, a foreign corporation. Victoria Hugo, a U.S. citizen, is Jon's sister. Victoria is not attributed to own Jon's shares in Javert Sarl for purposes of the stock ownership test in determining if Javert Sarl is an FPHC. If Victoria owned any shares in Javert Sarl directly, she would be attributed to own Jon's shares in Javert Sarl.

The second exception pertains to stock owned by a nonresident alien who is a partner of a U.S. citizen or resident alien. U.S. partners are not attributed ownership of the stock of their nonresident alien partners if the U.S. partners do not own stock in the foreign corporation, either directly or by attribution other than attribution through partners (section 554(c)(2)).

Example 9.4. Joy Church, a nonresident alien, owns 60 percent of foreign corporation Zeta. Joy's partner, William Temple, a U.S. citizen, does not own any stock in Zeta. William is not deemed to own any stock in Zeta for purposes of the stock ownership test in determining if Zeta is an FPHC. If William or his spouse, brother, sister, ancestor, or lineal descendant (who also is a U.S. citizen or resident alien) owns any stock in Zeta, then William will be deemed to own Joy's stock in Zeta.

Options and Convertible Securities. Stock that may be acquired by option is considered owned by the holder of the option.[6] The Internal Revenue

[5] *Estate of Nettie S. Miller*, 43 T.C. 760 (1965), *nonacq*. 1966-1 C.B. 4.

[6] Rev. Rul. 82-150, 1982-2 C.B. 110.

Service (IRS) has interpreted options to include warrants and debentures for purposes of the option rules of section 318(a)(4).[7] In addition, the IRS has held that an option that is exercisable only after a lapse of time is still an option for purposes of the attribution rules of section 318(a)(4).[8] Presumably these two rulings would also apply to the option attribution rules applicable to FPHCs. Securities of a foreign corporation that are convertible into stock of a corporation are considered outstanding stock and are subject to attribution when the effect would be to make the corporation an FPHC (section 554(b)). The option attribution rule takes precedence over the family and partnership attribution rules (section 554(a)(6)).

Reattribution. Section 554(a)(5) provides that stock constructively owned by a person is treated as actually owned by such person for purposes of reattributing the stock to other persons. These reattribution rules apply to stock owned due to section 554(a)(1) (from corporations, partnerships, estates, or trusts) and section 554(a)(3) (from options). Stock constructively owned through either of these two rules may be reattributed under section 554(a)(1) or section 554(a)(2) (family and partnership ownership). Stock constructively owned by an individual through section 552(a)(2) (family and partnership) is not reattributed to another person under the family and partnership rules (that is, there is no "double family attribution").

> *Example* 9.5. Tim's wife, Mary, owns all of the stock of Downers Corporation, a domestic corporation. Downers Corporation in turn owns all of the stock of Grove Corporation, a foreign corporation. Mary is attributed to own all of the stock of Grove Corporation through section 554(a)(1) (from a corporation, partnership, estate, or trust) for purposes of determining if the stock ownership test of section 552(a)(2) is met. If Mary was a nonresident alien and Tim was a U.S. citizen, then for purposes of determining if the stock ownership test is met with regard to Grove Corporation, Mary is treated as actually owning the Grove Corporation stock and such stock is reattributed to Tim through section 554(a)(2) (from family). The prohibition against family attribution from a nonresident alien individual to a U.S. citizen or resident alien (section 554(c)(1)) does not apply because Tim is Mary's spouse.

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[7]Rev. Rul. 68-601, 1968-2 C.B. 124.

[8]Rev. Rul. 89-64, 1989-1 C.B. 91.

Gross Income Requirement

The second requirement necessary for a foreign corporation to be considered an FPHC is that at least 60 percent of its gross income for a taxable year is *foreign personal holding company income*, as defined in section 553. Once a corporation is classified as an FPHC, the minimum percentage for subsequent years is reduced from at least 60 percent to at least 50 percent. A foreign corporation otherwise satisfying the FPHC provisions is considered as such unless the gross income requirement is not met for three consecutive taxable years.

Gross Income

Correct calculation of the *gross income* of a foreign corporation is essential for this test. Section 555 and the related regulations provide that the gross income of a foreign corporation that is a personal holding company is computed according to the rules for domestic personal holding companies. The gross income thus includes income from worldwide sources and is not limited to U.S.-source income or income connected with a U.S. trade or business. It does not, however, include income that is specifically excluded from gross income under provisions of the Code (such as proceeds from life insurance, gifts, and interest on municipal obligations). Dividends from controlled foreign corporations (CFCs) excluded under section 959(b) are also excluded from gross income. Exclusions provided only by treaties cannot be excluded from gross income for purposes of this test.

Special look-through rules apply to include certain "related-person dividend or interest" in the calculation of gross income and FPHC income (section 552(c)). A *related-person dividend or interest* is any dividend or interest received from a person that (1) is related to the recipient (as defined in section 954(d)(3)), (2) is not an FPHC, (3) is created or organized in the same country as the recipient corporation, and (4) has a substantial part of its trade or business assets located in such foreign country (section 552(c)(2)). A *related person* is defined in section 954(d)(3) as a person (individual, corporation, partnership, trust, or estate) that controls, or is controlled by, an FPHC, or is a corporation, partnership, trust, or estate that is controlled by the same person or persons who control the FPHC. *Control* is defined as the direct or indirect ownership of stock possessing more than 50 percent of the total voting power or total value of the FPHC. Although this related-person dividend or interest is included in the definition of gross income (that is, the denominator of the gross

income test), such income is treated as FPHC income only to the extent it is attributable to income (that is, paid out of earnings and profits) of the related person that would be FPHC income. Whether the dividend or interest is attributable to the FPHC income of the related person is determined using rules similar to the foreign tax credit look-through provisions in sections 904(d)(3)(C) and (D).

Example 9.6. The entire amount of foreign corporation Alpha's income is from dividends received from wholly owned foreign corporation Beta organized and operating in the same country as Alpha. Beta Corporation is not an FPHC, and 40 percent of its earnings and profits is from FPHC income. For purposes of the gross income requirement, Alpha Corporation is deemed to have FPHC income that is 40 percent of its gross income and will not be considered an FPHC.

It should be emphasized that the basis for this test is gross income, not gross receipts. Gross income is computed under section 61. Gross income from transactions involving property (whether from inventory or other properties) is gross receipts less the cost of goods sold or basis of property sold.

When an FPHC holds stock in another FPHC for purposes of the gross income test, the gross income of the first corporation must be increased by its share of the undistributed FPHC income from the second corporation. This income is considered dividend income. The purpose of this provision is to prevent the evasion of the FPHC provisions by forming chains of foreign corporations. In making this computation, the first corporation includes as a dividend in its gross income its pro rata share of the second corporation's undistributed FPHC income as of the last day of the second corporation's taxable year in which it is owned by a U.S. group. The income is included in the taxable year of the first corporation in which the second corporation's tax year ends.

Example 9.7. Foreign corporation Theta is wholly owned by Jane McCarthy, a U.S. citizen. Theta Corporation owns all of foreign corporation Kappa. Both Theta and Kappa have a December 31 taxable year-end. (An FPHC or a CFC that is 50-percent-or-more owned by a single U.S. shareholder is required under section 898 to adopt the same taxable year-end as the majority shareholder.) At year-end, Kappa has undistributed FPHC income of $100,000. Theta will include the $100,000 as a dividend in determining its undistributed FPHC income that is to be included in the gross income of Jane only if Theta meets the definition of an FPHC after taking the dividend into account. Both Theta and Kappa also meet the definition of a CFC in this example. The subpart F rules, if applicable, take precedence over the

FPHC rules. (The subpart F rules may not apply if FPHC income is below the de minimis amount.)

Definition of FPHC Income

Section 553 lists the following categories of income that constitute FPHC income.

Dividends. This category includes distributions from a corporation that are considered dividends under the normal meaning of section 316. The term also includes constructive dividends from the corporation's ownership in other FPHCs.

Interest. This includes amounts received, imputed, or both received and imputed, from the lending of money.

Royalties. This term includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property. Also included are amounts received as royalties from minerals, oil, and gas.

Annuities. These include only the taxable portions of the annuities that are determined under section 72.

Stocks and Securities. The excess of the gains over the losses from such transactions is to be included. However, transactions by regular dealers (corporations with an established place of business that is regularly engaged in the purchase and resale of stocks and securities) are to be excluded. A regular dealer must include the transactions from stock and securities that are held for investment purposes only.

Commodity Transactions. The excess of gains over losses from certain designated transactions is to be included. The designated transactions are futures transactions in any commodity subject to the rules of a board-of-trade or commodity exchange. These do not include transactions by a producer, processor, merchant, or handler of the commodity that arise from bona fide hedging transactions necessary and customary to such business.

Estates and Trusts. Income that must be included by a corporation from an estate or trust and gains from the sale or disposition of any interest in an estate or trust constitutes FPHC income.

Personal Service Contracts. Prior to the enactment of the FPHC provisions, tax savings on income from personal services could be achieved by assigning the income to a foreign corporation. This procedure was referred to generally as *incorporating talent*. At present, amounts received by a foreign corporation for personal services rendered constitute FPHC income (1) if some person other than the corporation can designate the individual who is to perform such services or if the person who is to perform the services is designated in a contract and (2) if the person who has performed such services has owned, directly or indirectly, at any time during the taxable year 25 percent or more of the outstanding stock of the corporation (sections 553(a)(5) and 553(a)(6)).

> *Example* 9.8. Sam Drury, a professional actor, owns all the stock of foreign corporation London Ltd. London Ltd. enters into a contract with Sam in which Sam agrees to work for London Ltd. for £50,000 per year. London Ltd. enters into a contract with Theatre Corporation in which Sam is designated to perform services for the Theatre Corporation, and Theatre Corporation is to pay London Ltd. £50,000. The £50,000 received by London Ltd. constitutes FPHC income.

Rents. Amounts received from the use of, or the right to use, property are FPHC income unless they constitute 50 percent or more of a foreign corporation's gross income. Rents include charter fees for the use of, or the right to use, property. Rents do not include interest on debts owed the corporation that represent the price paid for real property held primarily for sale to customers in the ordinary course of the corporation's trade or business (Treas. Reg. Sec. 1.553-1(a)). Rents also do not include income from the use of corporate property by an individual shareholder who owns 25 percent or more of the corporation.

Use of Corporate Property by a Shareholder. Rents received from any individual shareholder, who at any time during the taxable year owns 25 percent or more of the outstanding stock of a corporation, will constitute FPHC income and will not be included in the 50-percent-of-rental-income test discussed above. The purpose of this rule is to prevent the practice of avoiding the FPHC provision by merely renting more corporate assets to influential shareholders and thereby deriving at least 50 percent of gross income from rents. This separate treatment of such rents is not applicable unless a corporation's FPHC income, without the rents from these shareholders, exceeds 10 percent of its total gross income.

An exception to the definition of FPHC income was created by Congress in the Tax Reform Act of 1986 for "active business computer software royalties" (section 553(a)(1)). Such royalties are defined in section 543(d) and generally must meet the following criteria:

1. The royalties are derived by a corporation that is actively engaged in the trade or business of developing, manufacturing, or producing computer software.
2. The software royalties constitute at least 50 percent of the corporation's gross income.
3. The business and research expenses related to the royalties are at least 25 percent of ordinary gross income.
4. The dividends must be at least equal to the excess of personal holding company income over 10 percent of ordinary gross income.

For purposes of this exception, a corporation that is a member of an affiliated group is treated as having met the foregoing criteria if another member of the group meets the criteria.

A foreign corporation may be conducting an active business and, over a period of time, investing excess working capital in stocks, bonds, and savings accounts without concern, since passive income is much less than 60 percent of its total gross income. If active business income declines significantly because of a prolonged strike or a casualty that curtails operations, the corporation may inadvertently fall into the FPHC trap.

Undistributed FPHC Income

The U.S. shareholders of a corporation that passes the stock ownership and gross income tests and is classified as an FPHC are taxed on their respective shares of the undistributed FPHC income of such a corporation (section 551(b)). The term *undistributed FPHC income* is misleading because it may be interpreted as including only passive types of income subject to constructive dividend taxation. However, the term includes all the taxable income of a foreign corporation plus and minus some statutory adjustments explained below. In other words, income that is not FPHC income must also be included in the income of the shareholders.

Example 9.9. Foreign corporation Phi is an FPHC that has $600 FPHC income and $400 that is not FPHC income. Sue Ward, a U.S. citizen, owns all the stock of Phi Corporation. Sue must recognize $1,000 in gross income on account of her ownership in Phi.

Adjustments

In computing undistributed FPHC income, the following adjustments are to be made to the taxable income of a foreign corporation:

1. A deduction is allowed for federal income and excess profits taxes. A deduction is not allowed for the accumulated earnings tax or the domestic personal holding company tax (Treas. Reg. Sec. 1.556-2(a)(1)(i)). The taxes must be deducted on the accrual basis, regardless of the method of accounting used by the taxpayer, except that the corporation may deduct taxes paid rather than accrued if it satisfies the provisions of Treas. Reg. Sec. 1.556-2(a)(1)(ii). Taxes paid to foreign countries and U.S. possessions are deductible under section 164. Therefore, a deduction for such taxes is not allowed again in computing undistributed FPHC income unless the deduction was disallowed by section 275(a)(4). An unpaid tax that is being contested is not considered accrued until the contest is settled.
2. Charitable contributions are normally deductible by a corporation up to a limit of 10 percent of its taxable income (before contributions, the dividends-received deduction, and any net operating and net capital loss carrybacks). However, the higher limitations of 50, 30, and 20 percent normally applicable to individuals can be used by an FPHC for these purposes.
3. Special deductions allowed to corporations by sections 241 through 247 (that is, dividends-received deductions) are disallowed and must be included to arrive at undistributed FPHC income.
4. In the case of a net operating loss allowed under section 172 (that is, a loss from a U.S. trade or business), only a one-year carryover is allowed instead of the regular two-year carryback and twenty-year carryover. In computing the amount of the net operating loss carryover, the special deductions of sections 241 through 247 are not allowed.
5. Deductions regularly allowable against rental income under sections 162 and 167 are limited to the amount of rental income. The limitation will not apply, however, where it can be shown that the rental income was the highest obtainable, that the property was held for a profit motive, and that there was a reasonable expectation of making a profit.
6. Deductions normally allowed under section 164(e), for shareholder taxes paid by the corporation, and section 404, for employer contributions to employees' trusts, are not deductible.

Dividends-Paid Deduction

To compute undistributed FPHC income, taxable income as adjusted above is reduced by dividends paid during the taxable year and consent dividends (section 561).

Dividends Paid During the Taxable Year. In computing undistributed FPHC income, taxable income is reduced by dividends that are actually paid during the taxable year by a foreign corporation to its shareholders on a pro rata basis and that are taxable to them. To be eligible for a deduction, the dividends must be placed outside the control of the corporation and must be received by the shareholders during the taxable year for which the deduction is claimed. Section 563(c) provides a special rule that a distribution made by a corporation within two and one-half months from the end of its taxable year shall be considered as made on the last day of such taxable year for these purposes.

A dividends-paid deduction is not allowed for "preferential dividends" (section 562(c)). A *preferential dividend* is defined as (1) a distribution to a shareholder of a particular class of stock that is not pro rata when compared with the distributions made to other shareholders of the same class or (2) a distribution of a class of stock that is more or less than the amount to which the class is entitled as compared with any other class of stock. This provision is intended to prevent special distributions of dividends to shareholders in the lower income tax brackets.

> *Example* 9.10. Holding Corporation has two classes of stock outstanding: ten shares of cumulative preferred stock and ten shares of common stock. The cumulative preferred stock is entitled to $5 per share, but no dividend has been paid for two years. On December 31, 1999, Holding Corporation paid a dividend of $50 to the preferred stock shareholders and $75 to the common stock shareholders. No part of the dividend is deductible under section 562 because there has been a preference to the common stock shareholders. If Holding Corporation paid $100 to the preferred stock shareholders and $25 to the common stock shareholders, it would be entitled to deduct $125 as a dividends-paid deduction.[9]

Consent Dividends. Persons who own consent stock on the last day of the corporation's taxable year may agree, through consents filed with the Internal Revenue Service, to include in their gross income as an actual

[9]Treas. Reg. Sec. 1.562-2(b), example 3.

dividend a hypothetical dividend distribution from the FPHC (section 565). The foreign corporation is allowed a deduction against undistributed FPHC income for such amounts reported by shareholders. *Consent stock* is common stock, whether voting or nonvoting, and also includes participating preferred stock that has unlimited participation rights.

The purpose of a consent dividend is to alleviate the pressure on a corporation to make an actual distribution to receive a deduction when, for one reason or another, it does not wish to make a distribution or it does not have the financial ability to make a distribution. Consent dividends may also be used to alleviate an excess foreign tax credit position. A consent dividend has a foreign source and withholding taxes usually are avoided, thereby increasing the numerator of the foreign tax credit limitation formula.

The consent dividend, in effect, treats the dividend as a distribution to a shareholder coupled with an immediate contribution of paid-in capital to the corporation. The earnings and profits of the corporation are reduced, and the basis of the shareholder's stock in such corporation is increased, by the amount of the consent dividend. This provision is not allowed to the extent an amount would constitute a preferential dividend or a distribution not defined by section 316.

A consent is made by the shareholder on Form 972 and must be filed by or on behalf of a person who was the actual owner on the last day of the corporation's taxable year of any class of consent stock. The consent must be filed by the due date of the FPHC's tax return for the year in which the dividends-paid deduction is claimed. Once made, the consent is irrevocable. The corporation claiming the deduction for consent dividends must file a completed Form 973 with its income tax return and attach one completed Form 972 for each consenting shareholder. The consent dividend is included in the shareholder's gross income in the same year that the FPHC deducts the dividend.

Taxation of Undistributed FPHC Income

The U.S. shareholders, rather than the FPHC, are subject to taxation on their distributive share of the FPHC's undistributed FPHC income. The undistributed FPHC income included in the U.S. shareholder's income is reported as dividend income. However, it is not eligible for the dividends-received deduction for corporations under section 243.

A *U.S. shareholder* includes a U.S. citizen or resident, domestic corporation, domestic partnership, and estate or trust (other than a foreign estate or trust). Those shareholders subject to U.S. taxation under the FPHC rules are only those U.S. shareholders who directly own stock in the FPHC on the last day in the FPHC's taxable year on which a "U.S. group" existed with respect to the corporation. A *U.S. group* exists when five or fewer individuals who are U.S. citizens or residents meet the more-than-50-percent stock ownership requirement. A nonresident alien or foreign corporation that owns stock in an FPHC is not subject to U.S. taxation under these rules.

Example 9.11. Foreign corporation Alpha has been an FPHC for its entire taxable year, which ends on December 31. The U.S. shareholders who own stock on December 31 are subject to taxation on the undistributed FPHC income.

Example 9.12. Foreign corporation Beta has a taxable year that ends on December 31. The last day of its taxable year in which a U.S. group owned the requisite more-than-50-percent stock ownership was January 12. The U.S. shareholders owning stock on January 12 are subject to taxation on the undistributed FPHC income.

The Tax Court has held that U.S. shareholders who were not U.S. citizens or residents for the entire taxable year of an FPHC must still include their distributive share of the undistributed FPHC income for the entire year. The Fourth Circuit has held that such a person is taxable only on the portion of the undistributed FPHC income that is the same ratio as that of the U.S. shareholder's residence to the entire taxable year.[10]

Amount to Report

When a U.S. person is a shareholder for the entire year in a corporation that is an FPHC for the entire year, the amount of income to be reported is the shareholder's distributive share of the entire year's undistributed FPHC income. The amount to be included in income is the amount the U.S. shareholder would have received as a dividend if the FPHC had distributed its undistributed FPHC income to the shareholders on the last day of its taxable year (Treas. Reg. Sec. 1.551-2(c)). U.S. shareholders must take into account the number of shares owned in the FPHC, and the

[10]*Marsman v. Comm.*, 205 F.2d 335 (CA-4, 1953), *aff'g. in part and rev'g. and rem'g. in part* 18 T.C. 1 (1952).

relative rights of their class of stock, if there is more than one class outstanding. For example, if there is preferred stock outstanding and preferred shareholders are entitled to a specific dividend before the common shareholders, then undistributed FPHC is first treated as distributed to such preferred shareholders before any amount is allocated to the common shareholders.

Shareholders owning 5 percent or more in value of the outstanding stock must report "in complete detail" their share of gross income, deductions, credits, taxable income, FPHC income, and undistributed FPHC income (section 551(c)).

Example 9.13. Foreign corporation Omega is an FPHC with a fiscal year that ends June 30 and has undistributed FPHC income of $10,000 for the year. Sandy Callaghan owns 20 percent of the stock of Omega on June 30. Sandy must recognize $2,000 dividend income as a result of her ownership in Omega.

When a U.S. person is a shareholder in a corporation that is not an FPHC for its entire taxable year, the amount of income recognized from an FPHC is calculated as follows:

$$\frac{\text{Portion of taxable year in which FPHC provisions were met}}{\text{Entire taxable year of corporation}} \times \text{Undistributed FPHC income for entire year} \times \text{Percent of stock owned by shareholders}$$

Example 9.14. Foreign corporation Zeta has a calendar year that ends December 31. Larry Bajor, a U.S. shareholder, owned 70 percent of the stock of Zeta until he sold his entire interest to foreign corporation Beta on September 30. Zeta ceased to be an FPHC on September 30. The undistributed FPHC income of Zeta for the entire year is $100,000. Larry must report $52,500 dividend income, which is calculated as follows:

$$(9/12 \times \$100{,}000) \times 70\% = \$52{,}500$$

Income Inclusion Through a Foreign Entity

Prior to the enactment of section 551(f) in the Tax Reform Act of 1984, controversy existed as to whether taxpayers could avoid taxation on undistributed FPHC income by interposing a foreign corporation (which itself was not an FPHC), a foreign partnership, or an estate or trust whose

income included only income from sources within the United States between the taxpayer and the foreign corporation. Although the attribution rules would operate to cause the taxpayer to meet the stock ownership test and thus qualify the foreign corporation as an FPHC, some taxpayers argued that these rules did not operate to cause the owners of the interposed entities to report income under section 551.

To clarify the existing law and to prevent such an unintended abuse of the FPHC rules, Congress enacted tracing rules in section 551(f) that make it clear that for purposes of allocating undistributed FPHC income, stock of an FPHC owned by a partnership, estate, or trust that is not a U.S. shareholder or by a foreign corporation that is not an FPHC is treated as being owned directly and proportionately by its U.S. partners, U.S. beneficiaries, or U.S. shareholders (individual or corporate).

In the Technical and Miscellaneous Revenue Act of 1988, Congress authorized the Treasury Department to make adjustments to the tracing rules by regulation. Congress contemplates that such rules will be similar to the passive foreign investment rules of section 1297(b)(5) (discussed in chapter 10). It is intended that the regulations will provide for similar treatment of actual distributions from FPHCs and distributions to entities through which FPHC ownership is attributed. For example, distributions received by the interposed entity from the FPHC will be treated as having been received by the U.S. shareholders of the interposed entity.

> *Example 9.15.* Beth Peters, a U.S. citizen, is a 60-percent partner in a foreign partnership. The remaining 40 percent is owned by Nancy DuBois, a foreign individual. The foreign partnership owns 100 percent of foreign corporation Gamma, which meets the gross income requirement to be an FPHC. Gamma reports $200,000 of undistributed FPHC income at its year-end. By operation of the attribution rule of section 554(a)(1), Beth is treated as owning 60 percent of Gamma, thus satisfying the stock ownership requirements. By operation of section 551(f), Beth is treated as receiving a dividend of $120,000 (60% × $200,000) from Gamma as her distributive share of Gamma's undistributed FPHC income.

When to Report

The constructive dividend from an FPHC must be included in the gross income by a shareholder in the taxable year in which the taxable year of the FPHC ends.

> *Example 9.16.* Theta Corporation, an FPHC, has a taxable year that ends December 31, 1999. Ann Jett, the sole shareholder, has a calendar year-end.

Ann must report her December 31, 1999 constructive dividend from Theta in the year ending December 31, 1999.

An FPHC must adopt the same taxable year as its majority U.S. shareholder (section 898). This rule applies if 50 percent of the total voting power or total value of the FPHC is owned by a single U.S. shareholder (and certain related parties) on each day of the FPHC's taxable year.

Foreign Tax Credit

Foreign taxes withheld on dividends actually paid by an FPHC are eligible for the foreign tax credit by U.S. shareholders. A problem of credit limitation can occur when the undistributed FPHC income is taxed in a year that is earlier than the year of the actual distribution of such income. Foreign taxes are withheld on actual distributions, but the income can be taxed before distribution.

For deemed-paid credits under section 902 for foreign taxes paid by an FPHC, Rev. Rul. 74-59 holds that a qualified domestic corporate shareholder that owns 10 percent or more of the voting stock cannot claim a deemed-paid foreign tax credit under section 902 on undistributed FPHC income even though it is reported as a dividend.[11] However, the ruling states that the credit can be claimed on actual and consent dividends.

A dividend from an FPHC will generally be characterized as passive income for purposes of computing the foreign tax credit limitation.

Effect of Taxation

The FPHC provisions are structured to prevent double taxation of income. Taxation on undistributed FPHC income is treated as a deemed-dividend distribution to a shareholder and immediate reinvestment of such a deemed dividend in the foreign corporation (section 551(e)). The first U.S. shareholder recognizes income from the constructive dividend and increases the basis in his or her stock by the amount of income so recognized. In cases in which the shareholder recognizes income in a tax year that ends after the tax year of the FPHC, the Tax Court has held that the basis adjustment is made at the time the FPHC's year ends.[12]

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[11]Rev. Rul. 74-59, 1974-1 C.B. 183.

[12]*Mariana Frozen Foods, Inc.*, 81 T.C. 448 (1983).

The foreign corporation's accumulated earnings and profits are reduced by the amount of the constructive dividend, and paid-in capital is increased by the same amount (section 551(d)). Actual distributions of the previously taxed undistributed FPHC income will be considered made from capital and will constitute a reduction in basis of the shareholder's stock. Distributions, however, are considered to come first from current and accumulated earnings and profits and then from capital, unlike the subpart F rules (that is, under subpart F rules, previously taxed income is treated as distributed first).

Basis of Stock Acquired on Death

Under section 1014 the basis of stock to the estate of the decedent U.S. shareholder is the fair market value on the date of death or on the alternative valuation date, if elected.

Disposition of Stock by Liquidation

Any gain realized on the sale or liquidation of an FPHC by the U.S. shareholders will be treated as capital gain except when the rules of section 1248 apply. Under such rules, gain is taxable as dividend income to 10-percent-or-more U.S. shareholders to the extent their share of undistributed earnings and profits has not been taxable to the shareholder in the year of sale or in previous years.

A dividends-paid deduction cannot be taken in computing undistributed FPHC income for the final year of liquidation of an FPHC (section 562(b)).

Removal of Status

Once a foreign corporation meets the gross income and stock ownership requirements and is classified as an FPHC, it remains an FPHC until the stock ownership requirement is not met for an entire taxable year or the gross income requirement is not met for three consecutive taxable years.

Foreign Corporations and Domestic Personal Holding Company Status

A foreign corporation with U.S. shareholders can be a personal holding company even if it is not an FPHC. A foreign corporation that does not

satisfy the gross income requirement for FPHC status may have passive income from U.S. sources, thereby satisfying the personal holding company provisions, because gross income would include only the passive income from U.S. sources. Furthermore, a foreign corporation that does not have the required U.S. shareholder ownership can also be a personal holding company.

A foreign corporation will not be treated as a personal holding company if all its stock is owned directly or indirectly during the last half of its taxable year by nonresident aliens (section 542(c)(7)). This exemption, however, will not apply to U.S.-source personal service contract income described in section 543(a)(7) (which is comparable to the FPHC service income). This rule is particularly germane to foreign entertainers deriving U.S.-source income through foreign corporations. A foreign corporation may also be exempt from personal holding company tax under certain U.S. tax treaties.

For purposes of imposing the personal holding company tax on a foreign corporation that files a tax return, undistributed personal holding company income is computed on taxable income only from sources within the United States (Treas. Reg. Sec. 1.541(b)). If the foreign corporation does not file a tax return, the undistributed personal holding company income is computed on the basis of gross income only from sources within the United States and, in addition to other penalties provided by law, is subject to a penalty equal to 10 percent of the section 541 tax and any other tax imposed (section 6683).

If 10 percent or less of the stock of a foreign corporation subject to tax as a personal holding company is owned by U.S. shareholders, the personal holding company tax is imposed only on the undistributed personal holding company income attributable to the interest of the U.S. shareholders (section 545(a)).

FPHC Rules and Coordination With Subpart F

The income of a foreign corporation may be subject to taxation under both subpart F (section 951) and the FPHC rules. In the Tax Reform Act of 1984, Congress provided that income subject to both rules would be taxed under subpart F (section 951(d)) only. Income not subject to taxation under subpart F may still be taxed under the FPHC rules. A foreign corporation that is both a controlled foreign corporation and an FPHC

may be taxed under subpart F if it invests previously taxed undistributed FPHC income in U.S. property under section 956.

FPHC Rules and Coordination With Passive Foreign Investment Companies

Income that is potentially taxable under sections 551(a) and 1293 is included in gross income only under section 551(a) (section 551(g)).

Information Returns Required by Officers, Directors, and Shareholders

Section 6035 describes certain requirements for periodic filings by officers, directors, and shareholders of FPHCs. These filing requirements are covered in chapter 22.

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Passive Foreign Investment Companies

The U.S. shareholders of a foreign corporation are generally subject to U.S. taxation only when they receive a distribution of the corporation's earnings in the form of a dividend. The foreign corporation itself is subject to U.S. taxation only on income that is from U.S. sources or from a U.S. trade or business.

There are several exceptions to the general rule of deferral. Most notably, the subpart F provisions operate to tax U.S. shareholders currently on their pro rata share of subpart F income if the foreign corporation meets the definition of a controlled foreign corporation (CFC). The foreign personal holding company provisions also subject U.S. shareholders to current taxation on their pro rata share of undistributed foreign personal holding company income. In addition, the foreign corporation itself can be subject to penalty taxes on the accumulation of excess earnings (the accumulated earnings tax) or on undistributed personal holding company income if it meets the definition of a personal holding company. Finally, section 1248 and the foreign investment company provisions of section 1246 operate to convert what would have been capital

gain on the disposition of the stock of the foreign corporation into dividend or ordinary income.

A common thread linking these exceptions is the requirement that U.S. shareholders "control" the foreign corporation before the provisions become operative. Control generally requires that the U.S. shareholders own, directly or indirectly, more than (or in some cases, at least) 50 percent of the voting power or value of the foreign corporation's stock. In the case of subpart F, only U.S. shareholders owning at least 10 percent of the stock are included in the control test. For purposes of the foreign personal holding company and the personal holding company rules, the control test must be met by five or fewer U.S. shareholders who are individuals. Only section 1246 does not impose a minimum ownership level before the U.S. shareholder is included in the control test, but this provision is restricted to foreign corporations engaged primarily in investing in securities and commodities. U.S. shareholders and the foreign corporation itself can avoid taxation under this set of deferral exceptions by either widely dispersing the ownership of the corporation or by evenly dividing the ownership between U.S. and foreign individuals.

As part of the Tax Reform Act of 1986, Congress created an additional exception to the general rule of deferral with the enactment of the passive foreign investment company (PFIC) rules in sections 1291–1298. These rules further restrict the ability of U.S. shareholders in a foreign corporation that generates passive income to take advantage of the tax savings available through deferring the repatriation of earnings and the ability to convert the accumulation of earnings into capital gain upon disposal of the corporation's stock.

In general, if a foreign corporation meets the definition of a PFIC, all U.S. shareholders, regardless of their aggregate or individual ownership interest in the corporation, will be subject to one of two sets of tax rules. U.S. shareholders who make an election to treat the PFIC as a *qualified electing fund* (QEF) will be taxed currently on their pro rata share of the PFIC's total net capital gain and ordinary earnings. In lieu of making a QEF election, shareholders of "marketable" PFIC stock can make an election to mark-to-market their PFIC stock and include (deduct) the increase (decrease) in market value as ordinary income (loss) currently. Shareholders who do not make the QEF election or elect to mark-to-market their PFIC stock will not be taxed currently on their pro rata share of the PFIC's earnings. However, any subsequent *excess distributions* or gain realized on the disposition of the PFIC stock will be treated as

ordinary income earned pro rata over the time period during which the shareholder held the investment in the PFIC. The tax imposed on the excess distribution or gain realized is computed using the highest marginal rate in effect in the tax year to which the income is allocated. In addition, interest is charged on the tax beginning from the due date of the tax return for the year to which the income is allocated to the due date of the tax return (without extension) for the year in which the income is actually received. In the case of the QEF election, shareholders lose the benefit of deferral, but the PFIC income retains its character as capital gain or ordinary income. For a *nonqualified fund* (no QEF election is made), shareholders lose the tax benefit of deferral, and all income is characterized as ordinary income.

For taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons, Congress eliminated the overlap between subpart F and the PFIC provisions. In the case of a PFIC that is also a controlled foreign corporation (CFC), the corporation is treated as not a PFIC with respect to its U.S. shareholders (within the meaning of section 951(b)). This rule applies to the portion of the shareholder's holding period with respect to the corporation's stock that is after December 31, 1997 and during which the corporation is a CFC and the shareholder is a U.S. shareholder (section 1297(e)).

Motivation for the PFIC Rules

The PFIC rules were designed to address those situations in which U.S. shareholders were able to obtain deferral of U.S. taxation on foreign passive income by investing in a foreign investment company that was not controlled by U.S. shareholders. In its *General Explanation of the Tax Reform Act of 1986*, the Joint Committee on Taxation listed three reasons for the PFIC rules:

1. Congress did not believe that U.S. persons who invest in passive assets should avoid the "economic equivalent" of current taxation merely by investing in those assets indirectly through a foreign corporation.
2. Congress believed that the nationality of the owners of controlling interests of a corporation that invests in passive assets should not determine the U.S. tax consequences to U.S. investors (that is, lack

of U.S. control of this type of investment did not justify preferential tax treatment).

3. Congress recognized that U.S. persons who invested in passive assets through a foreign corporation received distinct tax advantages relative to U.S. persons investing in a domestic investment company. Not only did they avoid current taxation of earnings, but they also could convert what would have been ordinary income, if received or taxed currently, into capital gain by disposing of the stock.[1]

Although Congress intended to negate the tax motivation for investing in foreign investment companies and mutual funds, it also recognized that a U.S. shareholder who did not have a controlling interest in the foreign corporation may not have the ability to obtain information relating to the corporation's earnings and profits for the current year or to compel the corporation to distribute earnings that are sufficient to pay the U.S. tax. As a result, Congress adopted two tax mechanisms, both of which attempt to eliminate the economic benefits of deferral. Thus, U.S. shareholders of a PFIC can elect to be taxed currently on their share of the PFIC's capital gain and ordinary income, or shareholders can choose to defer U.S. taxation until the PFIC distributes income or the shareholder disposes of the PFIC stock. The economic benefit of deferral is eliminated in the latter case by taxing the shareholder using the highest tax rate in effect in the year(s) in which the income was accumulated and charging interest on the tax over the deferral period. In the Taxpayer Relief Act of 1997, Congress added a mark-to-market option for U.S. shareholders who wanted to report their share of PFIC income currently but who could not otherwise qualify for the election to be taxed on their share of the PFIC's income currently.

Definition of a PFIC

For a corporation to be considered a PFIC, it must be a foreign corporation, as defined by U.S. tax principles, that meets *either* a gross income test or an asset test (section 1297(a)).[2] To reiterate, in the case of a PFIC that is also a CFC, the corporation is treated as not a PFIC with respect to its U.S. shareholders (within the meaning of section 951(b)). This rule

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[1]Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 99th Cong., 2d sess. 1987, Committee Print, 1023.

[2]Rev. Rul. 88-8, 1988-1 C.B. 403.

applies to the portion of the shareholder's holding period with respect to the corporation's stock that is after December 31, 1997 and during which the corporation is a CFC and the shareholder is a U.S. shareholder (section 1297(e)).

Gross Income Test

The *gross income test* is met if 75 percent or more of the gross income of the foreign corporation for the taxable year is "passive income" (section 1297(a)(1)). *Passive income* is generally defined to be income "which is of a kind" that would be foreign personal holding company income as defined in section 954(c) (section 1297(b)(1)). Such income includes dividends, interest, royalties, rents, annuities, capital gains from the sale of nonbusiness assets, certain commodities gains, foreign currency gains, and income equivalent to interest (see chapter 8 for a more complete discussion).

Section 1297(b)(2) excludes the following types of income from the definition of passive income for purposes of this test—

1. Income derived in the active conduct of a banking business by a foreign bank licensed to do business as a bank in the United States (section 1297(b)(2)(A)). The definition of an active foreign bank and additional details are described in Prop. Reg. Sec. 1.1296-4. See also Notice 89-81.[3]
2. Passive income also does not include income derived in the active conduct of an insurance business by a corporation that is "predominantly engaged" in an insurance business and that would be taxed as an insurance company if it were a domestic corporation (section 1297(b)(2)(B)). In the case of insurance companies, the Senate Finance Committee report to accompany the Technical and Miscellaneous Revenue Act of 1988 stated that future regulations will provide that income derived by entities engaged in the business of providing insurance may be classified as passive to the extent the entity maintains financial reserves in excess of the reasonable needs of the insurance business.[4]

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[3]1989-2 C.B. 399.

[4]Senate Committee on Finance, *Report of the U.S. Senate Committee on Finance to Accompany the Technical and Miscellaneous Revenue Act of 1988* (H.R. 4333), 100th Cong., 2d Sess., Committee Print, 336 (hereinafter cited as Senate Finance Committee Report).

3. Interest, dividends, rents, or royalties received from a related person (as defined in section 954(d)(3) to the extent such amount is properly allocable to income of such related person that is not passive income.
4. Foreign trade income of a foreign sales corporation or export trade income of an export trade corporation.

For taxable years of U.S. persons beginning after September 30, 1993 and ending before January 1, 1998 (and taxable years of foreign corporations beginning with or within such years), passive income does not include income derived in the active conduct of a securities business by a controlled foreign corporation that is registered as a securities broker or dealer or as a Government securities broker or dealer in accordance with the Securities Exchange Act of 1934 (former section 1296(b)(3)(A)). Prop. Reg. Sec. 1.1296-6 provides details regarding this exception, which was repealed in 1997.

Asset Test

A foreign corporation meets the definition of a PFIC if the average percentage of assets held by the corporation during the taxable year produce passive income or are held for the production of passive income (section 1297(a)(2)).

For taxable years of U.S. persons beginning after December 31, 1997, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons, different measures apply, depending on whether the foreign corporation is publicly traded. In the case of a publicly traded corporation, the asset test is applied using fair market value (section 1297(f)(1)). The measurement test is applied on a quarterly basis. For purposes of determining whether the 50-percent test is met, the total value of the corporation's assets generally will be treated as equal to the sum of the aggregate value of its outstanding stock plus its liabilities.[5] A foreign corporation is treated as a *publicly traded corporation* if its stock is regularly traded on either (1) a national securities exchange that is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities and

[5]Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997: 313.

Exchange Act of 1934, or (2) any exchange or other market that the Secretary of the Treasury determines has rules sufficient to ensure that the market price represents a sound fair market value (section 1297(f)(3)).

The asset test applied to non-publicly-traded foreign corporations depends on whether the foreign corporation is a CFC or not. Non-CFCs are required to use fair market value in making the 50-percent computation. Non-CFCs can elect to use the adjusted basis method in lieu of fair market value (section 1297(f)(2)). A CFC that is not publicly traded must use the earnings-and-profits-adjusted basis of its assets in making the 50-percent computation. Note, however, that with the elimination of the overlap between subpart F and the PFIC rules, the only shareholders required to use the adjusted basis method are U.S. persons owning less than 10 percent of the CFC.

For purposes of the adjusted basis computation, section 1298(e) requires the imputation of basis for research and experimental expenses and certain licenses. A CFC increases its asset basis for purposes of the PFIC asset test by the research and experimental expenses (as defined by section 174) paid or incurred by the CFC during the current tax year and the two preceding tax years, less any reimbursement received by the CFC for such expenditures (section 1298(e)(1)). A CFC adds to the adjusted basis of its assets an amount equal to 300 percent of license payments made during the current tax year for any intangible property used by the CFC in the active conduct of its trade or business (section 1297(e)(2)(A)).

All foreign corporations required to or electing to use adjusted basis in the asset test must include tangible property leased by the corporation over a term of 12 months or more (section 1298(d)(1)). The adjusted basis of such leased tangible property is the unamortized present value of the payments under the lease for the use of the property. Although the determination of present value is to be prescribed in regulations, the discount rate is determined at the beginning of the lease term and is generally the applicable federal rate (AFR) used to determine original issue discount under section 1274(d) (section 1298(d)(2)).

The Internal Revenue Service issued Notice 88-22[6] to provide guidance on the application of the asset test pending the issuance of regulations. According to Notice 88-22, the regulations will provide that the

[6]1988-1 C.B. 489.

asset test will be applied on a gross basis. Liabilities will not be taken into account even if the liability is secured by a specific asset. The average value (or adjusted basis) of the assets for the taxable year is to be computed as of the end of each quarterly period during the taxable year. If value is used, the regulations will not require that the value be determined by independent appraisal.

Example 10.1. Foreign corporation Alpha, a non-publicly-traded CFC, has determined the value of its passive and nonpassive assets for each quarter of 19X0 as follows:

Quarter	*Passive Assets*	*Nonpassive Assets*	*Liabilities*
1	$ 500,000	$ 400,000	$100,000
2	500,000	600,000	100,000
3	550,000	600,000	100,000
4	650,000	550,000	100,000
Total	$2,200,000	$2,150,000	$400,000
Average	$ 550,000	$ 537,500	$100,000

The average value of the passive assets is 50.6 percent of the total average asset value ($550,000/$1,087,500), without regard to the liabilities. Alpha Corporation will be a PFIC as a result of meeting the asset test.

An asset is characterized as passive or nonpassive based on the type of income it generates, or is reasonably expected to generate, in the foreseeable future. For purposes of characterizing an asset, passive income is defined in section 1297(b). Assets that generate both passive and nonpassive income are treated as partly passive and partly nonpassive based on the relative amounts of income generated by the assets in that year. Notice 88-22 provides specific guidance with respect to the following kinds of assets.

Depreciable Property Used in a Trade or Business. Any asset used in a trade or business, as defined in section 1231(b), is considered a nonpassive asset, provided the trade or business itself does not produce passive income.

Trade or Service Receivables. A trade or service receivable is characterized as passive or nonpassive based on the character of the income derived from the corporation from the transaction that generated the receivable. An account receivable that arises in the ordinary course of business from sales or services will be considered a nonpassive asset. Interest incidentally received on the receivable will not affect the char-

acterization of the asset, although the interest itself will be considered passive income for purposes of the gross income test.

Intangible Assets. Intangible assets must be included in the asset test. In general, intangible assets that produce identifiable sources of income (for example, patents and licenses) are characterized on the basis of the income derived from the intangible assets. Goodwill and going-concern value must be identified with a particular income-producing activity and characterized according to the kind of income derived from the activity. If value is used in the asset test, the guidelines provided by Rev. Rul. 59-60, as amplified by subsequent revenue rulings,[7] must be followed. Rev. Rul. 59-60 directs the taxpayer to value an intangible asset based on all available financial data and other factors such as income potential, book value, recent sales of comparable assets, and economic conditions.

Working Capital. *Working capital* (that is, cash and cash equivalents) produces passive income; and therefore, these assets are considered to be passive assets.

Dealer Inventory and Investment Assets. Stock, securities, and other assets related to a foreign corporation's trading and investment activities are considered passive assets if the asset is held for the foreign corporation's own account. The stock or securities held in inventory by a foreign corporation that is a dealer are considered nonpassive assets, provided the corporation specifically identifies in its books and records the stock and securities it holds for sale to customers in the ordinary course of its trade or business, and the stock and securities held for investment. The dealer must classify the assets on the date of acquisition. A dealer may change the initial (erroneous) designation of the stock or security, provided (1) the erroneous designation was made in good faith by the dealer at the time of acquisition, (2) at least 90 percent of the initial designation of all stock and securities was proper, (3) the dealer identifies all changes of designations made in its books and records, and (4) each change in designation is made within seventy-five days after the day the initial designation was made.[8] Stock and securities considered to be in excess of the reasonable business needs of the dealer will be treated as passive assets.

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[7]1959-1 C.B. 237, amplified by Rev. Rul. 83-120, 1983-2 C.B. 170; Rev. Rul. 80-213, 1980-2 C.B. 101; Rev. Rul. 77-287, 1977-2 C.B. 319.

[8]Notice 89-91, 1989-2 C.B. 399.

Tax-Exempt Assets. An asset that produces tax-exempt income is considered a passive asset unless it is identified as inventory in the hands of a dealer in such assets or it is held by a bank or insurance company that is protected by the section 1296(b)(2) exception.

The Look-Through Rules of Section 1297(c)

A foreign corporation that owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation will, for purposes of determining if the foreign corporation is a PFIC, be treated as owning its proportionate share of the assets of such other corporation and as receiving its proportionate share of the income of the other corporation. Under these look-through rules, any dividends, interest, etc., received by the foreign corporation from the 25-percent-owned corporation are eliminated in applying the gross-income test. The foreign corporation's stock investment in the 25-percent-owned corporation is also eliminated in applying the asset test. The objective of these look-through rules is to prevent a foreign holding corporation of a subsidiary primarily engaged in an active business from being classified as a PFIC. In addition, a foreign corporation cannot avoid PFIC classification by transferring its passive assets to a subsidiary if such assets are significant relative to the active business assets. The following example, taken from Rev. Rul. 87-90,[9] illustrates this point.

> *Example 10.2.* U.S. Corporation (USCo) owns all of the stock of foreign corporation Theta, a non-publicly-traded CFC. Theta Corporation is actively engaged in manufacturing and sales. The average value of its nonpassive assets for the year was $1 million, and the average value of its passive assets was $100,000. Theta Corporation owns all of the stock of foreign corporation Omega and has a basis of $500,000 in this stock. Theta contributes most of its manufacturing profits to Omega for investment. For the current year, Omega owned only passive assets with an average value of $1 million. These assets produced only passive income, and Omega did not own 25 percent or more of any other corporation. Under section 1297(c), Theta is treated as owning all of Omega's assets, and Theta's stock investment in Omega is eliminated. Therefore, Theta will be a PFIC because more than 50 percent of its assets (in value) are passive assets ($1,100,000/$2,100,000).

[9] 1987-2 C.B. 216.

Omega will also be a PFIC because more than 75 percent of its gross income is passive income.

Section 1298(b)(8) provides an exception to the look-through rule if a foreign corporation owns 25 percent or more of a domestic corporation that owns stock in other domestic C corporations. For purposes of determining whether the foreign corporation is a PFIC, the C corporation stock owned by the 25-percent-owned domestic corporation is treated as a nonpassive asset and any income derived from the stock is nonpassive income. The objective of this provision is to equalize the tax treatment between U.S. individual shareholders who hold U.S. stock investments through a U.S. holding company and those who hold such investments through a foreign holding company. Before this exception applies, however, the foreign corporation must be subject to the accumulated earnings tax provisions of section 531 or waive any treaty benefit exempting the corporation from the accumulated earnings tax. In this way, a foreign corporation that avoids PFIC treatment under this exception may have to distribute its earnings to avoid the accumulated earnings tax. This exception is extremely rare in practice.

Exceptions to the Definition of a PFIC

A foreign corporation will not be considered a PFIC in the first year it has gross income (its "start-up year"), provided it satisfies three requirements (section 1298(b)(2)). First, no predecessor of the corporation was a PFIC. Second, the corporation must satisfy the secretary of the Treasury that it will not be a PFIC in either of the first two taxable years following the start-up year. Third, the corporation must not in fact be a PFIC in either of those two years.

A second exception exists for corporations that change their active businesses (section 1298(b)(3)). If a foreign corporation can satisfy the secretary that substantially all of its passive income for the current year is attributable to proceeds from the disposition of one or more active trades or businesses (that is, the passive income is from the temporary investment of the proceeds from such a sale), it can avoid PFIC status by satisfying essentially the same requirements as a start-up company. The corporation must establish that neither it nor a predecessor corporation was a PFIC in a prior year and that it will not be a PFIC in the first two years after the year of disposition of the active business assets. It must also not be a PFIC in fact for those two years.

Finally, a foreign investment corporation that is described in section 1247 will be excluded from the definition of a PFIC. This rule applies to corporations that made an election before 1963 to distribute their income currently and is thus limited in its scope.

Taxation of Shareholders Who Do Not Make the QEF Election

Shareholders who are U.S. persons and who do not make a qualified electing fund (QEF) election are subject to the tax rules of section 1291. Under these rules, shareholders are not subject to taxation on the earnings of the PFIC until the PFIC makes an "excess distribution" to the shareholders or the shareholders dispose of part or all of their PFIC stock. For taxable years of U.S. persons beginning after December 31, 1997 and taxable years of foreign corporations ending with or within such taxable years of U.S. persons, the section 1291 tax and interest charge will not apply to PFIC shareholders making the mark-to-market election under section 1296.

Under regulations proposed by the Treasury Department, a *distribution* for purposes of section 1291 includes any actual or constructive transfer of money or property by the fund (Prop. Treas. Reg. Sec. 1.1291-2(b)(1)). This definition would include a dividend or redemption and is broad enough to encompass even a return of capital. Nontaxable stock distributions under section 305(a) or 355(a) are not treated as distributions. Also not included are distributions previously included in income under subpart F, under the foreign personal holding company rules, or as the result of a QEF election.

The proposed regulations introduce *indirect* distribution rules that treat a direct distribution from a PFIC to a non-U.S. person as a distribution subject to section 1291 if the recipient of the distribution is owned by a U.S. person who is an *indirect shareholder* (Prop. Treas. Reg. Sec. 1.1291-2(f)). A U.S. person is considered an indirect shareholder for purposes of these rules if certain ownership tests are met (Prop. Treas. Reg. Sec. 1.1291-1(b)(8)). For example, a U.S. person who owns 50 percent or more in value of a foreign corporation that is not a PFIC is deemed to own a proportionate share of any stock owned directly or indirectly by that corporation. A U.S. person is deemed to own a proportionate amount (by value) of any stock owned by a PFIC or partnership in which the U.S. person has a direct or indirect ownership interest. For pre-1998

years, indirect distributions subject to inclusion under subpart F and section 1291 are taxed under the rules of section 1291 only (Prop. Treas. Reg. Sec. 1.1291-2(f)(3)).

If the distribution meets the definition of an *excess distribution*, the shareholder is subject to U.S. tax and an interest charge based on the value of the tax deferral. This "deferred tax amount" is computed by allocating the excess distribution to each day of the shareholder's holding period for the investment in the PFIC. The allocation is made on a share-by-share basis, except that shares with the same holding period may be aggregated (section 1291(b)(3)(A)). The holding period is generally determined under section 1223 (section 1291(a)(3)(A)). The holding period is deemed to end on the date of an excess distribution (section 1291(a)(3)(A)(i)). Where a shareholder makes a mark-to-market election under section 1296, the holding period is treated as beginning on the first day of the first taxable year after the last taxable year for which section 1296 applied (section 1291(a)(3)(A)(ii)).

The excess distribution that is allocated to the current tax year and to the taxpayer's holding period that precedes the first day of the first taxable year during which the corporation became a PFIC (beginning after 1986) is included in the shareholder's gross income as ordinary income and taxed at the shareholder's current-year marginal tax rate (section 1291(a)(1)(B)). The excess distributions allocated to other years during which the corporation was a PFIC ("noncurrent years") are subject to tax using the highest marginal rate imposed under section 1 or section 11 for the year to which the distribution was allocated (section 1291(c)(2)). The tax rate is imposed without regard to the actual marginal tax rate of the shareholder for that year (that is, without regard to the shareholder's deductions or credits). In addition, an interest charge is added to the tax using the rates and methods provided in section 6621 for the underpayment of tax. The interest is computed beginning with the due date of the tax return for the year to which the excess distribution was allocated (without regard to extensions) and ending with the due date of the tax return for the year in which the excess distribution was made (also without regard to extensions) (section 1291(c)(3)). Interest is not computed on the excess distribution allocated to the current year or the pre-PFIC years. The interest paid is treated as interest paid under section 6601 on the due date for the current-year tax return.

Gain from disposal of PFIC stock is treated as if the gain was an excess distribution (section 1291(a)(2)). Such gain is allocated to each

day of the shareholder's holding period, and a deferred tax amount is computed for the gain allocated to tax years other than the current year and pre-PFIC years. Gain included as gross income in the shareholder's current taxable year is treated as ordinary income even if the gain would have been capital gain had the PFIC provisions not applied.

Under proposed regulations, a disposition includes "any transaction or event that constitutes an actual or deemed transfer of property for any purpose of the Code or regulations" (Prop. Treas. Reg. Sec. 1.1291-3(b)(1)). This includes (but is not limited to) a sale, exchange, gift, transfer at death, liquidation, redemption treated as a sale or exchange, or a distribution subject to section 311, 336, 337, 355(c), or 361(c). Dispositions also include a change in U.S. citizenship or residence (to a nonresident alien) and direct and indirect pledges of PFIC stock as security for an obligation. Indirect disposition rules similar to the indirect distribution rules are also proposed (Prop. Treas. Reg. Sec. 1.1291-3(e)). Such rules would apply when a U.S. person disposes of an entity owning a PFIC or the entity itself disposes of the PFIC.

Example 10.3. Wheeler is a U.S. shareholder of foreign corporation Zeta, which has met the definition of a PFIC since January 1, 1996. Wheeler owns 1,000 of the 2,000 shares of Zeta outstanding, which he purchased on January 1, 1995. On December 31, 1999, Zeta made a distribution to Wheeler of $100,000. It was determined that all $100,000 of the distribution met the definition of an excess distribution. For purposes of determining the deferred tax amount, Wheeler must allocate the $100,000 distribution pro rata to each day beginning with the start of his holding period and ending with the date of the distribution. In this case, $20,000 is allocated to each year in the holding period. Amounts allocated to the current year (1999) and to pre-PFIC years (1995) are included in Wheeler's gross income for 1999 as ordinary income (that is, a total of $40,000). The $20,000 allocated to 1996-1998 is taxed at a rate of 39.6 percent ($7,920 for each year). In addition, interest is charged on the $7,920 of tax from 1996, beginning on March 15, 1997, and ending on March 15, 2000 (assuming a calendar taxable year), using the same rates applied to underpayments of tax under section 6621. Interest is computed on the $7,920 of tax from 1997 for the period beginning March 15, 1998, and ending March 15, 2000. Interest is computed on the $7,920 of tax from 1998 for the period beginning March 15, 1999, and ending March 15, 2000.

Example 10.4. Assume, in example 10.3, that Wheeler sold his stock in Zeta on December 31, 1999, for $200,000 and recognized a gain of $100,000. All of the gain would be treated as an excess distribution, and the calculation of

Wheeler's tax consequences would proceed in the same manner as if he had received an excess distribution. The amount included in his gross income in 1999 would be treated as ordinary income even if the gain was from the sale of a capital asset.

Definition of an Excess Distribution

An *excess distribution* is defined as the portion of the PFIC's current-year "total excess distribution" that is allocated to a share of stock for a particular year (section 1291(b)(1)). The total excess distribution is the excess of the PFIC's total current-year distribution with respect to stock held by the shareholder over 125 percent of the average amount distributed with respect to such stock during the three preceding years (section 1291(b)(2)).

Example 10.5. Surhoff, a U.S. individual, acquired 100 shares of Sigma Ltd., a PFIC, on January 1, 1995, and 100 shares on January 1, 1996. Surhoff received the following distributions from Sigma Ltd.:

Date of Distribution	*Amount Distributed*
December 31, 1995	$ 50
December 31, 1996	100
December 31, 1997	100
December 31, 1998	100
April 1, 1999	150
October 1, 1999	50

On a per-share basis, Surhoff received $0.50 per share from the distributions made in 1995, 1996, 1997, and 1998. Therefore, these distributions are not considered excess distributions. With respect to the distribution received in 1999, however, she received $0.75 per share on April 1 and $0.25 per share on October 1. The total for 1999 of $1 per share is $0.375 per share greater than 125 percent of the average of the prior three years (125% × $0.50 = $0.625). This amount becomes the excess distribution for each share of stock.

The total excess distribution with respect to Surhoff's 200 shares is $75 ($0.375 × 200 shares). The total excess distribution is allocated pro rata to each distribution made during 1999. Therefore, $56.25 ($75 × $150/$200) is allocated to the distribution made on April 1 and $18.75 is allocated to the distribution made on October 1. Each excess distribution must be allocated between each block of stock outstanding on the date of the distribu-

tion ($28.125 and $9.375 to each block of stock). The amount allocated to each block of stock must then be allocated to each day of Surhoff's holding period for the block of stock. In the case of the stock acquired on January 1, 1995, her holding period on April 1, 1999, is 1,552 days. The total excess distribution received on April 1 ($28.125) is allocated as follows to Surhoff's taxable years in the holding period: $6.61 in 1995, $6.63 in 1996, $6.61 in 1997 and 1998, and $1.65 in 1999. The holding period for the stock acquired in 1996 is 1,187 days as of April 1, 1999. The total excess distribution received on April 1 ($28.125) with respect to this stock is allocated to Surhoff's taxable years as follows: $8.67 in 1996, $8.65 in 1997 and 1998, and $2.16 in 1999.

Surhoff's tax on the April 1 distribution would be computed in two steps. The amount allocated to 1999 would be treated as ordinary income received in 1999. The amounts allocated to 1995, 1996, 1997, and 1998 would be taxed by multiplying the amounts times the highest individual marginal rate for those years. In addition, an interest charge would be assessed on each of the distributions allocated to years other than 1999. Because the distributions were not allocated to a year in Surhoff's holding period during which Sigma Ltd. was not a PFIC, all of the amounts allocated to other than the current year are subject to the deferred tax amount.

Surhoff's tax on the excess distribution received on October 1 would be computed in a manner similar to the April 1 distribution, except that her holding period would include the days from April 2 to October 1.[10]

In making the computation to determine whether a portion of a current-year distribution is an excess distribution, any excess distribution received during the three preceding years and allocated to a year other than the year in which it was received or a pre-PFIC year (that is, any amount subject to the deferred tax) is not taken into account in making the computation of the average amount received by the shareholder for that three-year period.

Example 10.6. Assume, in example 10.5, that Surhoff receives a distribution from Sigma Ltd. of $250 in 2000. For purposes of computing the portion of the distribution that is an excess distribution, the shareholder must compute the average distributions received for 1997, 1998, and 1999. She may include only the portion of the excess distribution received on April 1, 1999 ($56.25) that was included in her taxable income for 1999 ($3.81). The

[10]Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 99th Cong., 2d sess. 1987, Committee Print, 1027-1028 and Prop. Treas. Reg. Sec. 1.1291-4.

remainder is not included in the computation of the average for the preceding three years because it was subject to the deferred tax.

Section 1291(b)(2)(B) provides that the excess distribution will be zero for distributions received during the taxable year in which the U.S. shareholder's holding period for the stock begins. A deemed dividend under section 304 is treated as an excess distribution to the extent the dividend is treated as paid from the section 1291 fund's earnings and profits (Prop. Treas. Reg. Sec. 1.1291-2(b)(3)).

Anti-Avoidance Rules

Shareholders who have not made a QEF election are subject to several anti-avoidance rules. In particular, such shareholders are subject to the anti-avoidance rules applicable to shareholders in foreign investment companies found in sections 1246(c), 1246(d), 1246(e), and 1246(f). Under these rules, a shareholder who receives stock with a basis determined by the basis of PFIC stock (that is, a transferred or substituted basis) inherits the holding period and attributes of the PFIC stock. In addition, a shareholder is treated as owning PFIC stock to the extent of his or her pro rata share of any PFIC stock owned by a domestic corporation or a grantor trust in which the shareholder owns stock or certificates. Five-percent shareholders of a PFIC may be required by the secretary of the Treasury to provide additional information. Finally, as modified by section 1291(e)(1), PFIC stock is not given an increase in basis at the death of the shareholder, as would normally be the case under section 1014 (except if the shareholder was a nonresident alien at all times during his or her holding period).

To prevent the potential avoidance of the PFIC tax on tax-free transfers of the PFIC stock, Congress enacted section 1291(f), which authorizes the Secretary of the Treasury to write regulations that require the full recognition of gain at the time of the transfer of the PFIC stock, notwithstanding any other nonrecognition provisions applicable to the transfer. Proposed regulations under this subsection were issued in 1992.[11] In general, the situations in which gain is recognized are those in which the section 1291 tax and interest are potentially avoidable. Situations in which immediate gain recognition is required are gifts of stock in a nonqualified fund to a nontaxpaying entity such as a charity or a foreign person, or

[11] Prop. Treas. Reg. Sec. 1.1291-6.

otherwise nontaxable stock exchanges in which the transferor receives non-PFIC stock in exchange for PFIC stock.

Mark-to-Market Election for Marketable Stock

Recognizing that the interest charge rules were a substantial source of complexity and that some PFIC shareholders would prefer to recognize income currently but could not qualify for the QEF election, Congress enacted new section 1296 in the Taxpayer Relief Act of 1997. Section 1296 provides U.S. persons owning PFIC stock with an alternative method to include their share of PFIC income currently by allowing them to elect to mark to market PFIC stock that qualifies as "marketable stock."

In general, U.S. persons who elect under section 1296 to mark-to-market eligible PFIC stock include in income each year an amount equal to the excess, if any, of the fair market value of their PFIC stock as of the close of the taxable year over their adjusted basis in the stock (section 1296(a)(1)). Similarly, the shareholder is allowed a deduction for the excess, if any, of the stock's adjusted basis over its fair market value as of the close of the taxable year, not to exceed any net mark-to-market gains with respect to the stock included by the shareholder in prior taxable years (called "unreversed inclusions")(section 1296(a)(2) and (d)).

U.S. persons owning stock in a PFIC indirectly through a foreign partnership or fiduciary are treated as owning such stock proportionately and can elect to mark-to-market such stock under section 1296 (section 1296(g)(1)). Any disposition by a U.S. person that results in the person not being treated as owning the PFIC stock and any disposition of the PFIC stock by the actual owner are treated as an actual distribution of the PFIC stock by the U.S. person (section 1296(g)(2)).

Marketable stock is defined in section 1296(e) as including three categories of stock. A PFIC's stock is treated as marketable if it is regularly traded on either (1) a national securities exchange that is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934, or (2) any exchange or other market that the Secretary of the Treasury determines has rules sufficient to ensure that the market price represents a sound fair market value (section 1296(e)(1)(A)). PFIC stock is also treated as marketable if the PFIC is comparable to a regulated investment company (RIC) and offers for sale (or has outstanding) stock

of which it is the issuer and which is redeemable at its net asset value (section 1296(e)(1)(B)). Finally, to the extent provided by regulations, any option on stock described in section 1296(e)(1)(A) and (B) will be considered marketable stock (section 1296(e)(1)(C)). Under a special rule, all PFIC stock owned directly or indirectly by a RIC that offers for sale (or has outstanding) stock of which it is the issuer and which is redeemable at its net asset value is treated as marketable stock (section 1296(e)(2)). Details regarding when stock is publicly traded or when a foreign corporation resembles a RIC are provided in Prop. Reg. Sec. 1.1296(e), issued in February 1999.

U.S. persons who elect to mark to market their PFIC stock must increase (decrease) their adjusted basis in the PFIC stock for the amounts included in (deducted from) income (section 1296(b)(1)). If the U.S. person owns stock in the PFIC indirectly through a foreign entity, the basis adjustments are made by the entity actually holding the PFIC stock, but only for purposes of applying the PFIC rules to the U.S. person with respect to such stock (section 1296(b)(2)). PFIC stock acquired by bequest will have a basis equal to the lesser of the decedent's adjusted basis in the stock immediately before death or the basis determined under section 1014 (section 1296(i)).

Income and deductions recognized under the mark-to-market election are treated as ordinary income and loss (section 1296(c)(1)(A) and (B)). Gain or loss on the subsequent sale of stock that has been marked-to-market under section 1296 is also treated as ordinary gain or loss. The source of income or loss (as being within or outside the United States) is determined in the same manner as if the amounts were gain or loss from actual sale of the PFIC stock (section 1296(c)(2)).

Section 1296(j) provides a coordination rule in cases in which the U.S. person makes the mark-to-market election in a year after the beginning of the taxpayer's holding period in such stock. The coordination rule applies for each taxable year beginning after 1986 in which the corporation was a PFIC and was not a QEF with respect to the shareholder (section 1296(j)(1)(B)). In such cases, section 1291 applies to distributions with respect to the stock and dispositions of such stock that occur in the first taxable year for which the election is made and mark-to-market gains that would have been included in income for that first taxable year as if the gains were from the disposition of the stock (section 1296(j)(1)(A)).

Section 1291 also does not apply to distributions from, and dispositions of stock of, a PFIC where a shareholder who is a U.S. person has

marked-to-market such stock under section 475 or any other provision (for example, section 1092(b)(1)). This would include dealers required to mark to market such stock and traders who elect to do so under section 475(f). Coordination rules similar to those in section 1296(j) apply in the case where the shareholder marks to market the PFIC stock under section 475 or other provision later than the beginning of the shareholder's holding period for the PFIC stock.[12]

Taxation of Shareholders of Qualified Electing Funds

U.S. persons who make an election to treat a PFIC as a *qualified electing fund* (QEF) are taxed currently on their pro rata share of the PFIC's long-term capital gain and ordinary earnings for the taxable year that ends with or within the shareholder's taxable year (section 1293(a)). A *shareholder's pro rata share* is the cumulative amount that would have been distributed with respect to his or her stock if the PFIC had distributed, on each day, a pro rata amount of its net capital gain and ordinary earnings for the year. Under the Technical and Miscellaneous Revenue Act of 1988, it is intended that future regulations will allow a QEF to allocate income on other than a daily basis provided it maintains such records as the Secretary of the Treasury may require. For example, the QEF may allocate monthly income ratably over a daily basis. This could provide a more accurate determination of income for U.S. shareholders who own stock for part of the year.

The amount taxed currently under section 1293(a) increases the basis of the shareholder's PFIC stock (section 1293(d)(1)). Subsequent distributions of income previously taxed under section 1293(a) will be nontaxable when actually received (section 1293(c)). Such distributions reduce the PFIC's earnings and profits and reduce the shareholder's basis in the PFIC stock with respect to which the distribution was made (section 1293(d)(2)).

Ordinary Earnings and Net Capital Gain

Ordinary earnings are the excess of the QEF's earnings and profits for the taxable year over its net capital gain (section 1293(e)(1)). A QEF's net

[12]Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1998* (JCS-6-98), November 24, 1998: 206.

capital gain for the year cannot exceed its earnings and profits for the current taxable year.

A QEF computes its earnings and profits using the rules of section 312. However, the QEF may use the installment method of accounting, the completed contract method of accounting, or the LIFO inventory method, if applicable (that is, the adjustments required by sections 312(n)(4), (5), and (6) do not apply). These adjustments affect earnings and profits only for purposes of income inclusion under section 1293(a); they do not change the computation of earnings and profits for purposes of determining whether a distribution is a dividend. In addition, if income was distributed as a dividend prior to its inclusion in income as current PFIC earnings (for example, amounts received under the completed contract method are distributed as a dividend before the income is included in the PFIC's earnings and profits for purposes of computing its ordinary earnings), such income will not be included as PFIC income in the later year (section 1293(g)(2)).

Election to Defer Current Payment of Tax

Shareholders who have made a QEF election may elect to defer the tax due on their pro rata share of undistributed earnings of the QEF (section 1294). This election is not available if any of the income would otherwise be includable in income under the foreign personal holding company rules (section 551) or the subpart F rules (section 951). In addition, the election to defer tax is treated as an extension of time to pay the tax, and therefore, the shareholder is liable for interest on the deferred amount under the rules of section 6601.

The tax that may be deferred is the excess of the tax imposed with the inclusion of the "undistributed earnings" of the PFIC over the tax imposed without the inclusion of the undistributed earnings of the PFIC. The PFIC's undistributed earnings are computed as the amount included in the shareholder's income under section 1293(a) less any amounts distributed tax free to the shareholder during the taxable year by reason of section 1293(c).

> *Example 10.7.* Peters, a U.S. individual, owned 50 percent of Gamma Corporation, a PFIC, during 1999. Gamma had ordinary earnings of $100,000 and no capital gains. Peters had made a QEF election, and thus he included $50,000 in his income for 1999 as his pro rata share of undistributed earnings. Peters had $50,000 of domestic-source income and $10,000 of expenses not definitely related to any gross income. His taxable income for 1999 with the inclusion of the undistributed earnings would be $90,000

($50,000 + $50,000 – $10,000). Without the inclusion of the undistributed earnings, his taxable income would be $40,000 ($50,000 – $10,000). The tax on the difference (assuming a rate of 31 percent) would be $15,500 (31% × $50,000). Peters may elect to defer payment of the $15,500 by making an election under section 1294.

The extension to defer payment of tax on the undistributed earnings is terminated on the occurrence of several events (section 1294(c)). When earnings for which the extension was made are received by the shareholder, the extension terminates with respect to the tax deferred on those earnings. The election terminates when PFIC stock is transferred during the year with respect to earnings attributable to that stock. This rule applies to all transfers of stock, regardless of whether gain or loss is recognized on the transfer (for example, a gift of the stock or a transfer at death). If the PFIC ceases to be a QEF or the foreign corporation ceases to be a PFIC, all previous elections to defer tax with respect to that corporation are terminated.

A loan made directly or indirectly from the PFIC to a shareholder who has made an election to defer paying the tax is treated as a distribution that terminates the election to the extent the loan represents undistributed PFIC earnings. This deemed distribution also reduces the shareholder's basis in the PFIC stock if an actual distribution would have been nontaxable under section 951(c). Indirect loans can arise when the PFIC makes a loan to a domestic corporation controlled by the U.S. shareholder of the PFIC or the PFIC guarantees a loan by a third person to its U.S. shareholder.

A termination event causes the deferred tax and interest to be payable on the due date (without regard to extensions) for the tax return for the year in which the event takes place. A shareholder may elect to pay the deferred tax and interest prior to the occurrence of a termination event.

The election itself is made on an annual basis and must be made by the due date (including extensions) for the tax return for the year in which the undistributed PFIC earnings are included in the shareholder's gross income. The details for making the election are included in Temp. Treas. Reg. Sec. 1.1294-1T(d).

Making the QEF Election

The QEF election is made at the U.S. shareholder level rather than at the PFIC level (section 1295(a)). Once made, the election may not be

revoked for future years except with the permission of the secretary of the Treasury. For taxable years beginning after December 31, 1997, the rules for making and maintaining the QEF election are contained in Temp. Reg. Sec. 1.1295-1(c) through (g). Prior year elections were governed by Notice 88-125.[13]

The QEF election may be made by any U.S. person who is a direct or indirect owner of the PFIC. In a chain of ownership, only the first U.S. person who is a direct or indirect owner may make the election (Temp. Treas. Reg. Sec. 1.1295-1T(d)(2)). For example, a U.S. person who is a partner in a U.S. partnership that is a shareholder of a PFIC will only be eligible for QEF status if the partnership makes the QEF election (all U.S. partners will be subject to the election). If the U.S. person is a partner in a foreign partnership that is a shareholder in a PFIC, the U.S. partner must make the QEF election (Temp. Treas. Reg. Sec. 1.1295-1T(d)(2)(i)(B)). U.S. persons who are shareholders in an S corporation that is a shareholder of a PFIC will be eligible for QEF treatment only if the S corporation makes the QEF election (Temp. Treas. Reg. Sec. 1.1295-1T(d)(2)(i)(C)). In an affiliated group of corporations filing a consolidated income tax return, the common parent makes the QEF election for all members of the group, pursuant to Treas. Reg. Sec. 1.1502-77(a) (Temp. Treas. Reg. Sec. 1.1295-1T(d)(3)).

For taxable years beginning after December 31, 1997, a U.S. person who is a shareholder of a PFIC makes the QEF election by completing Form 8621 and attaching the form to its federal income tax return for the election year (Temp. Treas. Reg. Sec. 1.1295-1T(f)(1)). In addition, the Form 8621 must reflect information provided in the PFIC Annual Information Statement (described in Temp. Treas. Reg. Sec. 1.1295-1T(g)(1)), the Annual Intermediary Statement (described in Temp. Treas. Reg. Sec. 1.1295-1T(g)(3)), or the applicable combined statement described in Temp. Treas. Reg. Sec. 1.1295-1T(g)(4) for the taxable year of the PFIC ending with or within the taxable year for which Form 8621 is being filed (Temp. Treas. Reg. Sec. 1.1295-1T(f)(1)(iii)). A separate Form 8621 must be filed for each PFIC for which the shareholder makes a QEF election. The QEF election must be made on or before the due date (including extensions) for filing the shareholder's income tax return for the taxable year in which the election is made (Temp. Treas. Reg. Sec. 1.1295-1T(e)).

[13] 1988-2 C.B. 535.

The PFIC must provide a PFIC Annual Information Statement to electing shareholders for each taxable year in which the QEF election is in effect (Temp. Treas. Reg. Sec. 1.1295-1T(g)(1)). The PFIC Annual Information Statement must be signed by the PFIC or an authorized representative and must contain the following information:

- The first and last days of the PFIC's taxable year to which the Statement applies;
- *Either* the shareholder's pro rata share of the PFIC's ordinary earnings and net capital gain for the PFIC's taxable year or sufficient information to enable the shareholder to calculate such amounts or a statement that the PFIC has allowed the shareholder to examine its books, records, and other documents to calculate the amounts of the PFIC's ordinary earnings and net capital gain according to U.S. income tax accounting principles and to calculate the shareholder's pro rata share of the PFIC's ordinary earnings and net capital gain for the PFIC's taxable year;
- The amount of cash and the fair market of other property distributed or deemed distributed to the shareholder during the taxable year; and
- A statement that the PFIC will permit the shareholder to inspect and copy the PFIC's permanent books and records and such other documents as may be maintained by the PFIC to establish that the PFIC's ordinary earnings and net capital gain are computed in accordance with U.S. tax accounting principles, and to verify these amounts and the shareholder's pro rata shares, thereof (alternative documents verifying these amounts may be substituted for this statement if approved by the commissioner of internal revenue under a private letter ruling and a closing agreement).

Where the U.S. person is a shareholder in a PFIC through a foreign intermediary, the intermediary must provide such person with an Annual Intermediary Statement (Temp. Treas. Reg. Sec. 1.1295-1T(g)(3)). This Statement must provide the same information as the PFIC Annual Information Statement and report the indirect owner's pro rata shares of the PFIC's ordinary earnings and net capital gain. An Annual Intermediary Statement can be issued in lieu of the PFIC Annual Information Report if the following conditions are met:

- The intermediary received a copy of the PFIC Annual Information Statement from the PFIC or received an Annual Intermediary

Statement from another intermediary that states that the other intermediary received a copy of the PFIC Annual Information Statement;

- The representations and information contained in the Annual Intermediary Statement reflect the information contained in the PFIC Annual Information Statement; and
- The PFIC Annual Information Statement issued to the intermediary states the PFIC will permit the shareholder to examine its books, records, and other documents to calculate the amounts of the PFIC's ordinary earnings and net capital gain according to U.S. income tax accounting principles and to calculate the shareholder's pro rata share of the PFIC's ordinary earnings and net capital gain for the PFIC's taxable year or includes a copy of a private letter ruling and closing agreement that provides that alternative documentation was allowed to verify the PFIC's ordinary earnings and net capital gain.

A PFIC that owns directly or indirectly any stock of one or more PFICs with respect to which a shareholder may make the QEF election can file a combined PFIC Annual Information Report, as described in Temp. Treas. Reg. Sec. 1.1295-1T(f)(4).

Retroactive Elections. Section 1295(b)(2) provides that a shareholder may make a QEF election with respect to a PFIC later than the election due date if the shareholder reasonably believed that the foreign corporation was not a PFIC for the year in question. Temp. Reg. Sec. 1.1295-3T provides two distinct (and exclusive) sets of rules for making a retroactive election.

Under the first set of rules (called a "protective regime"), the shareholder can make a retroactive election without obtaining the Commissioner's consent provided the shareholder possesses reasonable belief, contemporaneous with the election due date, that the foreign corporation was not a PFIC (Temp. Reg. Sec. 1.1295-3T(b)). For example, the corporation's valuation of its assets showed that its passive assets were less than 50 percent of total assets; however, this valuation was later changed after IRS audit, and the value of the passive assets now exceeds 50 percent of the foreign corporation's total assets. Temp. Reg. Sec. 1.1295-3T(d)(2) interprets the reasonable belief standard to mean that the shareholder's analysis was based on a good-faith effort to apply the Internal Revenue Code, Treasury Regulations, and other administrative guidance. In effect, the shareholder must know and understand the PFIC

provisions and make a good-faith effort to apply the income and asset tests of section 1297.

Shareholders seeking to make a retroactive election under the protective regime must also file a single Protective Statement that applies to a taxable year to preserve the shareholder's ability to make a retroactive election with respect to such taxable year and subsequent future taxable years (Temp. Reg. Sec. 1.1295-3T(c)). Shareholders must include in the Protective Statement information describing the basis for the shareholder's conclusion that the foreign corporation was not a PFIC and agree to extent the statute of limitations for all taxable years to which the Protective Statement applies. Certain "qualified shareholders" (generally those shareholders owning, directly or indirectly, less than two percent of the vote and value of each class of the foreign corporation's stock) are not required to satisfy the reasonable belief standard or file a Protective Statement to preserve their ability to make a retroactive election (Temp. Reg. Sec. 1.1295-3T(e)).

The second set of rules (called the "consent regime") permits shareholders to seek the Commissioner's consent to make a retroactive election under certain circumstances (Temp. Reg. Sec. 1.1295-3T(f)). For example, a shareholder that reasonably relied on the advice of a qualified tax professional may request the Commissioner's consent to file a retroactive election. The regulations give as an example of reasonable reliance the failure of a qualified tax professional, either through ignorance of the law or negligence, to identify the foreign corporation as a PFIC or failed to advise the shareholder of the consequences of making, or failing to make, a QEF election (Temp. Reg. Sec. 1.1295-3T(f)(2)). In no case will the Internal Revenue Service grant consent under this regime if a retroactive election would prejudice the government's interests by putting the shareholder in a more favorable position than if the election had been made on a timely basis (Temp. Reg. Sec. 1.1295-3T(f)(3)).

The person making a retroactive election under either regime is the person the makes the QEF election, as provided in Temp. Reg. Sec. 1.1295-1T(d) (Temp. Reg. Sec. 1.1295-3T(c)(3) and (f)(4)(iv)). Entity-level requests must be made in the case of domestic partnerships, S corporations, domestic nongrantor trusts, and domestic estates that own PFIC stock, and partner or beneficiary-level requests must be made in the case of foreign partnerships, foreign trusts, domestic grantor trusts, and foreign estates that own PFIC stock (Temp. Reg. Sec. 1.1295-3T(g)(3)). The requirements for making the actual election are found in Temp. Reg. Sec. 1.1295-3T(g).

Maintaining and Terminating QEF Elections. For taxable years beginning after December 31, 1997, shareholders only need to file Form 8621 every year and maintain records that support the information reported on that form. Shareholders must retain copies of all Forms 8621, attachments to those forms, and PFIC Annual Information Statements of Annual Intermediary Statements for all taxable years subject to the QEF election (Temp. Reg. Sec. 1.1295-1T(f)(2)(ii)). For prior years, shareholders were required to attach the PFIC Annual Information Statement to the return.

The commissioner of internal revenue has the discretion to invalidate or terminate a QEF election if the shareholder or PFIC fails to satisfy the section 1295 election requirements (Temp. Reg. Sec. 1.1295-1T(i)(1)). The commissioner also has the authority to overlook an intentional failure to satisfy the section 1295 election requirements. If the commissioner *invalidates* a QEF election, the shareholder will be treated as if it never made a QEF election with respect to the PFIC. If the Commissioner *terminates* a QEF election for a taxable year, the QEF election will be inapplicable for such taxable year and subsequent years.

A shareholder may revoke its QEF election only with the Commissioner's consent. The rules for requesting such consent are found in Temp. Reg. Sec. 1.1295-1T(i)(2). A shareholder can make another QEF election with respect to the PFIC after the fifth taxable year following the revocation, termination, or invalidation (Temp. Reg. Sec. 1.1295-1T(i)(4)). The shareholder may request consent to make the reelection for an earlier taxable year.

The effects of an invalidation, termination, or revocation are provided in Temp. Reg. Sec. 1.1295-1T(i)(3). At the commissioner's discretion, stock of a foreign corporation with respect to which the QEF election no longer applies will be treated as sold as of the last day of the PFIC's last taxable year as a QEF.

Direct and Indirect Ownership

To determine the U.S. shareholder's pro rata share of the PFIC's ordinary earnings and net capital gain, the ownership attribution rules of section 1298(a) are applied. U.S. persons are deemed to own the stock owned by a partnership, estate, or trust in proportion to their interest in the entity. A U.S. person who owns 50 percent or more of the value of the stock of a corporation is deemed to own a proportionate share of the corporation's stock in a PFIC (section 1298(a)(2)(A)). If the corporation in which the U.S. person owns stock is itself a PFIC, the U.S. person is treated as own-

ing a proportionate share of the PFIC's stock in a second-tier PFIC, regardless of the person's ownership percentage (that is, the 50-percent rule does not apply) (section 1298(a)(2)(B)). This rule continues to apply to a foreign corporation that is treated as a non-PFIC with respect to a shareholder because the shareholder is subject to the subpart F rules with respect to the corporation (section 1298(a)(2)(B)). Finally, a U.S. shareholder who has an option to purchase PFIC stock is treated as owning the PFIC stock for purposes of section 1293(a). A U.S. person who is deemed to own stock under section 1298(a) is not treated as actually owning the stock for purposes of reattributing the stock to another person. This rule may be modified by regulations to treat a U.S. partnership that is the indirect owner of PFIC shares as actually owning the stock for purposes of reattributing the stock to its U.S. partners.

If a U.S. person is treated as owning stock in a PFIC under the attribution rules, any distribution to the actual owner of the stock is treated as a distribution to the U.S. person (section 1298(b)(5)). Such distributions will be treated as the receipt of previously taxed income and will not be included in the income of the U.S. person a second time.

Coordination of Section 1291 With the Taxation of Shareholders Making the QEF Election

The deferred tax and interest rules of section 1291 do not apply to distributions from a PFIC or to gain recognized on the sale of PFIC stock if (1) the PFIC is a QEF with respect to the shareholder for each of its taxable years beginning after 1986 for which it is a PFIC and (2) that includes any portion of the taxpayer's holding period (section 1291(d)(1)). Gain recognized on the sale of such PFIC stock will be capital gain if the stock is a capital asset and will not be subject to an interest charge. A PFIC for which a QEF election has been in place for all taxable years that include a shareholder's holding period is known as a *pedigreed QEF* (Treas. Reg. Sec. 1.1291-9(j)(2)(ii)).

If the PFIC was a nonqualified fund for a year beginning after 1986 and such year includes a portion of the shareholder's holding period, any subsequent gain on the sale of the PFIC stock will be subject to the section 1291 deferred tax and interest rules, even if the shareholder subsequently makes a QEF election. Such a QEF is referred to as an *unpedigreed QEF* (Treas. Reg. Sec. 1.1291-9(j)(2)(iii)). A shareholder who owns stock in a PFIC that previously was a nonqualified fund and for which a

QEF election is made in a subsequent year may avoid the deferred tax and interest charges (that is, "purge" the non-QEF years from the shareholder's holding period) by making either a "deemed sale election" (section 1291(d)(2)(A)) or, in the case of a PFIC that is also a CFC, a "deemed dividend election" (section 1291(d)(2)(B)).

In the case of a *deemed sale election*, the shareholder is deemed to sell the PFIC stock for its fair market value on the first day of the first taxable year of the corporation that it is treated as a QEF under section 1295 (Treas. Reg. Sec. 1.1291-10(e)). The deemed sale date is referred to in the regulations as the *qualification date*. Gain from this deemed sale is treated as an excess distribution received on the qualification date and is allocated to the days in the holding period of the shareholder prior to the qualification date (Treas. Reg. Sec. 1.1291-10(a)). The shareholder increases the basis in the PFIC stock by the amount of the gain (Treas. Reg. Sec. 1.1291-10(f)), and the holding period for the stock begins on the qualification date (Treas. Reg. Sec. 1.1291-10(g)). Any subsequent gain on the actual sale of the PFIC stock is taxed under the QEF rules.

The deemed sale election may be made by shareholders of an unpedigreed QEF provided the shareholders held stock of that PFIC on the qualification date (Treas. Reg. Sec. 1.1291-10(b)). The election can be made by shareholders who would realize a loss on the deemed sale, although such loss cannot be recognized (Treas. Reg. Sec. 1.1291-10(d)). The election is made by filing Form 8621 with the return for the taxable year of the shareholder that includes the qualification date, reporting the gain as an excess distribution, and paying the tax and interest due on the excess distribution (Treas. Reg. Sec. 1.1291-10(d)). The shareholder makes the election in the shareholder's return for the taxable year that includes the qualification date (Treas. Reg. Sec. 1.1291-10(c)).

Example 10.8. Jones, a U.S. individual, has owned stock in foreign corporation Phi since July 1, 1992. Phi met the definition of a PFIC for each of its taxable years. In 1999, Jones makes a QEF election with respect to Phi. On the qualification date, the fair market value of her stock in Phi was $100,000 and her adjusted basis was $60,000. Jones may elect to recognize the $40,000 unrealized appreciation as gain on the qualification date. The gain will be treated as an excess distribution and allocated to each day in her holding period prior to the deemed sale date and be taxed under section 1291. Jones's adjusted basis in the stock will increase to $100,000, and her holding period will begin on the qualification date. The PFIC will now be treated as a pedigreed QEF with respect to Jones. If she sells the PFIC stock in 2002 for

$120,000, the $20,000 gain will be treated as capital gain and will not be subject to deferred tax or interest.

Time for Determination of PFIC Status

Shareholders in a PFIC that is a *nonqualified fund* will continue to be treated as holding PFIC stock for every year they hold the stock, even if the foreign corporation no longer qualifies as a PFIC (section 1298(b)(1)) (the "once a PFIC, always a PFIC" rule). This means that distributions or any gain on the subsequent sale of the PFIC stock will be subject to deferred tax and interest. A shareholder of a foreign corporation that was not a QEF at some point during the shareholder's holding period and that ceases to be a PFIC may elect to purge the stock of its PFIC taint by making a deemed sale election or a deemed dividend election under section 1291(d)(2).

The stock of a PFIC that was a QEF for all of the shareholder's holding period automatically ceases to be PFIC stock when the foreign corporation no longer is a PFIC. However, this event is considered a disposition for purposes of terminating all prior elections to defer the payment of tax and interest under section 1294.

Coordination of PFIC Rules With Subpart F Rules

Amounts that are includable in a shareholder's income under both the subpart F rules (section 951) and the PFIC rules are included only under the subpart F rules (section 1297(e)). In effect, the foreign corporation is not treated as a PFIC with respect to U.S. shareholders during the "qualified portion" of such shareholder's holding period with respect to stock in such corporation (section 1297(e)(1)). The *qualified portion* means the portion of the shareholder's holding period that is after December 31, 1997 and during which the shareholder is a U.S. shareholder, as defined in section 951(b) (that is, a shareholder who owns, directly or indirectly, 10 percent or more of the total combined voting power of all classes of stock entitled to vote).

This rule does not apply to holders of options who are deemed to own stock indirectly in the foreign corporation under section 1298(a)(4) unless the holder establishes that the stock is owned by a U.S. shareholder who is not a tax-exempt entity (section 1297(e)(4)). Such share-

holders will be subject to the PFIC rules even if they are treated as U.S. shareholders in a foreign corporation that is a CFC because they are not deemed to have an income inclusion under subpart F (that is, the direct and indirect ownership rules under section 958(a) do not include option attribution).

QEF Status Not Elected

A U.S. shareholder of a CFC/PFIC that was not a QEF at some point during the shareholder's holding period and for which the shareholder makes a subsequent QEF election may make a *deemed dividend election* under section 1291(d)(2)(B) to purge the stock of its section 1291 taint. Instead of recognizing gain on the unrealized appreciation in the stock as of the qualification date, shareholders may elect to include in gross income as a dividend received on such date an amount equal to their pro rata share of the corporation's "post-1986 earnings and profits" (Treas. Reg. Sec. 1.1291-9(a)).

Post-1986 earnings and profits are defined as the earnings and profits accumulated as of the qualification date (1) in taxable years beginning after 1986 and (2) during the period in which the shareholder held the stock while the corporation was a PFIC (Treas. Reg. Sec. 1.1291-9(a)(2)).

The dividend is treated as an excess distribution and is allocated only to the days taken into account in computing the corporation's post-1986 earnings and profits (that is, the holding period takes into account only days in taxable years beginning after 1986 during which the shareholder held the stock and the corporation was a PFIC) (Treas. Reg. Sec. 1.1291-9(a)(1)). The dividend increases the basis of the shareholder's stock in the PFIC, and the holding period begins on the qualification date (Treas. Reg. Sec. 1.1291-9(f) and (g)).

The rules for who may make the election, the time for making the election, and the manner of making the election are similar to the deemed sale rules (see Treas. Reg. Sec. 1.1291-9(b) through (d)).

Qualified Electing Funds

In the case of a CFC/PFIC that is a QEF, any gain from the sale of the stock is not treated as a dividend under section 1248(a), to the extent it represents income that was previously taxed under the QEF rules and that has not been distributed by the PFIC.

Special rules apply to U.S. shareholders of a CFC/PFIC with respect to certain *high-tax income* (income subject to a rate of tax that is at least 90 percent of the highest rate specified in section 11) and income from U.S. sources that is effectively connected with a U.S. trade or business and that is not exempt from U.S. tax (or is subject to a reduced rate of tax) pursuant to a treaty with the United States (section 1293(g)(1)). Such income is excluded from the ordinary earnings and net capital gain of the QEF for purposes of determining the U.S. shareholder's pro rata share of the QEF's earnings under section 1293(a). It is anticipated that such income will have to be segregated into a separate earnings and profits account, and ordering rules to characterize subsequent distributions that are similar to the section 959(c) ordering rules will be prescribed.[14]

Congress also provided regulatory authority to prevent the same item of income of a QEF from being included in the gross income of a U.S. person more than once (section 1293(g)(2)). In the case of a CFC/PFIC that is a qualified election fund (QEF), it is intended that in cases in which the CFC/PFIC owns stock in a second-tier CFC that is not a PFIC, U.S. shareholders who include the subpart F income of the second-tier corporation in their income currently under the subpart F rules will not include such income in gross income a second time under the QEF rules when the second-tier corporation distributes such income to the first-tier CFC/PFIC (that is, the distribution will not be included in the ordinary earnings of the first-tier CFC/PFIC with respect to that shareholder).[15]

Coordination of the PFIC Rules With the Foreign Tax Credit Rules

QEF Status Not Elected

A shareholder of a PFIC for which QEF status was not elected is eligible for the direct foreign tax credit (section 901) on distributions received, and corporate shareholders are also eligible for the deemed-paid credit (section 902). Under the rules of section 1291(g), the U.S. shareholder first determines the direct (for example, withholding) foreign taxes and, if applicable, the indirect foreign taxes that are creditable under the gen-

[14]Senate Finance Committee Report, 340-341.

[15]*Ibid.*, 341.

eral foreign tax credit rules. The shareholder must then apportion, on a pro rata basis, the creditable taxes between the portion of the distribution that is an excess distribution and the portion that is not an excess distribution. The gross-up principles of section 78 are applied to determine the amount of the distribution and the portion that is an excess distribution. Examples of the apportionment process are found in Prop. Treas. Reg. Sec. 1.1291-5.

The creditable taxes that are attributable to the excess distribution that is apportioned to the current and pre-PFIC years are taken into account under the general foreign tax credit rules. The creditable taxes that are allocated to days in years on which the deferred tax is imposed are subject to the separate foreign tax credit limitation rules of section 904. The creditable tax may reduce the deferred tax due for a particular year, but not below zero. Any excess of creditable tax over the deferred tax due may not be carried over.

> *Example* 10.9. Lansing Corporation, a U.S. corporation, received a $100 dividend from Eta Corporation, a CFC/PFIC, on the last day of its taxable year. A creditable foreign tax of $5 was withheld on the payment. In addition, Lansing Corporation is entitled to a deemed-paid credit of $50 under section 902, and the dividend is all general limitation income. After taking into account the $50 gross-up under section 78, Lansing Corporation has an excess distribution of $90. Lansing Corporation purchased the stock of Eta on the first day of the fourth taxable year prior to the current year. For purposes of computing the creditable taxes under section 1291(g), Lansing Corporation has $55 of creditable taxes, $33 of which are allocated to the excess distribution ($90/$150 × $55). Assuming there are no pre-PFIC years in Lansing Corporation's holding period, $72 of the excess distribution is subject to deferred tax. (On a pro rata basis, four-fifths of the distribution would be allocated to years other than the current taxable year.) Therefore, $26.40 of the creditable taxes would be available to reduce the deferred taxes ($72/$90 × $33). Assuming a U.S. tax rate of 34 percent in each of the deferred tax years, the cumulative deferred tax would be $24.48 (34% × $72). The excess creditable tax of $1.92 may not be used to offset any other U.S. tax in the current year. The amount of the excess distribution that is allocated to the current year ($18) and the foreign tax credit attributable to it ($6.60) are combined with the nonexcess distribution ($60) and its attributable foreign tax credit ($22) and are taken into account in the current taxable year under the general foreign tax credit rules.[16]

[16] *Ibid.*, 338.

Qualified Electing Funds

U.S. persons who are shareholders of a QEF are eligible for the direct foreign tax credit and, if applicable, the indirect foreign tax credit on distributions from the PFIC (section 1293(f)). In cases in which the QEF is a CFC, a corporate shareholder that is also a U.S. shareholder will be eligible to treat the amounts included in income under section 1293(a) as received under section 951(a) for purposes of claiming the indirect foreign tax credit allowed under section 960 (section 1293(f)). Amounts distributed to such corporate shareholders and excluded from gross income under section 1293(c) are treated as excluded under section 959 for purposes of claiming a foreign tax credit under section 960.

For purposes of applying the foreign tax credit limitation under section 904, a U.S. person who is also a U.S. shareholder in a CFC/PFIC is subject to look-through treatment similar to the subpart F rules. If a QEF meets the definition of a noncontrolled section 902 corporation (section 904(d)(2)(E)) with respect to the taxpayer, the income inclusion under section 1293(a) is treated, for foreign tax credit purposes, as a dividend and is subject to a separate limitation. If neither of the previous two conditions is satisfied, the income is characterized as passive income for foreign tax credit purposes.

11

Earnings and Profits

The tax status of actual and deemed distributions from foreign corporations and the characterization of gains from the sale of stock of certain foreign corporations are determined by reference to the foreign corporation's earnings and profits. Specifically, the computation of a foreign corporation's earnings and profits is required in the determination of the following:

- The indirect (deemed-paid) foreign tax credit on actual distributions (section 902) and deemed distributions of subpart F income (section 960)[1]
- The amount of a controlled foreign corporation's (CFC) subpart F income included in a U.S. shareholder's gross income (section 952(c))[2]
- The amount of a CFC's investment of earnings in U.S. property or excess passive assets that is included in a U.S. shareholder's gross income (sections 956(a) and 956A)[3]

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[1]See chapters 7 and 8 for the specific details relating to this topic.

[2]See chapter 8 for the specific details relating to this topic.

[3]See chapter 8 for the specific details relating to this topic.

- The amount of an actual distribution from a CFC that is excluded from a U.S. shareholder's gross income to the extent it represents previously taxed earnings and profits (section 959(a))[4]
- The amount of gain from the sale of CFC stock that is considered a dividend (section 1248)[5]
- The tax consequences of an inbound or foreign-to-foreign reorganization (section 367(b))[6]
- The tax effects of a section 338 election with respect to the acquisition of the stock of a foreign corporation[7]
- The tax status of deemed and actual distributions from a passive foreign investment company (PFIC) and the characterization of gain on the sale of PFIC stock (sections 1291 and 1298)[8]
- The allocation of interest and other expenses under the asset-based allocation methods (section 864(e)(4))[9]

The Tax Reform Act of 1986 made significant changes in the computation of a foreign corporation's earnings and profits. Most important, the computation of the earnings and profits of a CFC and a non-CFC was harmonized, and such earnings and profits must now be calculated, with limited exceptions, using the foreign corporation's functional currency (as defined in section 985).

This chapter begins with a discussion of the "concept" of earnings and profits as it applies to domestic corporations. The current rules applicable to the calculation of foreign earnings and profits are then described. The chapter concludes with a summary of the methods applicable to foreign earnings and profits for years prior to the effective date of the Tax Reform Act of 1986 (years beginning after December 31, 1986). The application of foreign earnings and profits to the various transactions listed previously is discussed in the respective chapters, as noted, and is not repeated in this chapter.

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[4]See chapter 8 for the specific details relating to this topic.

[5]See chapter 14 for the specific details relating to this topic.

[6]See chapter 14 for the specific details relating to this topic.

[7]See chapter 14 for the specific details relating to this topic.

[8]See chapter 10 for the specific details relating to this topic.

[9]See chapter 5 for the specific details relating to this topic.

The Computation of Domestic Earnings and Profits

A fundamental principle of the U.S. tax system is the double taxation of distributed corporate income. A U.S. corporation is taxed on the income it earns (an exception exists for S corporations), and its shareholders are taxed on distributions of that income. A corporate distribution will be treated as a distribution of corporate earnings (and therefore included in the shareholders' income) to the extent it represents a distribution out of the corporation's "earnings and profits." Such distributions are classified as dividends and are included in the gross income of the shareholder recipient (section 61(a)(7)).

Not all distributions to a shareholder are dividends; a distribution may represent (1) a return of the shareholder's previous investment in the corporation (a return of capital), (2) proceeds from the sale or exchange of part or all of the shareholder's stock between the shareholder and the corporation (for example, a redemption or liquidation), (3) payment of compensation to the shareholder for services performed, (4) repayment of debt interest or principal by the corporation on a loan made by the shareholder, or (5) rental or lease payments for the use of the shareholder's property.

Section 316(a) defines a *dividend* as any distribution of property made by a corporation to its shareholders out of its (1) earnings and profits accumulated after February 28, 1913, or (2) earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of earnings and profits at the time the distribution was made.

Section 316(a) also states that "every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits." In other words, whenever a corporation makes a property distribution to its shareholders in their capacity as shareholders, the distribution will be treated as a dividend for tax purposes to the extent it is paid out of the corporation's earnings and profits account. The corporation must keep two earnings and profits accounts: an earnings and profits account for the current year's operations (current earnings and profits) and an earnings and profits account that represents the cumulative undistributed earnings and profits of all prior years (accumulated earnings and profits). Any undistributed balance in current earn-

ings and profits is added to accumulated earnings and profits at the beginning of the next taxable year.

This separation of current from accumulated earnings and profits dates back to 1936, when the United States taxed a corporation on distributed current-year income at a rate that was lower than that imposed on retained current-year income. The computation of a current-year earnings and profits account was necessary to determine whether current-year income had been distributed or retained. This dual tax rate structure was repealed in the United States in 1939, but the separation of current-year earnings and profits from accumulated prior-years earnings and profits was retained. For corporations that pay out less than their current earnings and profits each year, this separation is convenient because it does not require a computation of accumulated earnings and profits for each year.

Computation of Earnings and Profits

The term *earnings and profits* has been referred to by commentators as a "term of art"[10] due to the fact that the Internal Revenue Code and the regulations do not provide a comprehensive definition for it. The term first appeared in the federal income tax laws in the Revenue Act of 1916 and has since been defined through statute, regulations, rulings, and case law. Section 312 and related regulations provide a list of "partial" adjustments that must be made to taxable income to compute current earnings and profits. Earnings and profits are not equivalent to "retained earnings" on a financial balance sheet.[11] Earnings and profits are intended to be a measure of the earnings of the corporation available for distribution to its shareholders; however, "earnings" does not necessarily mean taxable earnings. Under this concept, there exists the possibility that a shareholder will be taxed on a distribution of income from a corporation that was not taxed at the corporate level (nor would have been taxed at the individual level if the shareholder had received the income directly).

Section 312 lists the types of adjustments that must be made to taxable income in order to calculate earnings and profits. Earnings and profits require a separate accounting system. These adjustments can be characterized as follows:

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[10]Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, 5th ed. (New York: Warren, Gorham & Lamont, 1987), 7–5.

[11]*Estate of Vincent DeNiro*, 60 T.C.M. 300 (1990).

- Inclusion of certain types of income that are excluded from taxable income
- Disallowance of certain deductions that are included in taxable income
- Allowance of certain deductions that are excluded from taxable income
- Deferral of deductions or acceleration of income due to separate accounting methods required for earnings-and-profits purposes

Exclusions From Taxable Income Included in Earnings and Profits. Treas. Reg. Sec. 1.312-6(b) states that "all income exempted by statute" must be added back to taxable income in computing earnings and profits. However, leading commentators do not interpret "all" to mean "all".[12] Adjustments that are made include (1) tax-exempt bond interest (section 103), (2) tax-exempt life insurance proceeds (section 101(a)), and (3) refunds of federal income taxes paid by a cash method corporation. Adjustments are not made for (1) gifts, (2) contributions to capital, and (3) bequests.

Deductions Allowed for Tax Purposes Disallowed in Computing Earnings and Profits. "Artificially created deductions" that require no cash outlay by the corporation or are carryovers from a different tax year are generally not deductible in computing current earnings and profits. This category would include any (1) dividends-received deduction (section 243), (2) net operating loss deductions from a different tax year (section 172), (3) net capital loss carryback or carryforward from a different tax year (section 1212), and (4) charitable contribution carryforward from a prior tax year (section 170).

Income Deferred for Tax Purposes Included in Computing Earnings and Profits. Certain accounting methods that defer the recognition of income into taxable income are not allowed in the computation of earnings and profits. If the installment sales method is used for federal income tax purposes, the deferred gain must be included in earnings and profits currently (section 312(n)(5)). Corporations using the completed contract method must use the percentage-of-completion method for earnings-and-profits purposes (section 312(n)(6)).

[12]For a comprehensive discussion of the details relating to the computation of domestic earnings and profits, see Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, chapter 7.

Expenses Deducted for Tax Purposes Deferred in Computing Earnings and Profits. Section 312(n) was added in 1984 to "ensure that a corporation's earnings and profits more closely conform to its economic income."[13] To achieve this result, expenses such as construction-period interest, property taxes, and similar carrying charges must be capitalized and depreciated over the life of the property (section 312(n)(1)). Intangible drilling costs deducted under section 263(c) must be capitalized and amortized over sixty months (section 312(n)(2)(A)). Mineral exploration and development costs deducted under sections 616 or 617 must be capitalized and amortized over 120 months (section 312(n)(2)(B)). Circulation expenditures (section 173) and organization expenditures (section 248) must be capitalized and treated as part of basis (section 312(n)(3)). Increases in the "LIFO recapture amount" (FIFO inventory less LIFO inventory) will increase earnings and profits (section 312(n)(4)).

Depreciation must be computed using the prescribed earnings-and-profits method (section 312(k)). The depreciation method used depends on when the assets were acquired. For property acquired after 1986, the "alternative depreciation system" of section 168(g)(2) must be used; that is, straight-line depreciation is taken over the asset's midpoint class life (forty years in the case of real property). The alternative depreciation system is required for assets used predominantly outside the United States. For property acquired from 1981 to 1986, straight-line depreciation must be taken using prescribed recovery periods depending on the asset's classification (for example, three-year property is depreciated over five years for earnings-and-profits purposes). For property acquired prior to 1981, straight-line depreciation must be taken over the asset's useful life that is used for federal income tax purposes. If an asset is subsequently sold or distributed, the gain or loss to be included in earnings and profits is based on the asset's basis for earnings-and-profits purposes.

Cost depletion, rather than percentage depletion, of minerals must be used in computing earnings and profits (Treas. Reg. Sec. 1.312-6(c)).

Items Deducted for Earnings-and-Profits Purposes Not Deductible in Computing Taxable Income. Certain items not deductible in computing taxable income are deductible in computing earnings and profits because such expenditures impair the corporation's ability to distribute earnings

[13]Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (H.R. 4170), 98th Cong., 2d sess., 1985, Committee Print, 177.

without reducing the corporation's capital. Such current-year expenditures include (1) federal income taxes (including the alternative minimum tax) paid or accrued (depending on the method of accounting), (2) expenses incurred in earning tax-exempt income (nondeductible under section 265), (3) excess current-year charitable contributions (nondeductible under section 170(b)(2)), (4) premiums on life insurance (nondeductible under section 264), (5) current-year net capital loss (nondeductible under section 1211), (6) entertainment expenses disallowed under section 274, and (7) lobbying expenses, political contributions, and perhaps penalties and fines under section 162(c).[14]

If a distribution is made to a 20-percent corporate shareholder that is entitled to the dividends-received deduction, the adjustments made by sections 312(k) and 312(n) are not made in computing earnings and profits solely for purposes of computing the amount of the corporate shareholder's income from the distribution (section 301(e)). The objective of this provision is to reduce the amount of a distribution treated as a dividend to a corporate shareholder. (Only 20 percent of the distribution is taxable due to the 80-percent dividends-received deduction.)

Accounting Methods

Treas. Reg. Sec. 1.312-6(a) states that a corporation uses the same method of accounting for earnings and profits as it does for taxable income unless otherwise specified in section 312(k) or section 312(n). Gains and losses deferred for tax purposes under section 1031 (like-kind exchanges) and section 1033 (involuntary conversions) are also deferred for earnings-and-profits purposes. A corporation using the accrual method for regular tax purposes must use the accrual method for earnings-and-profits purposes. Older court decisions have held that cash method corporations can use the accrual method in computing the adjustment to earnings and profits for federal income taxes.[15] In more recent decisions the Tax Court and the Third Circuit Court of Appeals have held that cash method corporations must use the cash method in computing earnings and profits.[16] There is no statute of limitations on

[14]Bittker and Eustice (*Federal Income Taxation of Corporations and Shareholders*, 7-22) speculate that to allow such deductions for earnings-and-profits purposes would frustrate public policy against such payments.

[15]*Demmon v. United States*, 321 F.2d 203 (CA-7, 1963).

[16]*Mazzocchi Bus Co., Inc.*, 14 F.3d 923 (CA-3, 1994), *aff'g*. 65 T.C.M. 1858 (1993).

the computation of earnings and profits. A summary of common adjustments made to taxable income to compute current earnings and profits is provided in table 11.1.

Table 11.1

Formula for Computing Current Earnings and Profits

Taxable Income (or net operating loss)

Add: *Exclusions* from taxable income
- Tax-exempt bond interest (state/municipal bonds)
- Life insurance proceeds
- Federal tax refunds

Add: *Deductions* allowed for tax purposes but not for earnings and profits
- Dividends-received deduction
- Net operating loss deductions from other tax years
- Net capital loss carrybacks or carryforwards
- Contribution carryforwards

Add: *Income deferred* for tax purposes but not for earnings and profits
- Deferred gain on installment sales
- Deferred gain on completed contract method of accounting

Add: *Deductions deferred* for earnings-and-profits purposes
- Tax depreciation in excess of earnings-and-profits depreciation
- Percentage depletion in excess of cost depletion
- Capitalization of construction-period interest, taxes, and carrying charges
- Amortization of intangible costs of oil and gas wells over sixty months
- Amortization of mineral exploration and development costs over 120 months
- Capitalization of circulation expenditures and organization expenses

Less: *Deductions* allowed for earnings-and-profits purposes but not for tax
- Federal income taxes paid or accrued
- Expenses of earning tax-exempt income
- Current-year charitable contributions in excess of 10-percent limitation
- Nondeductible premiums on life insurance policies
- Current year's net capital loss
- Excess of earnings-and-profits depreciation over tax depreciation
- Decreases in the "LIFO recapture amount" (FIFO inventory over LIFO)
- Disallowed entertainment expenses and other disallowed expenses
- Lobbying expenses and political contributions

Equals: *Current Earnings and Profits*

The Computation of Foreign Earnings and Profits After the Tax Reform Act of 1986

Prior to the enactment of the Tax Reform Act of 1986 (effective for taxable years beginning after December 31, 1986), the earnings and profits of a foreign corporation could be computed using four different methods. (These methods will be discussed in greater detail later in the chapter.) Different methods were required depending on whether the foreign corporation was a CFC or a non-CFC. In addition, different methods were required to determine the earnings and profits of a CFC for actual dividend distributions and for deemed distributions under subpart F (including investments in U.S. property, section 1248 transactions, and reorganizations subject to section 367(b)). Under the method required for subpart F income (sometimes referred to as the *full section 964 method*), the CFC was required to recognize exchange gain or loss resulting from the translation of the earnings and profits account into U.S. dollars.

Congress was concerned that these different methods of computing foreign earnings and profits gave U.S. shareholders of foreign corporations the opportunity to select the method that provided the most beneficial deemed-paid credit.[17] As a result, in the Tax Reform Act of 1986, Congress mandated that the earnings and profits of a foreign corporation be "computed consistently under the rules of sections 964(a) and 986(b) for all federal income tax purposes" (Temp. Treas. Reg. Sec. 1.964-1T(g)(5)). Section 986(b) requires that foreign earnings and profits be computed using the foreign corporation's *functional currency* (as defined in section 985(b)).[18] These rules apply to all foreign corporations (CFC or non-CFC) and to all transactions requiring the computation of foreign earnings and profits (for example, actual distributions, subpart F deemed distributions, section 1248 sales, and section 367(b) reorganizations). Similar rules apply to foreign branches and to other foreign qualified business units.

As described later in this chapter, a special rule applies to foreign corporations engaged in business in hyperinflationary economies. Such corporations are required to use the U.S. dollar as their functional currency and to compute their earnings and profits under the *dollar-approximate-separate-transactions-method* (Treas. Reg. Sec. 1.985-3).

[17]Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 99th Cong., 2d sess., 1987, Committee Print, 1087-1088.

[18]See chapter 18 for a comprehensive discussion of the definition of a foreign corporation's functional currency.

Functional Currency Method

The earnings and profits of a foreign corporation that does not keep its books and records in U.S. dollars must be computed "according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary" (section 964(a)). For taxable years beginning after December 31, 1986, foreign earnings and profits must be computed in accordance with the regulations under Treas. Reg. Sec. 1.964-1, except that translation into U.S. dollars (Treas. Reg. Sec. 1.964-1(d)) and recognition of exchange gain and loss (Treas. Reg. Sec. 1.964-1(e)) are not permitted (Temp. Treas. Reg. Sec. 1.964-1T(g)(1)(i)). In essence, the method required by the Tax Reform Act of 1986 is similar to the "partial section 964 method" existing before the act, except that foreign taxes are now maintained in U.S. dollars rather than in the foreign corporation's functional currency.[19]

The regulations under section 964 provide a three-step method for computing a foreign corporation's earnings and profits. Step 1 requires the foreign corporation to prepare a profit and loss statement for each year from the books of account regularly maintained by the corporation for the purpose of accounting to its shareholders. Step 2 requires the foreign corporation to adjust the profit and loss statement to conform to U.S. generally accepted accounting principles (GAAP). Step 3 requires the foreign corporation to make further adjustments to the profit and loss statement to conform it to U.S. tax accounting standards. Each of these steps will be discussed separately.

Step 1—Profit and Loss Statement Preparation. Treas. Reg. Sec. 1.964-1(a)(1) requires a foreign corporation to prepare a profit and loss statement in its functional currency from the books of account that it regularly maintains for the purpose of accounting to its shareholders. No additional elaboration is provided in the regulations. The objective of this provision is to ensure that the profit and loss statement is not created by the foreign corporation solely for use in computing earnings and profits for U.S. purposes.[20]

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[19]For a comprehensive discussion of the current and prior rules applicable to the computation of foreign earnings and profits, see Broenen, Engle, Mott, Shedivy, Stricof, and Zaiken, *Foreign Corporation Earnings and Profits*, Tax Management Portfolio No. 932 (Washington, DC: Tax Management, Inc., 1990).

[20]*Ibid.*, A-7.

Step 2—Accounting Adjustments. After the profit and loss statement is prepared, the foreign corporation must adjust the statement to conform to "those accounting principles generally accepted in the United States for purposes of reflecting in the financial statements of a domestic corporation the operations of its foreign affiliates" (Treas. Reg. Sec. 1.964-1(b)). Adjustments must be made for the following:

- *Clear reflection of income.* Any accounting practice that does not result in a clear reflection of income and expense on a current basis is not permitted. Examples include allocations made to an arbitrary reserve out of current income (Treas. Reg. Sec. 1.964-1(b)(1)(i)) and the inclusion of income from stock dividends and from corporate distributions representing a return of capital (Treas. Reg. Sec. 1.964-1(b)(3), example (2)).
- *Physical assets, depreciation, etc.* All physical assets, including inventory, must be accounted for at "historical cost" computed either for individual assets or groups of similar assets (Treas. Reg. Sec. 1.964-1(b)(1)(ii)). Physical assets include all assets other than a "financial asset" (for example, cash, bank deposits, marketable securities held for at least six months, loans, and accounts receivable) and include goodwill, patents, and other intangibles (Treas. Reg. Sec. 1.964-1(e)(5)(ii)). Depreciation, depletion, and amortization allowances are to be based on historical cost, and adjustments based on other than historical cost (for example, inflation accounting in a hyperinflationary economy) must be reversed.
- *Valuation of assets and liabilities.* Accounting methods that systematically undervalue assets or overvalue liabilities are not permitted, even if such methods are expressly permitted or required by foreign law (Treas. Reg. Sec. 1.964-1(b)(1)(iii)). An example requiring such an adjustment is inventory written down to market value. Accounting methods that comply with U.S. tax accounting standards allowed under Treas. Reg. Sec. 1.964-1(c) are permitted.
- *Income equalization.* Income and expense are to be taken into account without regard to equalization over more than one accounting period (Treas. Reg. Sec. 1.964-1(b)(1)(iv)). No effect is to be given to any equalization reserve or similar provision affecting income or expense, even though expressly permitted or required under foreign law, except to the extent that such method complies with U.S. tax accounting standards (for example, the percentage-of-completion method for long-term contracts).

- *Foreign currency.* Transactions recorded in a foreign currency other than the foreign currency in which the books of the foreign corporation are regularly kept must be translated into the foreign currency in which the books are kept, using the procedure described in Treas. Reg. Sec. 1.964-1(d) and section 985.

Accounting adjustments are only required if they are "material" (Treas. Reg. Sec. 1.964-1(a)). Whether an adjustment is material depends on the facts and circumstances of each case, including (1) the amount of the adjustment, (2) its size relative to the general level of the corporation's total assets and annual profit or loss, (3) the consistency with which the practice has been applied, and (4) whether the nature of the item to which the adjustment relates is recurring or merely nonrecurring. Most practitioners use a 5-percent-of-net-income threshold as a materiality standard.[21]

Step 3—Tax Adjustments. The profit and loss statement, after adjustment for U.S. generally accepted accounting principles, must be further adjusted to conform to U.S. tax accounting standards (Treas. Reg. Sec. 1.964-1(c)(1)). Adjustments are required for (1) accounting methods (the method must reflect the provisions of section 446 and the regulations thereunder), (2) inventories (inventories must be accounted for in accordance with the provisions of sections 471 and 472 and the regulations thereunder), and (3) depreciation (depreciation is computed in accordance with the provisions of section 167 if less than 20 percent of the gross income from all sources of the corporation is derived from U.S. sources; otherwise the earnings-and-profits depreciation method is required). For taxable years beginning after December 31, 1986, inventories must be calculated under the uniform capitalization rules of section 263A (with some exceptions), bad debts must be accounted for using the direct charge-off method, the percentage-of-completion method is required for long-term contracts, and the installment sale method may not be used for earnings-and-profits purposes (the effective date for this provision is taxable years beginning after December 31, 1987). In addition, any other methods allowed by the Internal Revenue Code or applicable regulations may be elected by the foreign corporation, and such election will have the same effect as if made by a domestic corporation (Treas. Reg. Sec. 1.964-1(c)(iv)).

[21]*Ibid.*

The Treasury Department issued proposed regulations in July 1992 that eliminate the book-to-tax adjustments attributable to depreciation and the section 263A uniform capitalization rules to simplify the computation of earnings and profits. Proposed Treas. Reg. Sec. 1.964-1(c)(1)(ii)(B) states that inventory accounting methods must conform to the tax accounting requirements of sections 471 and 472, but only those costs required to be capitalized under U.S. generally accepted accounting principles are required to be capitalized for earnings and profits purposes. For earnings and profits purposes, depreciation is computed using the recovery methods, conventions, and useful lives used by the foreign corporation in preparing its financial statements in accordance with U.S. generally accepted accounting principles. The asset's book basis can be used in computing earnings and profits unless the book basis differs materially in amount from the asset's tax accounting basis, in which case the tax accounting basis is to be used. The regulations contemplate that material differences are likely to occur if the "push down" or "purchase" method of accounting is used in determining the book basis of assets of an acquired foreign corporation, if a section 338 election has been made with respect to an acquired foreign corporation, or if the section 338 consistency rules apply (Prop. Treas. Reg. Sec. 1.964-1(c)(1)(iii)).

The proposed regulations will apply to taxable years beginning after December 31, 1991, if finalized. Proposed Treas. Reg. Sec. 1.964-1(c)(1)(v) grants an automatic consent to make any accounting method changes required by adherence to the proposed regulations, provided such changes take place in the first taxable year beginning after December 31, 1991, and any net adjustments under section 481 are amortized over six taxable years. The proposed regulations do not apply in computing a foreign corporation's taxable or gross income for subpart F purposes. Thus, a foreign corporation that is a CFC and is subject to subpart F must continue to make the inventory and depreciation tax accounting adjustments for purposes of computing its subpart F income.

A foreign corporation may adopt any acceptable accounting method in its first year of operations. In the first year in which a foreign corporation becomes a CFC, it is permitted to elect different tax accounting methods without the permission of the Internal Revenue Service, provided such methods are allowable under the Internal Revenue Code or regulations (Treas. Reg. Sec. 1.964-1(c)(2)). These elections must be made within 180 days after the close of the first taxable year of the CFC in which the computation of its earnings and profits is "significant for

United States income tax purposes with respect to its controlling U.S. shareholders" (Temp. Treas. Reg. Sec. 1.964-1T(g)(2)).

For taxable years of a CFC beginning before January 1, 1989, a significant event is one of the following:

- The U.S. shareholders are required to include an amount in their gross income under section 951(a) (that is, subpart F income or an investment of earnings in U.S. property).
- An amount is excluded from subpart F income by section 952(c) (the subpart F earnings-and-profits limitation), section 970(a) (export trade corporations), or former section 952(d) (the chain deficit rule).
- It is sought to be established that the corporation has foreign base company income (Treas. Reg. Sec. 1.964-1(c)(6)).

For taxable years of a CFC beginning after December 31, 1988, Temp. Treas. Reg. Sec. 1.964-1T(g)(2) expands the events that can cause a CFC's earnings and profits to have U.S. tax significance to include not only the events listed above, but also the following events:

- A distribution from the CFC to its shareholders with respect to their stock
- Any event making the CFC taxable under section 882
- An election by the CFC's controlling U.S. shareholders to use the tax book value method of allocating interest expense under section 864(e)(4)
- A sale or exchange of the CFC's stock by the controlling U.S. shareholders

The filing of the information return required by section 6038 does not by itself constitute a significant event. The addition of these events will significantly increase the number of CFCs that are required to make the necessary accounting method elections.

A failure to adopt or to elect an accounting method, except in cases in which reasonable cause is demonstrated to the satisfaction of the Commissioner of Internal Revenue, is treated as an affirmative election to compute earnings and profits using any permissible accounting method not requiring an election and reflected in the books of account regularly maintained by the CFC for the purpose of accounting to its shareholders (Temp. Treas. Reg. Sec. 1.964-1T(g)(3)). The elections must be made in accordance with the procedures described in Treas. Reg. Sec. 1.964-1(c)(3) and can only be made by the CFC or the controlling U.S. shareholder.

A *controlling U.S. shareholder* is defined for this purpose as those U.S. shareholders (as defined in section 951(b)) who, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of a foreign corporation that are entitled to vote and who undertake to act on its behalf (Treas. Reg. Sec. 1.964-1(c)(5)).

A minority shareholder may be required to compute a CFC's earnings and profits before the CFC or its controlling U.S. shareholders make an election or adopt a method of accounting for U.S. tax purposes. In this case, the CFC's earnings and profits are computed as if no elections had been made and any permissible accounting methods not requiring an election and reflected in the books of account regularly maintained by the CFC for the purpose of accounting to its shareholders have been adopted (Temp. Treas. Reg. Sec. 1.964-1T(g)(4)).

Illegal Payments. In addition to the adjustments required in steps 1-3 of Treas. Reg. Sec. 1.964-1, a foreign corporation's earnings and profits must not be reduced by any illegal bribe, kickback, or other payment (within the meaning of section 162(c)) (section 964(a)). This would include payments that are unlawful under the Foreign Corrupt Practices Act of 1977 if the payor is a U.S. person.

Blocked Foreign Income. Foreign earnings and profits for purposes of sections 952, 955, 956, 956A (that is, subpart F income and investment in U.S. property or excess passive assets) do not include any foreign income that could not have been distributed to the CFC's U.S. shareholders because of currency or other restrictions imposed by the country in which the corporation is located (section 964(b)). Whether a foreign corporation's currency is blocked is determined based on the facts and circumstances of each case (Treas. Reg. Sec. 1.964-2(b)(2)). Currency is generally considered blocked when it cannot be readily converted into U.S. dollars or into other money that is convertible into U.S. dollars or distributed as a dividend to its U.S. shareholders (Treas. Reg. Sec. 1.964-2(b)(2)).

U.S.-Dollar-Approximate Separate Transactions Method (DASTM)

As part of the significant changes made to the foreign currency translation in the Tax Reform Act of 1986, Congress permitted taxpayers to elect to use the U.S. dollar as the functional currency for a foreign cor-

poration or for any "qualified business unit" (QBU)[22] in two cases: (1) the QBU keeps its books and records in U.S. dollars, or (2) the taxpayer uses a method of accounting that approximates a separate transaction method (section 985(b)(3)).[23] This election was provided to provide relief to taxpayers operating in hyperinflationary economies.

A foreign corporation that would otherwise have a hyperinflationary currency as its functional currency must use the U.S. dollar as its functional currency and must compute its earnings and profits using DASTM, for taxable years beginning after August 24, 1994 (Treas. Reg. Sec. 1.985-1(b)(2)(ii)(A)). This requirement does not apply to a branch of a foreign corporation that uses the non-dollar functional currency of the foreign corporation as the branch's functional currency, provided such currency is not hyperinflationary. The requirement does not apply to a non-CFC because its minority U.S. shareholders may not be able to obtain the information required to apply DASTM.

The term *hyperinflationary currency* means the currency of a country in which there is cumulative inflation during the base period of at least 100 percent, as determined by reference to the consumer price index of the country listed in the monthly issues of the *International Financial Statistics* or a successor publication of the International Monetary Fund (Treas. Reg. Sec. 1.985-1(b)(2)(ii)(D)). The base period is the thirty-six calendar months immediately preceding the first day of the current calendar year. The cumulative inflation rate for the base period is based on compounded inflation rates. For example, if a country's annual inflation rates for 1997, 1998, and 1999 are 29 percent, 25 percent, and 30 percent, respectively, the cumulative inflation rate for the base period is 110 percent $[(1.29 \times 1.25 \times 1.3) - 1.0) \times 100 = 110$ percent]. The currency for such a country would be considered hyperinflationary for a QBU's 2000 year.

The computation of earnings and profits using the U.S.-dollar approximate separate transactions method of accounting is extremely complex. Details of the computation are provided in Treas. Reg. Sec. 1.985-3.[24] The regulations provide a four-step method that includes the following procedures:

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[22]See chapter 18 for a comprehensive discussion of the term *qualified business unit*.

[23]The classification of these methods is based on Broenen et al., *Foreign Corporation Earnings and Profits*.

[24]For the details related to the computation under this method, see Broenen et al., *Foreign Corporation Earnings and Profits*, A~26-A~29.

1. Prepare a profit and loss statement from the foreign corporation's books and records as recorded in the foreign corporation's hyperinflationary currency.
2. Adjust the profit and loss statement to conform it to U.S. generally accepted accounting principles and tax accounting methods (including the reversal of monetary correction adjustments).
3. Translate the amounts of hyperinflationary currency on the adjusted statement into U.S. dollars using the appropriate exchange rates.
4. Adjust the U.S.-dollar profit and loss statement to reflect the currency gain or loss, which is determined from the translation of the foreign corporation's year-end balance sheet into U.S. dollars.

This four-step method is similar to the pre-Tax Reform Act of 1986 "full section 964 method" of computing earnings and profits, except for differences in translation rates. Under the U.S.-dollar approximate separate transactions method, the amounts shown on the foreign corporation's adjusted profit and loss statement are translated into U.S. dollars at the exchange rate for the translation period to which they relate (Treas. Reg. Sec. 1.985-3(c)(1)). A *translation period* is generally defined as each month within the foreign corporation's taxable year. Special rules apply to cost of goods sold, beginning inventory, purchases, closing inventory, depreciation, depletion, amortization, and prepaid expenses or income. The exchange rate for a translation period can be determined under any reasonable method, including the average of beginning and ending exchange rates for the translation period and the spot rate on the last day of the translation period.

Currency gain or loss is computed based on the foreign corporation's balance sheet translation into U.S. dollars. The currency gain or loss is determined by comparing the foreign corporation's "net worth" in U.S. dollars (plus adjustments for dividends and returns of capital) at the end of the current taxable year with the foreign corporation's net worth, as adjusted, at the end of the previous taxable year (Treas. Reg. Sec. 1.985-3(d)(1)).

Treas. Reg. Sec. 1.985-3(d)(9) provides a comprehensive example illustrating how such gain or loss is computed. The DASTM gain or loss is included in the computation of gross income, taxable income, and earnings and profits (Treas. Reg. Sec. 1.985-3(e)). Treas. Reg. Sec. 1.985-3(e)(2) provides a "small QBU allocation method" for qualified business units (QBUs) with an adjusted basis in assets of $10 million or less at the end of any taxable year. All other QBUs must use the nine-step allocation method described in Treas. Reg. Sec. 1.985-3(e)(3).

Treas. Reg. Sec. 1.985-1(b)(2)(ii)(E) requires a foreign corporation that has been required to use DASTM to change its functional currency as of the first day of the first taxable year that follows three consecutive taxable years in which the currency of its economic environment is not hyperinflationary. Such change is considered to be made with the consent of the commissioner of internal revenue.

Alternative U.S.-Dollar Method

The regulations permit a QBU that is eligible to elect the U.S.-dollar approximate separate transactions method to use an alternative U.S.-dollar method of accounting if the QBU can demonstrate to the commissioner of internal revenue that it can "properly employ" such a method (Treas. Reg. Sec. 1.985-2(d)(2)(ii)). This requires that the QBU prove it can compute foreign currency gain or loss under the section 988 rules for each of its section 988 transactions.[25]

The Computation of Foreign Earnings and Profits Prior to the Tax Reform Act of 1986

Prior to the enactment of the Tax Reform Act of 1986, there were four methods available for computing a foreign corporation's earnings and profits: (1) the section 902 method, (2) the partial section 964 method, (3) the full section 964 method, and (4) the U.S.-dollar method. The particular method used depended on whether the foreign corporation was a CFC or a non-CFC and whether the corporation made an actual distribution, or was deemed to make a distribution under subpart F, to its U.S. shareholders. Distributions from pre-Tax Reform Act of 1986 years must use earnings and profits as computed under the preenactment methods and thus must maintain separate records of earnings and profits from these years. A summary of these methods is provided.

Section 902 Method

The section 902 method was required to be used to compute earnings and profits of all foreign corporations in pre-1963 years, non-CFCs in post-1962 years prior to the Tax Reform Act of 1986, and CFCs making

[25]See chapter 18 for a more detailed discussion of section 988.

actual dividend distributions in post-1962 years if such CFCs did not elect the partial section 964 election. No specific rules are provided for computing foreign earnings and profits under this method except that such earnings and profits are to be calculated using the rules applicable to domestic corporations.

Partial Section 964 Method

A CFC could elect the partial section 964 method in post-1962 years with respect to actual dividend distributions. The partial section 964 method required the foreign corporation to compute its earnings and profits using steps 1–3 under Treas. Reg. Sec. 1.964-1(a), (b), and (c). This method is identical to the post–Tax Reform Act of 1986 functional currency method, except that in the partial section 964 method, foreign taxes were maintained in foreign currency rather than the U.S. dollar.

Full Section 964 Method

The earnings and profits of a CFC for purposes of a subpart F inclusion of income, a section 1248 transaction, and a section 367(b) reorganization were required to be computed using the full section 964 method. The full section 964 method expanded the partial section 964 three-step method to a five-step method that required the adjusted profit and loss statement to be translated into U.S. dollars (step 4) and then adjusted again for unrealized exchange translation gain or loss of the foreign corporation's balance sheet for the year (step 5) (Treas. Reg. Sec. 1.964-1(d) and (e)).[26] The full section 964 method is similar to the U.S.-dollar separate transactions method except for the translation methods used to convert the balance sheet items into U.S. dollars.

U.S.-Dollar Method

A CFC that kept its books and records in U.S. dollars could elect to calculate its earnings and profits in U.S. dollars, provided its books and records were kept in accordance with GAAP and acceptable accounting methods (Treas. Reg. Sec. 1.964-1(f)). Under this method, exchange gains and losses would only be recognized on closed transactions.

[26]For comprehensive examples of how to compute currency exchange gain or loss under the full section 964 method, see Treas. Reg. Secs. 1.964-1(d)(9) and 1.964-1(e)(6).

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Foreign Sales Corporations and Domestic International Sales Corporations

The Revenue Act of 1971 created a tax category for corporations called domestic international sales corporations (DISCs). After creation of the DISC, there was a continuing controversy concerning the compatibility of the DISC with the prohibition under the General Agreement on Tariffs and Trade (GATT) on subsidization of exports. The Tax Reform Act of 1984 defused this controversy by significantly changing the way tax incentives for qualifying exports were taxed. In addition to changing the way DISC operations were treated, the Tax Reform Act of 1984 created a new entity called a foreign sales corporation (FSC). The DISC provisions were changed in several significant ways. Accumulated untaxed DISC income on December 31, 1984 was made permanently exempt from tax. The amount of DISC income immediately taxable to the shareholders was reduced. Interest is charged on DISC-related deferred tax liability. Only the taxable income related to $10 million of export receipts

is eligible for tax deferral, and the incremental gross receipts rules were repealed.

Exporters must choose one of three mutually exclusive entities from which to conduct operations eligible for DISC or FSC treatment: the interest charge DISC (IC DISC), the FSC, or the so-called small FSC. Choice of one of these entities involves many financial and tax considerations. If a DISC is used, a corporate shareholder is taxed on 1/17 and can defer 16/17 of the DISC taxable income related to export receipts of $10 million or less with an interest charge at a Treasury bill rate. Taxable income related to export receipts in excess of $10 million is not eligible for deferral.

If the FSC is chosen, part of the income earned by an FSC is exempt from U.S. tax and part may be taxed on a current basis or deferred depending on the pricing rules and the source of the income of the FSC. An FSC is required to meet the foreign management and economic process requirements, and costs will be associated with these requirements.

An FSC that does not satisfy the foreign management and foreign economic process requirements will be eligible for FSC treatment on the taxable income associated with foreign trading gross receipts of $5 million or less. This entity is called a *small* FSC. The balance of the foreign trading income may be taxed on a current basis or may be deferred depending on the pricing method used and source of the income.

Qualification for FSC Benefits

There are two general elements necessary for a federal income tax exemption on foreign trade income. First, a qualified FSC must exist, and second, the taxable income of the FSC must be attributable to foreign trading gross receipts. An FSC is defined in section 922 as any corporation that meets the following requirements.

First, an FSC must be created or organized under the laws of a country other than the United States. An FSC may be created or organized under the laws of a possession, including U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands, but not Puerto Rico (section 927(d)(5)). In addition, an FSC may be incorporated under the laws of a foreign country that is party to an exchange-of-information agreement that meets the standards of the Caribbean Basin Economic Recovery Act of 1983 or a bilateral income

tax treaty with the United States if the Secretary of the Treasury certifies that the country is covered under the exchange-of-information program.

The following countries are certified as meeting these requirements:[1]

Australia	Egypt	Malta
Austria	Finland	Morocco
Barbados	France	Netherlands
Belgium	Germany	New Zealand
Bermuda	Grenada	Norway
Canada	Guyana	Pakistan
Costa Rica	Honduras	Peru
Cyprus	Iceland	Philippines
Denmark	Ireland	Saint Lucia
Dominica	Jamaica	Sweden
Dominican Republic	South Korea	Trinidad & Tobago

Any termination by the Secretary of the Treasury will be effective 6 months after the date of the publication of the notice of such termination in the *Federal Register* (Treas. Reg. Sec. 1.921-2(d)).

Second, at all times during the taxable year, the FSC cannot have more than twenty-five shareholders.

Third, an FSC cannot have any preferred stock outstanding at any time during the taxable year. The corporation may have more than one class of common stock outstanding as long as it has bona fide business reasons for doing so. Dividends may not be specifically directed so that tax-exempt foreign trade income is paid to taxable persons, and other dividends to tax-exempt persons or to taxpayers with net operating losses (Treas. Reg. Sec. 1.922-1(g)).

Fourth, during the taxable year, an FSC must maintain an office located in a country or possession outside the United States. The office must have a fixed location. It must be a building or a portion of a building consisting of at least one room large enough for the equipment necessary to conduct the FSC's business and must be regularly used for some

[1]Treas. Rel. R-2914, 11/6/84; Notice 84-15, 1984-2 C.B. 271; Notice 87-52, 1987-2 C.B. 362; Notice 87-53, 1987-2 C.B. 363; Treas. Rel. B-1070, 7/23/87; Treas. Rel. B-1414, 5/18/88; Treas. Rel. NB-85, 12/16/88; Treas. Rel. NB-578, 11/27/89; Notice 89-114, 1989-2 C.B. 451; Treas. Rel. NB-684, 2/26/90; Treas. Rel. NB-1136, 2/15/91; Treas. Rel. NB-2088, 5/20/91; Treas. Rel. NB-1511, 10/22/91; Treas. Rel. NB-2088, 12/4/92; Treas. Rel. NB-305, 7/30/93.

business activity of the FSC. The FSC or its agent must own or lease it, operate it, and regularly use it in some business activity. In the case of a newly organized FSC, thirty days may elapse between the time the FSC is organized and the time the office is maintained (Treas. Reg. Sec. 1.922-1(h)).

Fifth, an FSC must maintain a permanent set of books and records at the foreign office and maintain the records required under section 6001 at a location in the United States. The documentation that must be maintained at the FSC's office must include, at a minimum, quarterly income statements, a final year-end income statement and a year-end balance sheet of the FSC, and all final invoices (or a summary of them) or statements of account with respect to sales by the FSC and sales by a related person if the FSC realizes income with respect to these sales.

If the documents are not prepared at the FSC's office, the quarterly income statements for the first three-quarters of the FSC year must be maintained at the FSC's office no later than ninety days after the end of the quarter. The quarterly income statement for the fourth quarter, the final year-end income statement, the year-end balance sheet, and the final invoices or summaries or statements of account must be maintained at the FSC's office no later than the due date, including extensions, of the FSC's tax return for the applicable taxable year (Treas. Reg. Sec. 1.922-1(i)).

A sixth requirement to be met if a corporation is to be considered an FSC is that at all times during the taxable year the FSC must have a board of directors that includes at least one individual who is not a resident of the United States. The nonresident director may be a U.S. citizen. If the only member of the board of directors who is not a resident of the United States dies, resigns, is removed from the board, or becomes a resident of the United States, the FSC has thirty days to appoint a board member who is not a resident of the United States (Treas. Reg. Sec. 1.922-1(j)).

Seventh, the FSC cannot be a member of any controlled group of corporations of which a DISC is a member (section 922(a)(1)(F)).

Finally, the FSC must make an election to be treated as an FSC that is in effect for the taxable year of the FSC (section 922(a)(2)). The election is made on Form 8279, Election to Be Treated as an FSC or as a Small FSC, for any taxable year at any time during the ninety-day period immediately preceding the beginning of that year. In addition, under section 441(h), the taxable year of the FSC must conform to the taxable year of its principal shareholder.

Small FSC

A *small FSC* is an FSC that meets the foregoing FSC requirements. A small FSC must make a separate election to be treated as a small FSC. A small FSC cannot be a member of a controlled group of corporations that includes an FSC; however, it can be in a group that includes another small FSC. A small FSC need not meet the foreign management and economic processes tests of section 924(b) in order to have foreign trading gross receipts. In determining the exempt foreign trade income of a small FSC, any foreign trading gross receipts for the taxable year in excess of $5 million are not taken into account. If the foreign trading gross receipts of a small FSC for the taxable year exceed the $5 million limitation, the FSC may select the gross receipts to which the limitation is allocated. To use the administrative pricing rules, a small FSC must satisfy the activities tests of section 925(c). In addition, the taxable year of a small FSC must conform to the taxable year of its principal shareholder (the shareholder with the highest percentage of its voting power).

Foreign Trading Gross Receipts

Foreign trading gross receipts are the gross receipts of an FSC derived from five types of transactions, which include—

1. The sale, exchange, or other disposition of export property as defined by section 927(a).
2. The lease or rental of export property for use by the lessee outside the United States.
3. Services that are related and subsidiary to any sale, exchange, or other disposition of export property by such corporation or any lease or rental of export property used by the lessee outside the United States.
4. Engineering or architectural services for construction projects located outside the United States.
5. The performance of managerial services for an unrelated FSC or DISC to further produce foreign trading gross receipts. In order that this provision apply, the FSC must derive at least 50 percent of its gross receipts from activities attributable to qualified sales of export property, leases, or subsidiary services.

Export Property

Section 924 provides that foreign trading gross receipts can arise only from sales, exchanges, or other dispositions of export property; from services related to sales, exchanges, or other dispositions of export property; or from lease or rental of export property. *Export property* is property that meets the following three requirements:

1. The property is manufactured, produced, grown, or extracted in the United States by a person other than an FSC.
2. The property is held primarily for sale, lease, or rental, in the ordinary course of trade or business, by or to an FSC for direct use, consumption, or disposition outside the United States.
3. Not more than 50 percent of the fair market value of the property is attributable to articles imported into the United States.

The following property is excluded from the definition of export property:

1. Property leased or rented by an FSC for use by any member of a controlled group of corporations of which such FSC is a member.
2. Patents, inventions, models, designs, formulas, or processes whether or not patented; copyrights (other than films, tapes, records, or similar reproductions for commercial or home use, computer software licensed for reproduction abroad after December 31, 1997 (IRC Section 927(a)(2)(B)); goodwill; trademarks; trade brands; franchises; or other like property.
3. Oil or gas or any primary product produced from oil or gas.
4. Products the export of which is prohibited or curtailed under policies relating to the protection of the domestic economy under the Export Administration Act of 1979 (section 927(a)(2)).
5. Any unprocessed timber that is softwood. The term *unprocessed timber* means any log, cant, or similar form of timber (section 927(a)(2)(E)).
6. Property that the President of the United States determines to be in short supply and designates as such by executive order (section 927(a)(3)).

Sales of Export Property

Foreign trading gross receipts of an FSC include gross receipts from the sale of export property by the FSC or by any principal if the FSC is a com-

mission FSC. The gross receipts must be received under the terms of a contract entered into with the purchaser by the FSC or by the principal at any time, or received by any person as long as these receipts are assigned to the FSC or the principal prior to the shipment of the property to the purchaser (Temp. Treas. Reg. Sec. 1.924(a)-1T(b)).

Leases of Export Property

Foreign trading gross receipts of an FSC include gross receipts from the lease of export property provided that the property is held by the FSC either as an owner or lessee at the beginning of the term of the lease. In addition, the FSC must be qualified as an FSC for its taxable year in which the term of the lease began. Prepaid lease receipts are treated as foreign trading gross receipts of an FSC if it is reasonably expected at the time of the prepayment that, for the period of the lease to which the prepayments relate, the lease will satisfy the requirements and the property will be export property. If it is reasonably expected at the time of the prepayment that the prepaid receipts would not all be foreign trading gross receipts throughout the term of the lease, only that allocable portion of the prepaid receipts will be treated as foreign trading gross receipts, and the balance would not be so treated (Temp. Treas. Reg. Sec. 1.924(a)-1T(c)).

Related and Subsidiary Services

Foreign trading gross receipts of an FSC include gross receipts from services by the FSC that are related and subsidiary to any sale or lease of export property by the FSC or to which the FSC acts as commission agent. The services may be performed within or without the United States. Services that may be related to a sale or lease of export property include warranty service, maintenance service, repair service, and installation service, among others. These services are considered related to a sale or lease of export property if the service is of the type customarily and usually furnished with the type of transaction in the trade or business in which the sale or lease arose, and the contract to furnish the service is expressly provided for, or is provided for by implied warranty under the terms of the sale, and is entered into within two years of the date on which the sale or lease contract was entered into. Transportation, separately stated, but included in the sale or rental price of the property or paid separately by the FSC, will be related to a sale or lease of export property. Financing or the obtaining of financing for a sale or lease is not

a related service (Temp. Treas. Reg. Sec. 1.924(a)-1T(d)). Services related to a sale or lease of export property are subsidiary to the sale or lease only if it is reasonably expected that at the time of the sale or lease the gross receipts from all related services furnished by the FSC will not exceed 50 percent of the sum of the gross receipts from the sale or lease and the gross receipts from related services furnished by the FSC (Temp. Treas. Reg. Sec. 1.924(a)-1T(d)(4)).

Engineering and Architectural Services

Foreign trading gross receipts of an FSC include gross receipts from engineering services or architectural services for a construction project located, or proposed for location, outside the United States. These services include feasibility studies for a proposed construction project, whether or not it is ultimately initiated. These services do not include services connected with the exploration for oil or gas or technical assistance or know-how. Technical assistance or know-how includes activities or programs designed to enable business, commerce, industrial establishments, and governmental organizations to acquire or use scientific, architectural, or engineering information (Temp. Treas. Reg. Sec. 1.924(a)-1T(e)).

Managerial Services

Foreign trading gross receipts of an FSC for its taxable year include gross receipts from the furnishing of managerial services provided for an unrelated FSC or unrelated DISC to aid the FSC or DISC in deriving foreign trading gross receipts or qualified export receipts. At least 50 percent of the gross receipts of the FSC furnishing services for the year must consist of foreign trading gross receipts derived from the sale or lease of export property and the furnishing of related and subsidiary services. Managerial services include staffing and operational services necessary to operate the unrelated FSC, but do not include legal, accounting, scientific, or technical services. Examples of managerial services are conducting export market studies, making shipping arrangements, and contacting potential foreign purchasers (Temp. Treas. Reg. Sec. 1.924(a)-1T(f)).

Excluded Receipts

The six categories of gross receipts that are not considered foreign trading gross receipts of an FSC include:

1. Sales and leases of property for ultimate use in the United States (Temp. Treas. Reg. Sec. 1.924(a)-1T(g)(2)).
2. Sales or leases of export property and furnishing of services accomplished by a subsidy granted by the United States or any instrumentality thereof (Temp. Treas. Reg. Sec. 1.924(a)-1T(g)(3)).
3. Sales or leases of export property and furnishing of architectural or engineering services for use by the United States in any case in which any law or regulation requires the purchase or lease of property manufactured, produced, grown, or extracted in the United States or requires the use of architectural or engineering services performed by a U.S. person (Temp. Treas. Reg. Sec. 1.924(a)-1T(g)(4)).
4. Related and subsidiary services related and subsidiary to the sale or lease of property that results in excluded receipts (Temp. Treas. Reg. Sec. 1.924(a)-1T(g)(5)).
5. Receipts for certain related party transactions. For example, W, X, Y, and Z are members of the same controlled group and Y and Z are FSCs. W sells property to X and pays Y a commission relating to that sale. X sells the same property to an unrelated party and pays Z a commission related to that sale. The receipts received by Y from the sale of such property by W to X would be considered derived from Z, an FSC that is a member of the same controlled group as Y, and thus will not result in foreign trading gross receipts to Y (Temp. Treas. Reg. Sec. 1.924(a)-1T(g)(6)).
6. Factoring discounts on accounts receivable related to foreign trading gross receipts. If an account receivable arising with respect to export property is sold at a discount, the gross receipts from the sale that are treated as foreign trading gross receipts for purposes of computing the FSC's profit under the administrative pricing rules are reduced by the amount of the discount (Temp. Treas. Reg. Sec. 1.924(a)-1T(g)(7)).

Under section 924(b)(2)(B), in determining exempt foreign trading gross income of a small FSC, the foreign trading gross receipts of the small FSC for the taxable year that exceed $5 million are not taken into account. Members of a controlled group are limited to one $5 million amount. The $5 million amount is allocated equally among the members of the small FSCs of the controlled group unless all member small FSCs consent to an apportionment providing unequal allocation of the $5 million amount.

Foreign Management and Foreign Economic

Process Requirements

An FSC is treated as having foreign trading gross receipts for the taxable year only if the management of the FSC takes place outside the United States and if the economic process with respect to otherwise qualifying FSC transactions takes place outside the United States (section 924(b)(1)(A)).

Foreign Management

The management of an FSC meets the management requirement if the following are satisfied:

1. All meetings of the board of directors and shareholder meetings take place outside the United States (section 924(c)(1) and Treas. Reg. Sec. 1.924(c)-1(b)).
2. The principal bank account of the FSC is maintained outside the United States at all times during the taxable year in a possession or a foreign country that has a bilateral or multilateral exchange-of-information agreement with the United States or an income tax treaty with the United States to which the FSC is subject that contains an exchange-of-information program that the Secretary of the Treasury certifies is satisfactory (section 924(c)(2)).
3. All dividends, legal and accounting fees, and the salaries of officers and members of the board of directors are disbursed out of bank accounts of the FSC maintained outside the United States (section 924(c)(3) and Treas. Reg. Sec. 1.924(c)-1(d)).

Economic Process Outside the United States

Section 924(b)(1)(B) provides that an FSC has foreign trading gross receipts only if economic processes with respect to such transaction take place outside the United States. The economic process requirement will be satisfied if two conditions are met. First, the FSC (or agent of the FSC) must have participated outside the United States in the solicitation (other than advertising), negotiation, or making of the contract relating to such transaction, and second, the foreign direct costs of the FSC attributable to the transaction must be 50 percent or more of the total direct costs attributable to the transaction. As an alternative to the 50-percent

test, if the total direct costs incurred by the FSC with respect to each of the designated economic processes equal or exceed 85 percent of the total costs incurred for each such process, the economic process requirement is also met. In general, sales activities are applied on a transaction-by-transaction basis. By annual election of the FSC, however, any sales activities may be applied on the basis of a group explained at Treas. Reg. Sec. 1.924(d)-1(c)(5).

To satisfy the 50-percent direct cost requirement, the foreign direct costs incurred by the FSC must equal or exceed 50 percent of the total direct costs attributable to the transaction. This test looks at the following costs as required by section 924(e) to determine if the direct costs of these activities equal or exceed 50 percent of the total direct costs of that activity (Treas. Reg. Sec. 1.924(d)-1(d)(5)):

1. Advertising and sales promotion (Treas. Reg. Sec. 1.924(e)-1(a))
2. Processing of customer orders and arranging for delivery of the export property (Treas. Reg. Sec. 1.924(e)-1(b))
3. Transportation from the time of acquisition by the FSC to the delivery to the customer (Treas. Reg. Sec. 1.924(e)-1(c))
4. Determination and transmittal of a final invoice or statement of account and the receipt of payment (Treas. Reg. Sec. 1.924(e)-1(d))
5. Assumption of credit risk (Treas. Reg. Sec. 1.924(e)-1(e))

The 85-percent test is satisfied if the foreign direct costs of a transaction incurred by the FSC attributable to activities described in at least two of the foregoing activities equal or exceed 85 percent of the total direct costs attributable to these activities (Treas. Reg. Sec. 1.924(d)-1(d)(6)).

Federal Income Tax Treatment of an FSC

The FSC is exempt from U.S. tax on a portion of its export income if the foreign presence and economic process tests are met. The amount of income an FSC earns is dependent on the pricing rules used to allocate income between the FSC and its supplier.

Exempt Foreign Trade Income

The term *exempt foreign trade income* means the aggregate amount of all foreign trade income of an FSC for the taxable year that is determined under section 482 or under the administrative pricing rules. If the FSC

uses the section 482 pricing method to determine its income from the transaction, or group of transactions that give rise to the foreign trade income, 30 percent of its foreign trade income will be exempt foreign trade income. If the FSC has a noncorporate shareholder, 32 percent of its foreign trade income attributable to the noncorporate shareholder's proportionate interest in the FSC will be exempt foreign trade income.

If the FSC uses either of the two administrative pricing rules to determine its income from the transaction or transactions, 15/23 of the foreign trade income that it earns from the transaction or group of transactions will be exempt foreign trade income. In the case of a noncorporate shareholder, the fraction is 16/23.

Any deductions of the FSC properly apportioned and allocated to the foreign trade income derived by an FSC from any transaction are allocated between the exempt foreign trade income derived from the transaction and the nonexempt foreign trade income derived from those transactions on a proportionate basis.

In the case in which a qualified cooperative is a shareholder of an FSC, the administrative pricing rules must be used with respect to that portion of the foreign trade income that is properly allocable to the marketing of agricultural or horticultural products. For this type of income, 100 percent is exempt foreign trade income as long as the FSC distributes this exempt income before the due date for filing the FSC's tax return for the year (section 923(a)(4)).

The exempt foreign trade income relating to the disposition of, or services relating to, military property will equal 50 percent of the amount that would otherwise be treated as exempt foreign trade income under the section 482 method or administrative pricing methods. The foreign trade income no longer treated as exempt income under this rule will be treated as nonexempt foreign trade income. *Military property* includes any arms, ammunition, or implements of war designated in the munitions list published pursuant to section 38 of the International Security Assistance and Arms Export Control Act of 1976 (22 U.S.C. sec. 2778).

Nonexempt Foreign Trade Income

Nonexempt Foreign Trade Income Determined With Regard to the Administrative Pricing Rules. The FSC's nonexempt foreign trade income from a transaction or group of transactions will be treated as U.S.-source income that is effectively connected with the FSC's trade or business con-

ducted through its permanent establishment within the United States if either of the administrative pricing rules is used to determine the FSC's foreign trade income from a transaction or group of transactions.

Nonexempt Foreign Trade Income Determined Without Regard to the Administrative Pricing Rules. The source and taxation of the FSC's nonexempt foreign trade income will be determined under the appropriate Code and regulations sections. This type of income includes both income not effectively connected with the conduct of a trade or business in the United States and effectively connected income.

Investment Income and Carrying Charges. All of the FSC's investment income and carrying charges will be treated as income that is effectively connected with the FSC's trade or business through its permanent establishment within the United States. The source of the income will be determined under sections 861, 862, 863, and 865. Investment income includes dividends; interest; royalties; annuities; rents (other than rents from the lease or rental of export property for the use by the lessee outside the United States); gains from sale of stock or securities; gains from futures transactions in any commodity on or subject to rules of a board of trade or commodity exchange (other than trade or business-related hedging transactions of an FSC); income of estates, trusts, beneficiaries, and decedents under part 1 of subchapter J; and gains from the sale or other disposition of any interest in an estate or trust (Treas. Reg. Sec. 1.921-2(f)).

Carrying charges means charges that are imposed by an FSC or a related supplier that are identified as carrying charges, and charges that are considered to be included in the price of the property or services sold by the FSC or a related supplier (Treas. Reg. Sec. 1.921-2(f)). If carrying charges are considered to be included in the sales price of property income or rental payment services, the amount is calculated using the method prescribed in Treas. Reg. Sec. 1.927(d)-1(a)).

Transfer Prices

Section 925 permits a related party to an FSC to determine the allowable transfer price charged to the FSC or commission paid to the FSC under one of three transfer pricing methods. The transfer pricing methods are in two categories, administrative pricing and section 482. There is a "no loss" rule that, when applied, prohibits a transfer price that produces a

loss to the related supplier. All of the transfer pricing methods may be used in the same taxable year of the FSC for separate transactions or groups of transactions. If administrative pricing is used, the IRS cannot impose the section 482 pricing method to that transaction. The transfer pricing methods will apply only to transactions that give rise to foreign trading gross receipts to the FSC, whether the FSC acts as a principal or earns commissions from a related supplier who is the principal. For an FSC to use the administrative pricing rules (formula pricing), the following requirements must be met:

1. All of the contract-making activities, those relating to the solicitation (other than advertising), negotiation, and making of contracts of sales were performed by the FSC or another person acting under contract with the FSC.
2. The FSC (or its agent) has performed the following:
   a. Advertising and sales promotion
   b. Processing of customers' orders and the arrangement for delivery of export property
   c. Transportation from the time of acquisition by the FSC, or, in the case of a commission relationship, from the beginning of such relationship to delivery to the customer
   d. Determination and transmittal of final invoices or statements of account and receipt of payment
   e. Assumption of credit risk attributable to the sale

Administrative Pricing

There are two administrative pricing rules, the 1.83-percent-of-gross-receipts method and the 23-percent-combined-taxable-income method. Applying these pricing methods does not depend on the extent to which the FSC performs substantial economic functions beyond the section 925(c) requirements.

Under the *1.83-percent-of-gross-receipts method*, the transfer price for a sale by a related supplier to the FSC from the sale will not exceed 1.83 percent of the foreign trading gross receipts of the FSC derived from the sale of the export property. The profit earned by the FSC under the 1.83-percent method cannot exceed twice the amount of profit that would be determined under the combined-taxable-income method (section 925(d)).

Under the *combined-taxable-income method of pricing*, the transfer price for a sale by a related supplier to the FSC is the price that will result in a profit to the FSC of 23 percent of the combined taxable income of the FSC and the related supplier.

The administrative price rules are applied on a transaction-by-transaction basis unless a special grouping election is made. This annual election permits determinations on the basis of groups of products or product line. The election must be made on a timely filed return (including extensions) and cannot be made on a late-filed return (Treas. Reg. Sec. 1.925(a)-1T(C)(8)(I)). For tax years beginning prior to 1998, such group election could be made on a late-filed or amended return.

The transfer price on a sale by the related supplier to the FSC will be determined on the basis of the sales prices actually charged subject to the rules under section 482 if administrative pricing cannot be used because the section 925(c) requirements are not met or the related supplier chooses not to use the administrative pricing rule.

Pricing for Transactions Other Than Sales

Leases. In the case of a lease of export property by a related supplier to an FSC, the amount of rent an FSC must pay to the related supplier is computed in a manner that will yield profits that are permissible in the case of sales and resales of export property under the administrative pricing rules. Transactions cannot be grouped on a product or product-line basis in order to combine in any one group of transactions both lease transactions and sale transactions.

Commissions. If a transaction is handled on a commission basis for a related supplier by an FSC and if commissions paid to the FSC give rise to foreign trading gross receipts to the related supplier, then the administrative pricing methods may be used to determine the FSC's commission income as long as the section 925(c) requirements are met. The amount of income that may be earned by the FSC is the amount permitted under the gross-receipts method, the combined-taxable-income method, or the section 482 method.

Services. The income that the FSC may earn from the performance of either related and subsidiary services or other services is computed in the same way as income would be computed if export property were sold.

The "No Loss" Rule. If there is a combined loss on a transaction or group of transactions, an FSC may not earn a profit under either the combined-taxable-income method or the gross-receipts method. In addition, an FSC's profit may not exceed 100 percent of full-costing combined taxable income determined under the full costing method. This rule prevents pricing at a loss to the related supplier. The related supplier may set a transfer price or rental payment or pay a commission in an amount that will allow the FSC to recover its costs even if this would create or increase a loss in the related supplier. There is also a rule that prevents segregation of transactions to allow gains on some and losses on some. If the FSC recognizes income while the related supplier recognizes a loss on a sale transaction under the section 482 method, neither the combined-taxable-income method nor the gross-receipts method can be used for any other sale transaction of a product within the same three-digit Standard Industrial Classification (SIC) code.

Before the administrative pricing rules are applied, it is necessary to take into account the price of a transfer or other transaction between the related supplier or FSC and a related party that is subject to the arm's-length standard of section 482. For example, if a related supplier sells export property to an FSC that the related party purchased from related parties, the costs taken into account in computing the combined taxable income of the FSC and the related supplier are determined after any necessary adjustments under section 482 of the price paid by the related supplier to the related parties.

If the amount of the transfer price or rental payment actually charged by a related supplier has not been paid, an account receivable will be deemed created as of the extended due date of the FSC's tax return. The receivable is an interest-bearing receivable, with an interest rate computed under section 482 and interest accruing from the date the account receivable is created until the debt is paid.

Payment of dividends, transfer prices, rents, commissions, service fees, receivables, or payables may be in the form of money, property, sales discount, or an accounting entry offsetting the amount due from the related supplier or the FSC against debt of the other party to the transaction. Any balance must be paid in money. Offsetting entries must be clearly identified in the books of both the related supplier and the FSC.

Example 12.1. FSC purchased export property from its related supplier P, which manufactured the property in the United States. FSC sells the property to an unrelated purchaser for $1,000. The cost of the manufactured

goods to P was $600. P incurred direct selling costs in connection with the sale of $50. The deductible general and administrative expenses of P allocable under Treas. Reg. Sec. 1.861-8 to export sales of P sold to FSC were $100. FSC's expenses were $150. FSC satisfies the section 925(c) requirements. Transfer prices under the administrative pricing rules are calculated as follows:

1.83-Percent-of-Gross-Receipts Method
Under the 1.83-percent-of-gross-receipts method, the FSC is permitted to earn a profit of $18.30 ($1,000 × 1.83%). The transfer price is calculated as follows:

FSC's foreign trading gross receipts		$1,000.00
Less: FSC's expenses	$150.00	
FSC's profit	18.30	168.30
Transfer price		$ 831.70

Combined-Taxable-Income Method

Foreign trading gross receipts		$1,000.00
Less: P's cost of goods sold	$600	
P's direct selling costs	50	
Allocable G & A expenses	100	
FSC's expenses	150	900.00
Combined taxable income		$ 100.00
FSC's profit—23% of $100		$ 23.00
Foreign trading gross receipts		$1,000.00
Less: FSC's expenses	$150.00	
FSC's profit	23.00	173.00
Transfer price to FSC		$ 827.00

Given the foregoing facts, the transfer price to the FSC that would maximize FSC profits is the combined-taxable-income method.

Marginal Costing Rules

If an FSC is seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property, the marginal costing rules may be applied. *Marginal costing* is a method under which only direct production costs of producing a particular item, product, or product line are taken into account for computing the combined taxable income of the FSC and its related supplier. The costs to be taken into account are the related supplier's direct material and labor costs. Costs that are

incurred by the FSC and that are not taken into account in computing combined taxable income are deductible by the FSC only to the extent of the FSC's nonforeign trade income.

Under marginal costing, the combined taxable income (calculated using direct costs only) of the FSC and its related supplier may not exceed the overall profit percentage multiplied by (1) the FSC's foreign trading gross receipts if the FSC is the principal on the sale or (2) the related supplier's gross receipts if the FSC is a commission FSC. The marginal costing rule will not apply if there is a combined loss to the related supplier and the FSC. In other words, direct costs must be recovered in order to use marginal costing. In addition, the profit determined under marginal costing may be allowed to the FSC only to the extent it does not exceed the FSC's and the related supplier's full-costing combined taxable income; that is, profit under marginal costing cannot exceed profit under full costing. The related supplier may charge a transfer price or pay a commission that will allow the FSC to recover its full costs (direct and indirect) even if it would create or increase a loss in the related supplier.

In summary, the FSC's profit is limited to the lesser of (1) 23 percent of maximum combined taxable income determined under the marginal costing rules, (2) 23 percent of overall profit percentage limitation, or (3) 100 percent of the full-costing combined taxable income (Temp. Treas. Reg. Sec. 1.925(b)-1T(a)).

The FSC will be treated as seeking to establish or maintain a foreign market with respect to export property from which foreign trading gross receipts are derived if the combined taxable income computed using marginal costing is greater than the full-costing combined taxable income (Temp. Treas. Reg. Sec. 1.925(b)-1T(c)).

The overall profit percentage is computed by dividing the combined taxable income of the FSC and its related supplier from the sale of the export property plus all other taxable income of its related supplier from all sales by the total gross receipts of the FSC and the related supplier from all sales of the product.

Example 12.2. FSC purchased qualifying property from related supplier P. P and FSC have a written agreement that provides that the transfer price between P and FSC will be that price that allocates the maximum profit to FSC under the administrative pricing rules. P sold property to FSC that was resold by FSC for $1,000. P's cost of goods sold attributable to the property sold was $700, consisting of $400 of direct materials and $300 of direct labor. P incurs $100 of selling expenses attributable to the sale and has $50 in expenses allocable under Treas. Reg. Sec. 1.861-8. FSC's expenses attributable to the resale of the property are $50. P and FSC have gross receipts of

$5,000 from all domestic and foreign sales. P's total cost of goods sold and total expenses relating to foreign and domestic sales are $3,600 and $450, respectively.

Full-Costing Combined Taxable Income

FSC's foreign trading gross receipts		$1,000
P's cost of goods sold		700
Combined gross income		$ 300
Less: P's direct selling expenses	$100	
FSC's expenses	50	
P's allocable expenses	50	200
Combined taxable income		$ 100

FSC's profit under the full-costing combined-taxable-income method is $23 (23 percent × $100 of full-costing combined taxable income). FSC's profit under the gross receipts method will be $18.30 (1.83% × $1,000 of FSC's foreign trading gross receipts). Under the marginal costing rules, FSC would have a profit attributable to the export sale of $41.40 (23 percent × $180 of combined taxable income under marginal costing). The combined taxable income under marginal costing is limited to the overall profit percentage limitation, since that amount is less than the maximum combined-taxable-income amount.

Maximum Combined Taxable Income Under Marginal Costing

Foreign trade gross receipts		$1,000
Less: P's direct materials	$400	
P's direct labor	300	700
Maximum marginal costing combined taxable income		$ 300

Overall Profit Percentage Limitation

Gross receipts of P and FSC from all sales		$5,000
P's cost of goods sold		3,600
Combined taxable income		$1,400
Less: P's expenses	$450	
FSC's expenses	50	500
Total taxable income from all sales computed on a full-costing method		$ 900

(continued)

Overall profit percentage:
Taxable income ($900)/gross receipts ($5,000) = 18%
Overall profit percentage limitation:
18% × $1,000 = $180

Transfer Price From P to FSC

FSC's foreign trading gross receipts		$1,000.00
Less: FSC's expenses	$50.00	
FSC's profit (23% × $180)	41.40	91.40
Transfer price		$ 908.60

Allocation and Apportionment of Deductions

Expenses, losses, and deductions incurred by the FSC must be allocated and apportioned under Treas. Reg. section 1.861-8 to the FSC's foreign trade income and to the FSC's nonforeign trade income. Any deductions incurred by the FSC on a transaction or group of transactions, which are allocated and apportioned to the FSC's foreign trade income from the transaction or group of transactions, must be allocated on a proportionate basis between exempt foreign trade income and nonexempt foreign trade income (Temp. Treas. Reg. Sec. 1.921-3T(b)).

Net Operating Losses and Capital Losses

It is rare for an FSC to incur losses or deficits in earnings and profits. If an FSC does incur a deficit in earnings and profits attributable to foreign trade income determined under the administrative pricing rules, the regulations at Temp. Treas. Reg. Sec. 1.921-3T(c)(1) and (2) prescribe the proper application of this loss to earnings and profits and any carryover treatment of this loss.

Other Provisions Applying to FSCs

Payment of Estimated Tax. Every FSC that is subject to tax under section 11 and section 882 must make estimated tax payments. For purposes of the estimated tax payments, the FSC must also make estimated tax payments for amounts determined under section 881.

Accumulated Earnings, Personal Holding Company, and Foreign Personal Holding Company. The accumulated earnings tax, personal holding company, and foreign personal holding company provisions apply to FSCs to the extent they would apply to foreign corporations that are not FSCs.

Investments in U.S. Property. For purposes of determining whether a U.S. shareholder must include in income amounts resulting from increases in investment in U.S. property, the following foreign trade income items are not taken into account:

1. Foreign trade income other than nonexempt income determined without regard to administrative pricing rules.
2. Generally, investment income and carrying charges of an FSC.
3. Any deductions that are allocated and apportioned to those classes of income.

Section 1248 Earnings and Profits. Section 1248 provides that part or all of the gain recognized by a U.S. person from the sale or exchange of stock in a controlled foreign corporation (CFC) will be treated as a dividend. The amount treated as a dividend is the portion of the gain attributable to certain earnings and profits accumulated while the corporation was a CFC (see section 1248). Section 1248 and the regulations under that section do not apply to an FSC's earnings and profits attributable to foreign trade income (section 1248(d)(6)).

Limitations on Certain Multiple Tax Benefits. The provisions of section 1561, Limitations on Certain Multiple Tax Benefits in the Case of Certain Controlled Foreign Corporations, and section 1563, Definitions and Special Rules, and the regulations under these sections apply to an FSC and its controlled group.

Boycott Income. If the FSC or any member of the FSC's controlled group participates in or cooperates with an international boycott as defined under section 999, the FSC's exempt foreign trade income will be reduced by the product of the FSC's exempt foreign trade income multiplied by the international boycott factor. The amount of the reduction will be considered as nonexempt foreign trade income (Temp. Treas. Reg. Sec. 1.927(e)-2T(a)). If the taxpayer clearly demonstrates that the income earned for the taxable year is attributable to specific operations, in lieu of applying the international boycott factor, the amount of the exempt foreign income that will be reduced will be the amount specifically attributable to the boycott operations. The amount of the reduction will be considered nonexempt foreign trade income (Temp. Treas. Reg. Sec. 1.927(e)-2T(b)).

Special Sourcing Rules. For section 482 purposes, the income of a related person from a transaction giving rise to foreign trading gross receipts of an FSC that is treated as from sources outside the United

States cannot exceed the amount that would be treated as foreign source income earned by such person if the pricing rule under the DISC pricing rules that corresponds to the FSC pricing rule had been used for that transaction. This special sourcing rule applies to any transaction giving rise to foreign trading gross receipts of an FSC. The special sourcing rule also applies if the FSC is acting as a commission agent for the related supplier that gives rise to foreign trading gross receipts and the transfer pricing rules of section 925 are used to determine the commission payable to the FSC. This special sourcing rule does not apply to a transaction to which the section 482 pricing rule under section 925(a)(3) applies. If grouping of transactions was elected, the same grouping shall be used for making the determinations under this special sourcing rule (Treas. Reg. Sec. 1.927(e)-1(a)).

Example 12.3. R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, which is an FSC acting as a commission agent for R. For the taxable year, R and F used the combined taxable income pricing rule of section 925(a)(2). For the taxable year, the combined taxable income of R and F is $100 from the sale of export property, as defined in section 927(a), manufactured by R using production assets located in the United States. Title to the export property passed outside of the United States.

Under section 925(a)(2), 23 percent of the $100 combined taxable income of R and F, that is $23, is allocated to F and the remaining $77 is allocated to R. Absent the special sourcing rule, under section 863(b) the $77 income allocated to R would be sourced $38.50 U.S. source and $38.50 foreign source. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of an FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2). Under section 994(a)(2), $50 of the combined taxable income ($100 × .50) would be allocated to the DISC and the remaining $50 would be allocated to the related supplier. Under section 863(b), the $50 income allocated to the DISC's related supplier would be sourced at $25 U.S. source and at $25 foreign source. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed $25 (Treas. Reg. Sec. 1.927(e)-1(b), example 1).

Taxable Year

Section 441 provides that the taxable year of every FSC or DISC must be the taxable year of that shareholder or group of shareholders with the

same fiscal year that has the highest percentage of voting power determined on the basis of total combined voting power of all classes of stock entitled to vote. If two or more shareholders or groups have the same percentage of voting power, the taxable year of the DISC or FSC is the same twelve-month period as that of one of the shareholders or groups.

Election and Termination of FSC Status

Election. A valid election to be treated as an FSC or a small FSC is made on Form 8279 for a taxable year at any time during the ninety-day period immediately preceding the beginning of that year. It applies to the taxable year of the corporation for which it is made and remains in effect for all succeeding taxable years for which the FSC qualifies unless the election is revoked by the corporation or unless the corporation fails for five consecutive years to qualify as an FSC or as a small FSC. As long as an FSC election remains in effect, neither the corporation nor any other member of the controlled group is permitted to elect to be treated as a small FSC. Any FSC within the controlled group must affirmatively revoke its election for a taxable year including any part of a taxable year for which small-FSC status is elected. As long as a small-FSC election remains in effect, neither the corporation nor any other member of the controlled group is permitted to be treated as an FSC for any taxable year, including any part of a taxable year during which the small-FSC election continues to be effective.

Termination. A corporation may revoke its election to be treated as an FSC or a small FSC for any taxable year of the corporation after the first taxable year for which the election is effective. If the election is filed within the first ninety days of the taxable year, the revocation will be effective for the taxable year and all years thereafter. A revocation made after ninety days from the beginning of the taxable year will be effective as of the first day of the next taxable year. A revocation of an election is made by filing a statement that the corporation revokes its election under section 922(a) to be treated as an FSC or under section 922(b) to be treated as a small FSC. The statement must indicate the corporation's name, address, employer identification number, and the first taxable year of the corporation for which the revocation is to be effective. The statement must be signed by any person authorized to sign a corporate return under section 6062. The revocation is filed in the service center in which the corporation's tax returns are filed (Temp. Treas. Reg. Sec. 1.927(f)-1(b)).

Distributions to Shareholders

Any distribution by an FSC or former FSC to its shareholders will be included in income under the provisions of section 301. If the shareholder is a corporation, 100 percent of any dividend received that is distributed out of earnings and profits attributable to foreign trade income earned while the payer corporation was an FSC may be deducted. For dividends distributed out of earnings and profits attributable to qualified interest and carrying charges, the deduction percentage is 70 percent, 80 percent, or 100 percent, depending on ownership percentages. No deduction is permitted for distributions from earnings and profits attributable to foreign trade income that is income determined without regard to administrative pricing rules. This treatment of dividends makes an FSC much more advantageous for the corporate shareholder than for an individual shareholder.

Earnings and profits distributed to a foreign shareholder are treated as U.S.-source income that is effectively connected with the conduct of a trade or business conducted through a permanent establishment within the United States. Distributions to a foreign partnership, foreign trust, foreign estate, or other foreign entities that are treated as pass-through entities under U.S. law are treated as made directly to the partner or beneficiaries in proportion to their respective interest in the entity (Temp. Treas. Reg. Sec. 1.926(a)-1T).

Any actual distribution to a shareholder by an FSC or former FSC that is made out of earnings and profits is treated as made in the following order:

1. Earnings and profits attributable to exempt foreign trade income under section 923(a)(4)
2. Earnings and profits attributable to exempt foreign trade income
3. Earnings and profits attributable to nonexempt foreign trade income determined under administrative pricing rules
4. Earnings and profits attributable to nonexempt income under section 923(a)(2)
5. Other earnings and profits (Temp. Treas. Reg. Sec. 1.926(a)- 1T(b))

Earnings and profits of an FSC or former FSC are determined in accordance with the rules at Treas. Reg. Secs. 1.964-1(a), (b), and (c).

A dividend from an FSC that is from foreign trade income (other than income determined without regard to administrative pricing rules)

is not treated as a dividend for personal holding company and foreign personal holding company purposes. A shareholder may treat distributions from an FSC or former FSC that are not treated as personal holding company income under a look-through option for purposes of other personal holding company tests. This option is described at Temp. Treas. Reg. Sec. 1.926-1T(d)(2).

FSC Tax Return Requirements

Form 1120-FSC is used to report an FSC's income, deductions, credits, and tax. Form 1120-FSC must be filed on the fifteenth day of the third month after the end of the tax year. Form 7004, Application for Automatic Extension of Time to File Corporate Income Tax Return, is used to request an automatic six-month extension of time to file Form 1120-FSC. Form 1120-FSC is filed with the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, PA 19155.

Domestic International Sales Corporations

A domestic international sales corporation (DISC) (called an IC-DISC) is a domestic corporation whose income is derived almost exclusively from U.S. export-related activities. An FSC conducts the same types of activities, but the major tax advantage of a DISC is that most of the profits receive a deferral from U.S. taxation, although there is an interest charge on the tax on the deferral. The DISC itself is not subject to taxation. The portion of DISC income subject to taxation is included in the income of the DISC shareholders. The tax-deferred income of the DISC remains untaxed until it is distributed to its shareholders, the shareholders of the DISC dispose of their stock, or the DISC loses its special tax status. There is an interest charge levied on the deferred tax on the deferred income.

Tax Attributes of a DISC

There are several unique tax advantages applicable to DISCs. Three distinct advantages are indefinite deferral of tax on a significant amount of qualifying income, use of the deferred income in the United States, and section 482 relief. The only limitation placed on the use of the invested

capital and profits of a DISC is that at least 95 percent of its assets be invested in qualified export assets. The breadth of the definition of qualified export assets allows for investments to be made in the United States without triggering additional tax. Business activities conducted between related entities are subject to the provisions of section 482. The complexities of this section and other related uncertainties have caused problems for taxpayers dealing with related entities. Relief from section 482 through special DISC pricing rules was intended to make DISC provisions viable and allow for significant economic and tax incentives by eliminating the pricing problems between a DISC and a related supplier. In addition, it was intended that a DISC be allowed to have little substance. It is not required to have any employees or provide any services in connection with the sale of its goods. If the section 482 provisions were applied to such operations, virtually no profit could be earned by the DISC and no benefits from the DISC provisions could be realized. These advantages apply to $10 million of qualified gross receipts of the DISC.

Requirements for Qualification as a DISC

Section 992 and the related regulations state eight requirements that must be met for a corporation to qualify as a DISC. A DISC is a corporation that meets the following criteria for the taxable year:

1. The corporation must be a domestic corporation.
2. Ninety-five percent or more of its gross receipts must consist of qualified export receipts.
3. The adjusted basis of the qualified export assets at the close of the taxable year must be at least 95 percent of the sum of the adjusted basis of all assets of the corporation at the close of the taxable year.
4. Only one class of stock may be outstanding with a par or stated value of at least $2,500 on each day of the taxable year.
5. The corporation elects to be treated as a DISC.
6. The corporation has its own bank account.
7. It maintains separate books and records.
8. It is not an ineligible corporation.

Each of these requirements is discussed in detail as follows.

Domestic Corporation

Only corporations duly incorporated and existing under the laws of any state or the District of Columbia are eligible for the DISC election. A corporation created or organized in a possession of the United States cannot qualify as a DISC. An association cannot qualify as a DISC even if such an association is taxable as a corporation (Treas. Reg. Sec. 1.992-1(a)).

Qualified Export Receipts Test

To qualify for DISC treatment, a corporation must derive at least 95 percent of its gross receipts from any of eight different categories of income. An analysis of the categories shows that the activities a DISC is allowed to engage in are quite broad. Taxpayers should analyze their transactions thoroughly to identify all possible sources of earnings that can be handled by a DISC. Under section 993(a), qualified export receipts are—

1. Gross receipts from the sale, exchange, or other disposition of export property.
2. Gross receipts from the lease or rental of export property that is used by the lessee outside the United States.
3. Gross receipts from services that are related and subordinate to any qualified sale, exchange, lease, rental, or other disposition of export property.
4. Gross receipts from the sale, exchange, or other disposition of qualified export assets, which consist of nine categories of assets.
5. Dividends from stock ownership of a related foreign export corporation including income includable in the DISC's gross income under section 951. Defined at section 993(e), a related foreign export corporation is generally a foreign-selling subsidiary of a DISC. That is, a DISC can choose to sell through a foreign corporation rather than directly, thereby acting as an intermediary or wholesaler. A related foreign export corporation can be one of three kinds: (a) a foreign international sales corporation, of which the DISC owns more than 50 percent of the voting power; (b) a real property holding company, of which the DISC owns more than 50 percent of the voting power; or (c) an associated foreign corporation, of which less than 10 percent of the voting power is owned by the DISC and such ownership is used in generating qualified export receipts.

6. Interest on obligations that are qualified export assets, including interest from, but not limited to, (a) accounts receivable arising from qualified export sales, lease, or rental transactions; (b) producer's loans; (c) obligations issued, guaranteed, or insured by the Export-Import Bank (Eximbank); and (d) obligations issued by the Private Export Funding Corporation (PEFCO).
7. Gross receipts from the performance of engineering or architectural services for construction projects located (or proposed for location) outside the United States. These services include feasibility studies, design, engineering, and construction supervision. They do not include technical assistance or know-how or services connected with the exploration for oil. These services may be performed within or without the United States.
8. Gross receipts for the performance of managerial services in the production of other qualified export receipts of another, unrelated DISC. This would include managerial, staffing, and operational services necessary to operate an unrelated DISC.

Under Treas. Reg. Sec. 1.993-1(j), qualified export receipts do not include—

1. Sales and leases of property for ultimate use in the United States.
2. Sales of export property accomplished by any subsidy, such as agricultural products sold under the P.L. 480 program.
3. Sales or leases of export property to the United States and the furnishing of architectural or engineering services for use by the United States.
4. Services related to nonqualified export receipts.
5. Receipts from another related DISC. Any gross receipts received by one DISC from another DISC that is a member of the same controlled group cannot be counted as qualified export receipts. This provision is to prevent counting receipts more than once for the qualifying tests. The term *controlled group* for these purposes is defined by section 1563(a), except that "more than 50 percent" is to be substituted for "at least 80 percent" each place it appears in section 1563(a).

Export Property. The term *export property*, found in the definitions of both qualified export receipts and qualified export assets, is property that meets the following three requirements (section 993(d)):

1. The property has been manufactured, produced, grown, or extracted in the United States by a person other than a DISC. A DISC may assemble or package goods it sells, but it may not manufacture, produce, grow, or extract such goods (Treas. Reg. Sec. 1.993-3(c)).
2. The property is held primarily for sale, lease, or rental in the ordinary course of business by or to, a DISC for direct use, consumption, or disposition outside the United States; or it is sold to another unrelated DISC for such purpose (Treas. Reg. Sec. 1.993-3(d)).
3. Not more than 50 percent of the fair market value of the asset is from imported components. The fair market value of any such component is its appraised value, as determined by the Secretary of the Treasury under sections 402 or 402a of the Tariff Act of 1930. This requirement is to ensure that export property is primarily U.S. products. The fair market value for these purposes is the full dutiable value without regard to any special provisions in the tariff laws that result in a lower dutiable value. The foreign content test is generally to be applied on an article-by-article basis, but it is permissible to apply the test on a mass basis if the goods are substantially identical. Even if the component is a U.S. product, it is treated as an imported component if it is exported and then imported back into the United States (Treas. Reg. Sec. 1.993-3(e)).

Property excluded from the definition of export property comprises—

1. Property leased or rented by a DISC for use by any member of a controlled group of which it is a member. This provision is designed to prevent U.S. corporations from using a DISC to convert substantial amounts of what would otherwise be manufacturing or operational income into tax-deferred income (Treas. Reg. Sec. 1.993-3(f)(2)).
2. Patents, inventions, models, designs, formulas, or processes (whether or not patented), copyrights (other than films, tapes, records, or similar reproductions for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property. Even though the sale or license of a copyright itself is not export property, the sale of a book or article made from the copyright does produce qualified export receipts (Treas. Reg. Sec. 1.993-3(f)(3)).
3. Products of such a character that a deduction for depletion under sections 613 or 613A is allowable, including oil, gas, coal, or uranium products. This provision does not apply to any commodity or product if at least 50 percent of the fair market value is attributable to manu-

facturing or processing. The provision does apply to primary products from oil, gas, coal, or uranium (Treas. Reg. Sec. 1.993-3(g)).

4. Products whose export is prohibited or curtailed under section 7(a) of the Export Administration Act of 1979 (section 993(c)(2)(d)).
5. Any processed timber that is a softwood. The term *unprocessed timber* means any log, cant, or similar form of timber (section 993(c)(2)(E)).
6. Any item of export property that would otherwise be included but is determined by the President of the United States to be in short supply for the requirements of the domestic economy (section 993(c)(3)).

Distributions Upon Failure of the Qualified Export Receipts Test. When the DISC fails the gross export receipts test in a taxable year, section 992(c) allows a distribution in order to meet the qualification requirement if there was a reasonable cause for failure. A DISC must distribute all of its taxable income attributable to the nonqualified gross receipts. If the qualified export receipts requirement is met, a portion of the taxable income from the nonqualified gross receipts may be deferred; whereas if the requirement is not met, none of such taxable income related to the nonqualified gross receipts may be deferred.

A DISC's failure to meet the qualified export receipts test will be considered reasonable if the action or inaction that resulted in the failure occurred in good faith. For example, if a DISC's reasonable determination of the percentage of its total gross receipts that are qualified export receipts is subsequently redetermined to be less than 95 percent because of a section 482 adjustment, then the failure to meet the qualified export receipts test is considered to be reasonable (Treas. Reg. Sec. 1.992-3(c)(2)). In addition, if a DISC makes a deficiency distribution for a taxable year on or before the fifteenth day of the ninth month after the close of such taxable year, the failure of the qualified export receipts test is considered reasonable if (1) at least 70 percent of the gross receipts of the DISC for the taxable year consisted of qualified export receipts and (2) the sum of the adjusted bases of the qualified export assets held on the last day of each month of the taxable year equals or exceeds 70 percent of the sum of the adjusted bases of all assets held by the DISC on each such day (Treas. Reg. Sec. 1.992-3(d)).

The deficiency distribution must be made within ninety days of the date of the first written notification to the DISC by the IRS that it has not satisfied the 95-percent requirement, with provisions for extensions for reasonable cause and provisions for payment of deficiency distribu-

tions after court action (Treas. Reg. Sec. 1.992-3(c)(3)). If a DISC makes a deficiency distribution after the fifteenth day of the month after the close of the taxable year for which the distribution is made, an interest charge of 4.5 percent is levied on the distribution (Treas. Reg. Sec. 1.992-3(c)(4)).

Qualified Export Assets Test

To qualify for DISC treatment, the adjusted basis of the qualified export assets of a corporation must equal or exceed 95 percent of the sum of the adjusted bases of all assets at the close of the taxable year. Under section 993(b), qualified export assets include the following items:

1. *Export property. Export property* is basically inventory items made in the United States[2] (other than by a DISC) and destined for ultimate use outside the United States.
2. *Business assets.* Assets used primarily in connection with the distribution of export property (whether from storage, handling, transportation, or packaging) or the assembly or servicing of export property constitute *qualified export assets*. This category of assets also includes goodwill acquired by a DISC upon the purchase of an ongoing export sales business.[3] Qualified export assets do not include assets used for manufacturing. At issue is the difference between assembling and manufacturing. A DISC is defined as engaged in manufacturing if it substantially transforms a product. Operations will be considered manufacturing if the value added to the product accounts for 20 percent or more of the total costs of goods sold (Treas. Reg. Sec. 1.993-3(c)(2)(iv)).
3. *Trade receivables. Trade receivables* are accounts receivable and evidences of indebtedness arising out of seven different transactions generating qualified export receipts. The seven types of transactions are (a) sale or disposition of export property; (b) lease, rental, or license of export property; (c) services related to export property; (d) sale or disposition of export assets; (e) engineering and architectural services on foreign construction projects; (f) managerial services in the pro-

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[2]Rev. Rul. 82-115, 1982-1 C.B. 108, also provides that goods manufactured in a U.S. foreign trade zone by a domestic corporation are considered manufactured in the United States.

[3]Rev. Rul. 82-18, 1982-1 C.B. 107.

duction of other qualified export receipts; and (g) commissions from such sales, leasing, or services.

4. *Working capital. Working capital* includes money, bank deposits, and other similar temporary investments reasonably necessary to meet the working capital requirements of the DISC. *Temporary investments* are defined as demand obligations or obligations with a maturity of not more than one year. Treas. Reg. Sec. 1.993-2(e)(3) prescribes how the reasonable working capital needs of a DISC are to be determined.
5. *Investments in certain foreign corporations*. Stock or securities of a related foreign export corporation constitute qualified export assets. Section 993(e) defines three kinds of related foreign export corporations: the foreign international sales corporation, the real property holding company, and the associated foreign corporation.
6. *Eximbank and Foreign Credit Insurance Association obligations*. The *Eximbank* is a wholly owned U.S. government corporation whose function is to provide credit arrangements for the sale of U.S. goods and services abroad. Its purpose is to assure that a U.S. producer can provide foreign customers with credit facilities. This assurance allows a U.S. exporter to compete in world markets solely on the basis of its products and prices. The Eximbank has developed several programs to meet varying needs, such as direct loans, credit guarantees made to financial institutions, credit insurance, discount loan facilities, and cooperative financing facilities. The Eximbank receives its funds primarily by borrowing from both the U.S. Treasury and the general public.

   The *Foreign Credit Insurance Association (FCIA)* is an association of over fifty maritime, casualty, and property insurance companies formed to provide credit protection for exporters. The FCIA will issue its insurance to the manufacturer or its DISC. The FCIA can fashion insurance policies to satisfy many different credit insurance needs.

   Investments in obligations issued, guaranteed, or insured (including reinsurance) by either the Eximbank or FCIA constitute qualified export assets if the obligations are acquired either directly from the Eximbank, FCIA, a person selling or purchasing goods and services giving rise to the obligations, or any corporation that is a member of the same controlled group as such person. Also included is a certificate of participation, insured by FCIA, in a loan made by a U.S. bank to a foreign corporation to purchase goods produced in the United

States.[4] Obligations of the Eximbank purchased from a person qualify if the purchase is within ninety days after the obligation was first offered to the public. (For other limitations to this provision, see Treas. Reg. Sec. 1.993-2(h)(2).)

7. *Loans to domestic corporations*. These are obligations of a domestic corporation organized solely to finance sales of export property under an agreement with the Eximbank, where the loans are guaranteed by such bank. An example of this type of obligation would be one issued by Private Export Funding Corporation.
8. *Deposits in U.S. Banks*. These include amounts on deposit in the United States at year's end that are in excess of reasonable working capital needs but are invested after year's end and in a designated reasonable period become qualified export assets. This provision's purpose is to allow a DISC flexibility in its operations where it may receive a substantial payment in the latter part of its taxable year and does not have sufficient time to convert the amount into a qualified export asset prior to the end of the year. Treas. Reg. Sec. 1.993-2(j) defines what constitutes a reasonable period for these purposes.
9. *Producer's loans*. These include obligations arising in connection with a producer's loan (defined and discussed below).

Producer's Loans. A DISC is limited in its operations primarily to sales and services; it cannot manufacture or produce. In the interest of encouraging U.S. exports, a DISC is permitted to lend its tax-deferred profits to producers of U.S. export goods without endangering either its DISC election or its deferral from current U.S. taxation on the funds lent, except to the extent that loaned amounts are invested outside the United States (section 993(d) and Treas. Reg. Sec. 1.993-4). Furthermore, a producer's loan is not considered a dividend to a borrower even if the borrower is also a shareholder of the DISC. These loans can be to a related company or to unrelated producers of U.S. exports. Producer's loans considerably increase the attractiveness of DISCs. A producer's loan is a qualified export asset, and the interest from such a loan paid to a DISC is a qualified export receipt (section 993(a)(1)(F)).

There is no statutory requirement as to either the minimum or maximum rate of interest that must be charged on producer's loans. The rate

[4]Rev. Rul. 81-251, 1981-2 C.B. 156.

of interest provides some degree of opportunity to shift income among related entities. However, the standards of section 482 would apply as a limit to the rates charged.

Each of the following requirements must be met by the lending DISC: (1) At the time the loan is made, it must be designated as a producer's loan by stating, "This obligation is designated a producer's loan within the meaning of section 993(d) of the Internal Revenue Code," or by making a statement with similar meaning; and (2) the loan must be evidenced by a note (or some other indication of indebtedness) and must have a stated maturity date of not more than five years.

In addition to the foregoing requirements, the amount of loans that qualify as producer's loans in any one year is subject to two limitations. The first limitation is that a DISC can make qualifying producer's loans in the aggregate only up to the amount of its total undistributed tax-deferred profits (accumulated DISC income). This determination is to be made at the beginning of the month in which a loan is made. The amount of the loan, when added to the unpaid balance of all other producer's loans, should not exceed the DISC's untaxed accumulated DISC income. The determination of whether a loan qualifies as a producer's loan is made at the time the loan is made. If the untaxed accumulated DISC income of the DISC later slips below the unpaid balance of all producer's loans previously made, the subsequent decrease will not disqualify the previous loans.

A second limitation is placed on the amount that can be lent to any one borrower. The limit is the amount of the borrower's assets that are considered to be export-related. Such assets are to be determined by the complex formula found at section 993(d)(3) and the related regulations.[5]

Distributions Upon Failure of the Qualified Export Assets Test. When a DISC fails the qualified export assets test in a taxable year, section 992(c) allows a distribution in order to meet the qualification requirement if there was reasonable cause for failure. If a DISC fails the test, it must distribute the fair market value of those assets that were not qualified export assets on the last day of such taxable year.

A DISC's failure of the qualified export assets test will be considered reasonable if the action or inaction that resulted in the failure occurred in good faith (for example, the failure was because of blocked currency or

[5]There is also a special limitation for domestic filmmakers provided in section 993(d)(4).

expropriation) (Treas. Reg. Sec. 1.992-3(c)(2)). In addition, if a DISC makes a deficiency distribution for a taxable year on or before the fifteenth day of the ninth month after the close of such taxable year, the failure of the qualified export assets test is considered reasonable if the adjusted bases of the qualified export assets held by the DISC on the last day of each month of the taxable year are at least 70 percent of the sum of the adjusted bases of assets held by the DISC on each such day (Treas. Reg. Sec. 1.992-3(d)).

The deficiency distribution must be made within ninety days of the date of the first written notification by the Internal Revenue Service (IRS) that the DISC has not satisfied the qualified export assets requirement. There are extensions for reasonable cause and provisions for payment of deficiency distributions after court action (Treas. Reg. Sec. 1.992-3(c)(3)). If a DISC makes a deficiency distribution after the fifteenth day of the month after the close of the taxable year for which the distribution is made, an interest charge of 4.5 percent is levied on the distribution (Treas. Reg. Sec. 1.992-3(c)(4)).

Capitalization Requirements

The purpose of restriction of outstanding stock to only one class is to prevent unwarranted complexities from arising in allocation of undistributed profits to shareholders of more than one class of stock. Outstanding stock with different voting rights, dividend rights, liquidation preferences, or other different interests in control, profits, and assets is to be considered as more than one class of stock. The regulations provide a safe harbor rule, which states that in no event will debt be treated as a second class of stock, regardless of amount, as long as the following requirements are met:

1. Such debt is a written obligation to pay a fixed amount on a fixed maturity date.
2. Interest is payable at an arm's-length rate, as determined under Treas. Reg. Sec. 1.482-2(a)(2).
3. Such debt is not convertible into stock.
4. Such debt does not confer voting rights.
5. Interest and principal are paid in accordance with the terms of the debt. Modifications of payments are allowed if a DISC becomes unable to pay. If trade accounts are payable within fifteen months after they arise or if they otherwise satisfy the definition of debt,

including the safe harbor rule (Treas. Reg. Sec. 1.992-1(d)(2)(ii)), they will be considered a debt. Treas. Reg. Sec. 1.992-1(d)(1) provides that the par or stated value of a corporation's outstanding stock must be at least $2,500 at all times during the year, none of which may be allotted to paid-in or other surplus accounts. The law of the state of incorporation of the DISC determines what consideration may be used to capitalize the DISC. If the corporation has realized or unrealized loss during a taxable year that results in the impairment of all or part of the capital required, the impairment does not result in disqualification, provided the corporation does not take a legal or formal action under state law to reduce capital below $2,500 (Treas. Reg. Sec. 1.992-1(d)(1)).

In the case of a new corporation, the foregoing requirements are satisfied if they are met on the last day of the period within which such election must be made and on each succeeding day of such year.

The Proper Election

The election to be treated as a DISC is made by filing Form 4876 with the service center where the corporation would file a federal income tax return, accompanied by a list of signatures of all shareholders (either signed on Form 4876 or on a separate list) who are shareholders as of the beginning of the first taxable year in which the corporation will be a DISC. A new corporation has ninety days after the beginning of its first taxable year to make the election. All other corporations must make the election within a ninety-day period immediately before the beginning of the year for which the election is to be effective.

All persons who are shareholders at the beginning of the first taxable year for which the election is made must consent (either on Form 4876 or on a separate sheet) to the election. The consent is binding on each shareholder and all transferees of the shares, and it may not be withdrawn. When stock is owned by more than one party (such as community property or joint tenants), each party must consent to the election.

When the filing of an election is timely and would be valid except for the failure to attach the consent of any shareholder, the election will not be invalid if the shareholder can show reasonable cause for failure to file the consent and then does file within the extended time granted by the IRS.

A valid election remains in effect until terminated by either of two methods. In the first method, the corporation itself can revoke the elec-

tion after the first taxable year for which the election is effective by filing a statement of revocation with the service center in which the corporation filed its election. The statement must be filed within the first ninety days of a taxable year to be effective for that year.

In the second method, if a DISC fails to qualify as a DISC for each of five consecutive years, such an election terminates automatically, effective for the years after such fifth year. This five-year rule refers only to the election. Treas. Reg. Sec. 1.992-1(e) provides that to be taxed as a DISC, a corporation must have an election in effect and must also satisfy the requirements of Treas. Reg. Sec. 1.992-1(a) through (d). A corporation that fails the DISC requirements of section 992(a) as provided by Treas. Reg. Sec. 1.992-1 in any one year has not terminated its election, and it need not go through the election process again. However, in certain instances when shares are transferred, a supplemental Form 4876 must be filed.

Own Bank Account and Separate Books and Records

A DISC must have a separate bank account on each day of the taxable year; in the case of a corporation that elects to be treated as a DISC for its first taxable year, such a corporation must have a separate bank account within ninety days after the beginning of such taxable year, on each succeeding day of such taxable year, and as above, on each day of every succeeding tax year.

Not an Ineligible Corporation

DISC provisions are specifically denied to certain types of domestic corporations, including:

1. Tax-exempt organizations.
2. Personal holding companies.
3. Banks, savings and loan associations, and other financial institutions.
4. Insurance companies.
5. Regulated investment companies.
6. China Trade Act corporations.
7. A subchapter S corporation (referred to as an S corporation).
8. Corporations claiming the section 936 Puerto Rico and possessions tax credit. A corporation that is a DISC or a former DISC (defined in section 992(a)), or is a shareholder in a DISC or former DISC for

a taxable year, is not entitled to the section 936 Puerto Rico and possessions tax credit for such taxable year (section 936(f)).

Computing DISC Income

Typically, a business forms a DISC through which it may channel its export activities. If the DISC is selling merchandise, it will either buy the products from the related supplier (a buy-sell DISC) or act as commission agent for the related supplier (a commission DISC). The qualifications for DISC status are liberal enough to allow it to have little substance (a paper DISC or desk DISC). The DISC need not have any employees or inventory, make its own sales, or even handle the billings of the sales. As a result, under normal tax rules, significant problems could arise in that, whenever related parties deal with each other, section 482 becomes operative, setting standards for the transfer prices charged. Section 482, which provides in effect that the transfer prices must be essentially the same as those made to unrelated parties (arm's-length standard), acts as a limit to the amount of profits and expenses that can be shifted between related parties. Furthermore, section 482 has been criticized for its complexities and uncertainties and, especially in the foreign area, for accuracy-related penalties and for the exposure to double taxation caused by IRS adjustments to prior years, which cannot be used to adjust the amount of income taxed by foreign governments.

To avoid the problems of section 482 and to encourage the utilization of DISCs, section 994 provides special rules that can guide the setting of transfer prices between related parties. One method is the 4-percent-gross-receipts method and the other is the 50-percent-combined-taxable-income method. These two special rules should help not only to reduce the previous problems connected with intercompany transfer prices but also to increase the amount of profits a DISC can earn. These two special pricing rules are among the most attractive aspects of the DISC legislation.

The limitations of the two special pricing rules are as follows:

1. The special rules apply only to transactions between a related supplier and a DISC that gives rise to qualified export receipts (Treas. Reg. Sec. 1.994-1(b)). These special pricing rules may not be used for nonqualified receipts. Section 482 will apply to these transactions of DISCs with related parties.
2. The special rules determine the apportionment of income resulting from a transaction between the DISC and its related supplier. When

the DISC resells to an unrelated customer, the special rules apportion the income in such an arm's-length sale by giving a portion to the DISC and a portion to the related supplier. However, when the DISC resells to a related customer, the complex allocation rules of section 482 may first operate to readjust the price and income on the DISC's resale, and then the special rules will apportion the adjusted price and resulting income to the DISC and its related supplier.

3. Both special rules can be used on the same tax return; that is, a 4-percent-gross-receipts method can be used on one transaction and a 50-percent-combined-taxable-income method used on another transaction. However, a certain grouping of transactions is allowed by Treas. Reg. Sec. 1.994-1(c)(7).
4. Under the regulations (Treas. Reg. Sec. 1.994-1(e)) (with no support in the U.S. Internal Revenue Code), the profits that can be shifted to a DISC under either of these two pricing methods are limited to 100 percent of the combined taxable income. Where combined taxable income is positive on a transaction, considering both the DISC and the related supplier, neither method can be used to cause a loss to be incurred by the related supplier. That is, the minimum transfer price must be at least high enough to cover the supplier's costs. This rule is called the "no-loss rule."

Taxpayers should carefully select the method or methods that will allocate the greatest amount of profits to a DISC (unless extraordinary circumstances exist in which one might want to allocate the minimum profit to a DISC) to ensure the maximum tax benefits that can be derived. Treas. Reg. Sec. 1.994-1(e)(4) allows the transfer prices to be adjusted for the prior year up to the date the DISC files its return for that year. This allows additional flexibility and time in determining the amount of income desired for a DISC. Treas. Reg. Sec. 1.994-1(e)(4) also permits a redetermination of the commission in an amended return if otherwise permitted by the Internal Revenue Code and regulations. Rev. Rul. 82-81 permits a timely filed, amended return of a DISC and its parent company in which the DISC recomputes its income under a different pricing rule from the one used in the original return to determine a maximum allowable commission.[6]

[6]Rev. Rul. 82-81, 1982-1 C.B. 109.

The 4-Percent-Gross-Receipts Method

The 4-percent-gross-receipts pricing method provides that a transfer price can be set to allow a DISC's income from a transaction to equal 4 percent of the gross receipts from the sale of such export property plus 10 percent of the export promotion expenses attributable to the transaction. The pricing rule can be expressed algebraically as follows:

$$\text{Maximum allowable taxable income to DISC} = \left(4\% \times \begin{array}{c}\text{Gross receipts}\\ \text{from sale of}\\ \text{export property}\end{array}\right) + \left(10\% \times \begin{array}{c}\text{Export}\\ \text{promotion}\\ \text{expenses}\end{array}\right)$$

Once the maximum amount of taxable income is determined, the transfer price can then be calculated as follows:

Sales price by DISC
Less:
1. Export promotion expenses
2. Other attributable costs of DISC
3. Maximum taxable income (per 4-percent method)

Equals: Transfer price to DISC

Example 12.4. Baltam, a domestic corporation, produces export property that is sold to its wholly owned DISC. During the year, Baltam produces and sells a line of export property to the DISC, which was resold for $200,000. Baltam's cost of goods sold attributable to the export property is $85,000, and expenses directly related to export sales are $35,000. The DISC incurred export promotion expenses of $20,000. The DISC's net income under the 4-percent method is $10,000 [(4% × $200,000) + ([10% × $20,000)]. The selling price to the DISC is $170,000 ($200,000 − [$20,000 + $10,000]). A loss is not incurred by the related supplier, since $170,000 − ($85,000 + $35,000) = $50,000 profit to Baltam. Therefore, the $170,000 transfer price may be used.

If the DISC is a commission DISC, the maximum profit is also 4 percent of the gross receipts plus 10 percent of the export promotion expenses attributable to the transaction. The total commission payable to the DISC is calculated as follows:

Maximum taxable income (per 4-percent method)
Plus:
1. Export promotion expenses
2. Other attributable costs of DISC

Equals: Commission payable to the DISC

Example 12.5. Calton, a domestic corporation, produces export property that is sold by its wholly owned DISC. The related supplier agreement states that the DISC may earn a profit from the commission sales of qualified property of a 4-percent commission plus 10 percent of the export promotion expenses. The DISC sells qualified export property for $100,000 and incurs $5,000 in export promotion expenses and $2,000 in other costs. The DISC profit is $4,500 [(4% × $100,000) + (10% × $5,000)], and the commission payable to the DISC is $11,500 ($4,500 + $5,000 + $2,000).

The 50-Percent-Combined-Taxable-Income Method

Under the 50-percent-combined-taxable-income method, the income that may be earned by a DISC is equal to 50 percent of the combined taxable income from export property of the related supplier and the DISC plus 10 percent of the DISC's export promotion expense. This pricing rule can be expressed algebraically as follows:

$$\text{Maximum allowable taxable income to DISC} = \left(50\% \times \text{Combined taxable income}\right) + \left(10\% \times \text{Export promotion expenses}\right)$$

Treas. Reg. Sec. 1.994-1(c)(6) states that combined taxable income shall be determined as follows:

$$\text{Gross receipts from sale by DISC} - \text{Total costs of DISC and related supplier that relate to gross receipts} = \text{Combined taxable income}$$

In determining the amount of total costs of the above, Treas. Reg. Sec. 1.994-1(c)(6)(i)-(iv) and Treas. Reg. Sec. 1.861-8 provide several rules to follow.[7]

Once the maximum amount of combined taxable income is determined above, a commission for a commission DISC can be computed as shown above, and the transfer price for a buy-sell DISC can be determined as follows:

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[7]See *St. Jude Medical, Inc. v. Comm.* (CA-8, 1994), 34 F.3d 1394, 74 AFTR2d 94-6166, *aff'g.* in part and *rev'g.* in part 97 T.C. 457 (1991), *nonacq*, AOD 95-1, 2/13/95, and *General Dynamics Corp., et al.* (1997), 108 T.C. 107, regarding allocation of expenses under Treas. Reg. Sec. 1.861-8.

Sales price by DISC
Less:
1. Export promotion expenses
2. Other attributable costs of DISC
3. Maximum taxable income (per 50-percent method)

Equals: Transfer price to DISC

Example 12.6. Golden, a domestic manufacturing company owns all the stock of Bear, a DISC. During the year, Golden produces and sells Bear a line of export property, which is resold by Bear for $200,000. Golden's cost of goods sold attributable to the export property is $115,000, so that the combined gross income from the sale of the export property is $85,000 ($200,000 − $115,000). Golden's expenses directly related to the export sales are $35,000, and deductible overhead and other supportive expenses allocable to all gross income are $6,000. Apportionment of these overhead expenses under Treas. Reg. Sec. 1.861-8 results in $2,000 apportioned to the export activities. Golden's gross income from other sources is $170,000. Bear's export promotion expenses are $20,000. Bear's net income is computed under the combined taxable income method as follows:

Bear's sales		$200,000
Golden's costs of goods sold	$115,000	
Golden's directly related expenses	35,000	
Golden's allocable indirect expenses	2,000	
Bear's expenses	20,000	172,000
Combined taxable income		$ 28,000
		50%
		$ 14,000
10-percent export promotion expenses		2,000
Net income to Bear		$ 16,000

The price Bear pays Golden is computed as follows:

Bear's sales		$200,000
Bear's expenses	$20,000	
Bear's net income	16,000	36,000
Transfer price from Golden to Bear		$164,000

Marginal Costing Rules

Marginal costing is a method under which only marginal or variable costs of producing and selling a particular item, product, or product line are taken into account (Treas. Reg. Sec. 1.994-2(b)). A DISC seeking to

establish a foreign market for sale of an item, product, or product line of export property may use marginal costs. Marginal costs are not applicable either to sales income under section 954(d) or for leases of property or the performance of services, whether or not related, and subsidiary services.

In applying the marginal costing method, only *variable costs* are taken into account (that is, direct production costs and export promotion expenses if they are claimed as such in determining taxable income derived by the DISC under the 50-percent-combined-taxable-income method).

For purposes of the computation of profits under the 50-percent-combined-taxable-income method, a DISC is allowed to use marginal costing in calculating the combined taxable income on a transaction if it is treated as seeking to establish or maintain a foreign market for export property. Establishing or maintaining a foreign market is considered to exist when the combined taxable income computed using marginal costs is greater than when using full costing. The marginal costing rule should be considered in conjunction with Treas. Reg. Sec. 1.482-2(e)(2)(iv), which permits selling at reduced prices, and perhaps even at a loss, to introduce the product into an area or to meet competition.

The maximum amount of combined taxable income to be allowed using the marginal costing rules is subject to two limitations. The first limitation is that if combined taxable income exists for a transaction, this method cannot cause a loss to the related supplier. A *loss to a related supplier* exists when the taxable income recognized by a DISC exceeds the combined taxable income of the related supplier and DISC.

The second limitation is that the combined taxable income cannot exceed gross receipts derived from such sales multiplied by the overall profit percentage that is calculated based on full costing. The limitation is expressed algebraically as follows:

$$\text{Maximum combined taxable income} = \frac{\begin{array}{c}\text{Combined taxable income of DISC and related supplier on product} \\ + \\ \text{Taxable income of related supplier from all other sales (domestic and foreign) of such product}\end{array}}{\text{Total gross receipts from above sales}} \times \text{Gross receipts derived by DISC on product}$$

In applying the foregoing formula, certain groupings of transactions are allowed by Treas. Reg. Sec. 1.994-1(c)(7). (For an example of the marginal costing rule, see Treas. Reg. Sec. 1.994-2(3), example (1)).

The Section 482 Method

The section 482 pricing method is used for all applicable transactions between a DISC and a related supplier when the DISC is not eligible for either the 4-percent-gross-receipts method or the 50-percent-combined-taxable-income method or when it chooses not to use them. Section 482 pricing may produce a larger profit in some cases. The transfer price under this method is to be determined by the guidelines of section 482 and the related regulations. As was mentioned above, when section 482 arm's-length pricing methods are applied to a DISC, it must have commercial or entrepreneurial substance[8] or little or no profit is allocated to the DISC. This could result in little or no deferral of U.S. taxation on qualified export receipts.

Export Promotion Expenses

The taxable income allocated to a DISC can be increased by 10 percent of the export promotion expenses it incurs. The term *export promotion expenses* is broadly defined and includes items that one would not generally associate with the term *promotion*. The provision was added to encourage the transfer of selling functions and other business activities to the DISC.

The general definition of export promotion expenses includes all those costs that advance the sale, lease, or other distribution of export property outside the United States. The following are some specific examples from the regulations that meet this general definition:

- Costs of installation (but not assembly) services at the site
- Costs of meeting warranty commitments
- General and administrative expenses attributable to billing customers
- Clerical functions
- Market studies and advertising

[8]International Canadian Corp., 308 F.2d 520 (CA-9, 1962), *aff'g.* 61-1 U.S.T.C. (CCH) para. 9405 (W.D. Wash. 1961).

- Salaries and wages of sales, clerical, and other personnel
- Rentals of property
- Sales commissions, warehousing, and other selling expenses
- Reasonable allowance for depreciation and obsolescence
- Freight (subject to limitations of Treas. Reg. Sec. 1.994-1(f)(4))
- Costs of packaging for export
- Costs of designing and labeling packages exclusively for export markets

The following are some items specifically excluded from this definition by the regulations: (1) interest, (2) bad debts, (3) freight insurance, (4) cost of manufacture or assembly operations, (5) income or other taxes for which a foreign tax credit is given, and (6) state and local income and franchise taxes.

For an expense to be an export promotion expense, it must be incurred by the DISC, must advance the distribution or sale of export property for use outside the United States, must be an ordinary and necessary business expense, and must be attributable to qualified export receipts to which section 994 applies. An expense will qualify as an export promotion expense incurred by the DISC even if the accounting and payment of these expenses is handled by a related party and the DISC reimburses the related party (Treas. Reg. Sec. 1.994-1(f)(7)(vi)).

Payment of Transfer Price or Commission

The transfer price or reasonable estimate actually charged by a related supplier to a DISC, or a sales commission actually charged by a DISC to a related supplier, must be paid no later than sixty days following the close of the taxable year of the DISC during which the transaction occurred. The payment must be in the form of (1) money; (2) property, including accounts receivable from sales by or through the DISC; (3) a written obligation that qualifies as debt under the safe-harbor rule of Treas. Reg. Sec. 1.992-1(d)(2)(ii); or (4) an accounting entry offsetting the account receivable against an existing debt owed by the person in whose favor the account receivable was established to the person with whom it engaged in the transaction. The form of the payment to a DISC need not be a qualified export asset but the 95-percent-qualified-export-assets requirement must be satisfied.

If the amount actually paid results in the DISC realizing at least 50 percent of its taxable income from the transaction (as reported in its tax

return for the taxable year the transaction is completed), that amount will be deemed a reasonable estimate of the transfer price or commission.

There is a danger involved in not paying the transfer price or commission within the sixty-day period. The indebtedness owed to the DISC is treated as an asset, but not as a trade receivable or other qualified export asset, thereby jeopardizing the satisfaction of the 95-percent-qualified-export-assets requirement.[9]

Taxation of a DISC

A DISC is not subject to income taxation; however, a DISC is a separate reporting entity, and taxable income of a DISC must be determined. Such taxable income is determined in the same manner as if the DISC were a domestic corporation not electing DISC status. A DISC chooses its method of depreciation, inventory method, and annual accounting period as if it were a corporation that had not elected DISC status (Treas. Reg. Sec. 1.991-1(b)(1)).

A DISC may generally choose any method of accounting permissible under section 446(c). If a DISC is a member of a controlled group, the DISC may not choose a method of accounting that will result in a material distortion of the income of the DISC or any other member of the controlled group when applied to transactions between the DISC and other members of the controlled group (Treas. Reg. Sec. 1.991-1(b)(2)). Under section 441(h), the taxable year of a DISC must be the same as that of the shareholder (or group of shareholders with the same twelve-month taxable year) who has the highest percentage of voting power.

Income Taxable to DISC Shareholders

The earnings and profits of a DISC are taxed to the shareholders based on six possible taxable events:

1. Deemed distributions
2. Dividends (other than distributions from previously taxed income)
3. Disposition of DISC stock

[9] CWT Farms, Inc., 79 T.C. 68 (1982). Fritzche Dodge & Olcott, T.C. Memo. 1983-56.

4. Disqualification of DISC election
5. Qualifying distributions (to preserve DISC election)
6. Bribe- and boycott-produced income

Deemed Distributions

Deemed distributions are the earnings of a DISC that are constructively taxed to the shareholders on an annual basis. At the minimum, shareholders are taxed on these amounts annually. The effect of deemed distributions is that the shareholders recognize dividend income but are not eligible for the dividends-received deduction. Such distributions are taxed to the shareholders on a pro rata basis in their taxable year in which the last day of the taxable year of the DISC ends. Deemed distributions increase the basis of the stock of the shareholders (section 996(e)). Once such amounts are taxed, they are classified as previously taxed income. The significance of previously taxed income is that it can be distributed to shareholders at a later time without tax consequences, except for a reduction in the basis of their stock in the DISC.

There are two categories of deemed distributions. The first category is deemed distributions in qualified years from—

1. Interest from producer's loans.
2. Gains on the sale or exchange of nonqualified export assets acquired in a nontaxable exchange.
3. Gains to the extent of ordinary income recapture on the sale or exchange of qualified export assets acquired in a nontaxable exchange.
4. Fifty percent of the taxable income attributable to military property.
5. The taxable income of the DISC attributable to qualified export receipts of the DISC for the taxable year that exceed $10 million.
6. In the case of a shareholder that is a C corporation, 1/17 of the excess of the taxable income of the DISC for the taxable year before any distributions during the year, over the sum of items 1 through 5 plus an amount equal to 16/17 of the excess multiplied by the international boycott factor and any illegal bribe, kickback, or other payment within the meaning of section 162(c). The fact that some income is always taxed to the corporate shareholder favors individual ownership of DISC shares over corporate ownership.

7. The amount of foreign investment attributable to producer's loans (Prop. Treas. Reg. Sec. 1.995-2A(a)).

The second category of deemed distributions is the distributions upon disqualification of the DISC.

Interest From Producer's Loans. Defined in Treas. Reg. Sec. 1.993-4, interest from such loans is to be recognized as a deemed distribution by the DISC shareholders. No reduction is allowed for any attributable expenditure. Producer's loans generate interest income for the DISC and an interest deduction for the borrower. If the borrower is a shareholder in the DISC, the effect is to offset interest deduction and interest income for the borrower-shareholder. As a result, an opportunity arises for shifting income among related parties where the borrower and the shareholder are different parties.

Gains on the Sale or Exchange of Nonqualified Export Assets. Without this particular provision, a DISC could be used to avoid taxation on a percentage of the gains from the sale of property other than qualified export assets by transferring appreciated assets to a DISC in a tax-free exchange, with a subsequent sale of such property by the DISC. The provision requires the inclusion of the unrecognized gain (determined at the time of the tax-free transfer of property to a DISC) in the income of the shareholders when the DISC disposes of the property. All such gains are treated as ordinary income because all deemed distributions are taxed as dividend income. This provision can be quite severe when the sale of the property would otherwise have been taxed as a long-term capital gain when rates are lower than those on ordinary income.

Gains to the Extent of Ordinary Income Recapture on the Sale or Exchange of Qualified Export Assets Acquired in a Nontaxable Exchange. Shareholders of a DISC must recognize as a deemed distribution a gain recognized by the DISC on the sale or exchange of qualified export property (except inventory) previously transferred in a nontaxable transaction, to the extent the gain on the previous transfer was not recognized and would have been treated as ordinary income if the property had been sold or exchanged rather than transferred to the DISC.

Example 12.7. Xenon, a domestic corporation, transfers property to a DISC in a tax-free exchange in which Xenon's entire realized gain of $100,000 is not recognized. The property would have been subject to a section 1245

recapture of $60,000 (ordinary income). When the DISC sells the property at a realized gain of $150,000, the amount of income that must be recognized as a deemed distribution is $60,000 (the lesser of $150,000 or $60,000).

Fifty Percent of the Taxable Income Attributable to Military Property. Shareholders of a DISC must recognize as a deemed distribution 50 percent of the taxable income of the DISC attributable to military property. *Military property* means any property that is an arm, ammunition, or implement of war designated in the munitions list published pursuant to the Mutual Security Act of 1954 (22 U.S.C. sec. 1934), which is referred to in section 995(b)(3)(B) as the "Military Security Act of 1954."

Taxable Income Attributable to Gross Receipts Exceeding $10 Million. If the qualified export receipts of a DISC exceed $10 million, the taxable income attributable to the receipts in excess of $10 million is deemed distributed to the DISC shareholders. If the receipts exceed $10 million, the DISC must segregate the qualified export receipts into two amounts, those that are below $10 million and those exceeding $10 million. This selection may be made in any manner the DISC chooses and will normally be done in such a way that the greatest amount of taxable income will be allocated to the DISC for purposes of applying the intercompany pricing rules. Except in the case of services related to any disposition or rental of export property (which cannot be treated separately) or the transaction that causes the DISC receipts to exceed $10 million (which is treated as partly receipts under $10 million and partly receipts over $10 million), the allocation may be made on a transaction-by-transaction basis or on the basis of a grouping consistent with the grouping used for intercompany pricing. After identifying the transactions of the taxable year that are considered to exceed the $10 million amount, the excess receipts are reduced by cost of goods sold, if applicable, and by deductions properly allocated and apportioned under Treas. Reg. Sec. 1.861-8 and following. Members of a controlled group determined under section 1563(b) are entitled to only one $10 million amount (Prop. Treas. Reg. Sec. 1.995-8(a)).

An Amount Equal to 1/17 of the Excess DISC Income. The minimum amount of income subject to current taxation to an individual shareholder is zero, and to a shareholder that is a C corporation the amount is 1/17 of the net income, calculated as follows:

Total taxable income of DISC

Less:

1. Gross interest from producer's loans
2. Gains on sale of nonqualified export assets acquired in a non-taxable transaction
3. Gains on sale of qualified export assets acquired in a non-taxable transaction
4. Fifty percent of the taxable income of the DISC attributable to military property
5. The taxable income of the DISC attributable to qualified export receipts in excess of $10 million

Equals: Net taxable income

× 1/17 for a shareholder that is a C corporation

Equals: Deemed distribution of taxable income

Example 12.8. A DISC had total taxable income for the year of $500,000, of which $40,000 is attributable to gross receipts in excess of $10 million. It has gross interest from producer's loans of $12,000 and has a gain on sale of assets acquired in nontaxable transactions of $23,000. The portion of the taxable income that constitutes a deemed distribution to a shareholder that is a C corporation for the current year is calculated as follows:

$$(\$500{,}000 - \$40{,}000 - \$12{,}000 - \$23{,}000) = \$425{,}000$$
$$\times\ 1/17$$
$$= \$\ 25{,}000$$

The total deemed distribution from all sources for the shareholder that is a C corporation is $100,000 – $40,000 + $12,000 + $23,000 + $25,000). The income that constitutes a deemed distribution to a shareholder that is not a C corporation is $75,000 ($40,000 + $12,000 + $23,000) for the year.

Foreign Investment Attributable to Producer's Loans. The tax significance of producer's loans is that tax-deferred profits may be used to expand U.S. export activities without constituting dividend income to the borrower (which is usually related). When the DISC legislation was drafted, there was a concern that such amounts lent might be used by the borrowers for foreign rather than for U.S. expansion, thereby thwarting some of the economic objectives of the legislation.

To the extent producer's loans are made to a related corporation and such borrower uses the proceeds for foreign investments, that portion shall constitute a deemed distribution (ordinary income) to the shareholders of a DISC, a rule dubbed the *fugitive capital rule*. The calculations

for this provision are to be made on the basis of a controlled group, not just the DISC and the related borrower. The purpose is to prevent other related parties from shielding such foreign investments. The term *controlled group* is defined by section 993(a)(3) as corporations connected through stock ownership of more than 50 percent. The regulations divide the controlled group into two subgroups: domestic and foreign members (that is, domestic and foreign corporations of the group).

The amount to be taxed under this provision in general is the smallest of the following three items: (1) net increase in foreign assets of the controlled group, (2) actual foreign investments by domestic members of the controlled group, or (3) outstanding producer's loans.

Because of the problem with fugitive capital, producer's loans are risky at times. One of the objectives of utilizing a DISC is to benefit the parent/related supplier. Since a DISC normally has little substance, it has little need for the deferred accumulated profits. Without using producer's loans, it is possible to use excess cash in the DISC by purchasing the parent's export receivables or export inventory. The DISC should purchase specific receivables and inventory. Purchasing receivables at a discount also allows the DISC to earn additional qualified export receipts.

Distributions Upon Disqualification of a DISC

The tax-deferral privileges provided to DISCs continue only as long as a corporation remains a DISC. In any year when the corporation either voluntarily revokes its DISC election or involuntarily fails to meet the several conditions of DISC status, taxation of all previously deferred accumulated DISC income (earnings and profits accumulated while it was a DISC) is triggered and is a deemed distribution to shareholders.

The DISC election for a corporation does not terminate involuntarily until the corporation fails to satisfy the conditions of election for five consecutive taxable years. However, it only takes one year's failure to cause distribution of all previously deferred accumulated DISC income.

Shareholders who own stock in a corporation that loses its DISC status are taxed on their pro rata portion of the corporation's untaxed income accumulated during the years the corporation was a DISC. The pro rata share of such income shall be determined as of the close of the last consecutive taxable year for which the corporation was a DISC. An exception is the extent to which the seller of DISC stock had to recognize any gain as ordinary income on the sale.

The income that must be recognized upon a corporation's disqualification as a DISC can be income earned over a period of several years under DISC status. Considering progressive taxation, this lumping effect could create high marginal tax liabilities. Such income recognition may be spread out in equal installments over ten years, but in no case may the number of installments exceed twice the number of years for which the corporation was a DISC (section 995(b)(2)(B)). The first year in which such income must be recognized is the first year after the disqualification occurs.

Example 12.9. Dole Corporation elects to be taxed as a DISC beginning with calendar year 1985. Dole qualifies as a DISC from 1985 through 1995 and revokes its election effective January 1, 1996. The shareholders of Dole will be deemed to receive distributions of Dole's accumulated DISC income pro rata as a dividend on the last day of each of Dole's succeeding taxable years beginning in 1996 and spread over 1996 through 2017 (eleven years of DISC qualification − 2).

Interest on DISC-Related Deferred Tax Liability

For each year, the shareholder of a DISC must pay interest equal to the shareholder's DISC-related deferred tax liability for the year times the base-period T-bill rate (section 995(f)(1)). The *DISC-related deferred tax liability* is the excess of the amount that would be the tax liability of the shareholder for the taxable year if the deferred DISC income were included in gross income as ordinary income over the actual amount of the tax liability of the shareholder for the taxable year determined without regard to carrybacks to the taxable year. *Deferred DISC income* means the excess of the shareholder's pro rata share of accumulated DISC income for periods after 1984 of the DISC as of the close of the computation year over the amount of distributions-in-excess-of-income for the taxable year of the DISC following the computation year. The *base-period T-bill rate* means the average annual rate of interest determined by the U.S. Treasury that is equivalent to the average investment in U.S. Treasury bills with maturities of fifty-two weeks that were auctioned during the one-year period ending on September 30 of the calendar year ending with the close of the taxable year of the shareholder (section 995(f)(4)). The interest accruing during any taxable year that the shareholder is required to pay must be paid at the time the tax return would be due for that shareholder (section 995(f)(6); Prop. Treas. Reg. Sec. 1.995(f)-1).

Earnings and Profits

Shareholders receiving deemed or actual distributions will not be taxed on amounts in excess of earnings and profits of the DISC. Earnings and profits of a DISC consist of three categories: (1) previously taxed income, (2) accumulated DISC income, and (3) other earnings and profits.

Regarding previously taxed income, shareholders of a DISC are taxed on some of the income of a DISC without receiving an actual distribution. To prevent double taxation, each shareholder is entitled to receive such earnings without further taxation when they are actually distributed. The mechanism for tracing the portions previously taxed is to segregate the DISC earnings and profits into a "previously taxed income" account.

Amounts in this account increase the basis in the shareholders' stock of the DISC. Distributions charged to this account are a reduction of their basis in the DISC stock. When a change of ownership occurs, the pro rata portion of previously taxed income attributable to such stock carries over to the new owner.

Accumulated DISC income is basically the remainder of all earnings and profits earned while the corporation was a DISC (after 1984) but untaxed to the shareholders. Any distribution out of this portion of earnings and profits is taxed to the shareholders as dividend income. However, such dividend income is not eligible for the corporate dividends-received deduction.

Other earnings and profits represent earnings derived in taxable years for which the corporation was not a DISC. Distributions from this amount are taxed as dividend income to the shareholders. These distributions are eligible for the dividends-received deduction because the earnings have been previously taxed to the corporation while it was not a DISC.

Deficits in Earnings and Profits

Deficits in earnings and profits of a particular year are to be charged in the following sequence: first, to other earnings and profits; second, to accumulated DISC income; and third, to previously taxed income. The foregoing order changes if the corporation is a former DISC. In that event, the first account to be charged is other earnings and profits, then previously taxed income, with any balance being charged to other earnings and profits and creating a deficit therein (Treas. Reg. Sec. 1.996-2(b) and example (3) in Treas. Reg. Sec. 1.996-2(c)).

Qualifying Distributions

Any actual distribution made to meet the qualified export assets requirement or deemed distributions relating to foreign investment attributable to producer's loans is treated as coming first from accumulated DISC income, second from other earnings and profits, and finally from previously taxed income. In the case of any amount of any actual distribution to a C corporation to meet the qualification requirements, 1/17 is treated as an actual distribution and 16/17 is treated as a qualifying distribution (section 996(a)).

Actual Distributions

Actual distributions shall be treated as coming first from previously taxed income, second from accumulated DISC income, and third from other earnings and profits (section 996(b)).

Disposition of DISC Stock

It was the intent of Congress that the income of a DISC be eventually taxed to the shareholders at ordinary income rates. To prevent the untaxed deferred income of a DISC from being converted from ordinary income to capital gains (when there is a rate differential) by the disposition of such DISC stock (which is generally a capital asset), section 995(c)(1)(A) provides that to the extent that there are deferred untaxed earnings applicable to the disposed stock that were accumulated during the time the seller held the stock, the gain shall be taxed as dividends. This provision is similar in effect to section 1248, which is applicable to the sale of the stock of certain foreign corporations.

In cases in which a DISC is absorbed (that is, separate existence ceases) by a non-DISC entity in a tax-free transaction, section 995(c)(1)(B) provides that gain must be recognized on such nontaxable transactions to the extent of the DISC income accumulated (after 1984) during the period the stock was held by the transferor. Treas. Reg. Sec. 1.995-4(c)(2) states that a DISC is considered to cease as a separate corporation when (1) there is no separate entity that is a DISC and (2) there is no entity that carries over the accumulated DISC income and other tax attributes of the DISC. A DISC does not cease to exist as a corporate entity in the case of a mere change in place of organization. The regula-

tions state, for example, that in a section 381(a) transaction, relating to carryovers in certain corporate acquisitions, no gain is recognized if the DISC is acquired by a corporation that, immediately after the acquisition, qualifies as a DISC.

The regulations provide the following computation, which may be used to determine the accumulated DISC income attributable to the stock (Treas. Reg. Sec. 1.995-4(e)). The computation is made separately for each year the stock was held and then added for all the years held.

$$\text{Accumulated DISC income attributable to disposed stock} = \frac{\text{Increase in total accumulated DISC income for year}}{\text{Total number of shares of stock outstanding}} \times \text{Number or shares disposed of by transferor}$$

The total yearly increase of accumulated DISC income is determined by subtracting the accumulated DISC income at year's end from the immediately preceding year's accumulated DISC income.

The *total number of shares of stock to be considered outstanding* for purposes of this calculation is the number outstanding on each day of the taxable year. If the number changes during the year, the denominator will be determined by a ratio: that of the number of days the shares were outstanding to the total number of days in such taxable year. For example, if 100 shares of stock of a calendar-year DISC were issued on July 1, the number of shares to be used in the denominator is 50 (183/365 × 100).

Example 12.10. For its first calendar year (19X1), Delta Corporation elects to be taxed as a DISC. One hundred shares of stock were issued on January 1, 19X1, and 100 shares on July 1, 19X2. The accumulated DISC income at the end of the taxable year 19X1 is $20,000, and at the end of 19X2 it is $35,000. On December 31, 19X2, shareholder Carlson sells ten shares of stock and recognizes a gain of $12,500. The gain will be taxed as follows:

Accumulated DISC income attributable to disposed stock:

19X1 $20,000/100 shares × 10 =	$ 2,000
19X2 $15,000/150* shares × 10 =	1,000
Ordinary income	$ 3,000
Portion of gain taxable as capital gains	9,500
Total recognized gain	$12,500

*150 = 100 + (100 × 183/365)

Other Provisions for DISCs

Foreign Tax Credit

Because a DISC is treated as a foreign corporation for purposes of the foreign taxes it pays, deemed-paid foreign tax credits can be taken by the qualified shareholders of DISCs on both actual and deemed dividends received from DISCs subject to the separate basket limitation prescribed in section 904(d).

An important figure in the calculation of the foreign tax credit limitation is the amount of foreign taxable income. Section 901(d) provides that DISC dividends shall be treated as foreign corporation dividends to the extent such dividends are income from sources outside the United States. The source rules in section 861(a)(2)(D) provide that DISC dividends are considered to be from sources outside the United States to the extent that they are attributable to qualified export receipts. The term *qualified export receipts* carries the same definition as found in section 993(a)(1) but with some modification to ensure that credits are taken only on foreign-source income. The following are not included as qualified export receipts:

1. Interest received during the taxable year from producer's loans (section 995(b)(1)(A))
2. Gains required to be recognized by section 995(b)(1)(B)—generally, gains from the sale of property acquired by the DISC in a transaction not taxable to the party transferring the property to the DISC
3. Gains required to be recognized by section 995(b)(1)(C)—generally, the recapture of gains from the sale of depreciable property that would be taxed as ordinary income to the party transferring the property to the DISC

Consolidated Returns

A corporate shareholder is not allowed a dividends-received deduction under section 243 in connection with deemed or actual distributions from a DISC. The rationale for this exception is that the income of the DISC is not subject to the typical double tax at both the corporate and the shareholder levels. For this same reason a DISC cannot be included in a consolidated return. To allow otherwise would be to permit a 100-percent dividends-received deduction.

Tax Returns

Even though a DISC is not subject to tax, it must keep adequate records to furnish information to the IRS and to the shareholders regarding the performance of the DISC and other information as required by the commissioner. Section 6072(b) requires an annual return to be filed by the DISC on or before the fifteenth day of the ninth month following the end of its taxable year. The following special forms should be used for DISCs:

1. Form 1120—DISC, a four-page tax return with schedules provided for calculation of taxable income and deemed and actual distributions to shareholders
2. Schedule K—shareholder's Statement of IC-DISC Distribution, to be prepared by the DISC for each shareholder receiving a deemed or actual distribution from the DISC
3. Schedule N—Geographic Source of Gross Receipts, a schedule requiring the DISC to list the country of destination of sales
4. Schedule P—Intercompany Transfer Price or Commission, a schedule to provide required intercompany pricing information
5. Form 8404—Interest Charge on DISC-Related Deferred Tax Liability, to be prepared to show the interest and deferred tax liability

Former DISC

The term *former* DISC is seen frequently in the Internal Revenue Code sections applicable to DISCs and is often used in conjunction with the term DISC (DISC or former DISC). Two potential tax consequences arise from the fact that a corporation had been a DISC in a former year. One is that the corporation may have some earnings that still must be taxed to the shareholders (accumulated DISC income). The other is that the corporation may have some undistributed earnings previously taxed to the shareholders (previously taxed income) that can be received tax-free.

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Bribe- and Boycott-Produced Income

Taxpayers who pay bribes or make other illegal payments under the Foreign Corrupt Practices Act of 1977 (FCPA) or who participate in or cooperate with international boycotts lose several benefits that might otherwise be allowed. These penalties include the denial of the foreign tax credit (section 908), denial of deferral of international boycott amounts (section 952(a)(3)), denial of foreign sales corporation (FSC) benefits (Temp. Treas. Reg. Sec. 1.927(e)-2T(a)), and denial of domestic international sales corporation (DISC) benefits (section 995(b)(1)(F)(ii)). Bribe and boycott provisions were added to the law by the Tax Reform Act of 1976 as a direct reaction to the publicized bribe scandals and the blacklisting by Arab countries of U.S. companies doing business with Israel. In addition to the loss of tax benefits, the FCPA imposes certain civil and criminal penalties for illegal payments to certain foreign persons.

Bribes

Section 162(c) provides that illegal payments by U.S. taxpayers to U.S. government officials or employees or to an official or employee of a for-

eign government if unlawful under FCPA cannot be deducted in computing U.S. taxable income. The United States has control over foreign taxpayers through an adjustment to the earnings-and-profits accounts for deemed-paid foreign tax credit calculations on dividends paid to a domestic corporation. In addition, section 952(a)(4) expands the definition of subpart F income to include the sum of the amounts of any illegal bribes, kickbacks, or other payments within the meaning of section 162(c) that are paid by, or on behalf of, the corporation, directly or indirectly, to an official, employee, or agent-in-fact of a government.

Illegal payments are deemed distributions to the DISC shareholders on the last day of the taxable year of the DISC in which the income is derived (section 995(b)(1)(F)(iii)). In addition, illegal payments neither decrease earnings and profits nor increase a deficit (section 964(a)). Two principal types of payments that are permitted under section 162(c) if made to a foreign person are illegal if made to a U.S. person. The first is "grease" payments made to government officials to facilitate routine administrative actions that are nondiscretionary on their part. Payments to a customs official to expedite goods through customs are permitted. The second type of payment is one that is legal under the local law of the foreign jurisdiction but would violate a U.S. federal law other than the FCPA.

The definition of illegal payment presents few problems, since the legal principles are well established. The definition of government official, employee, or agent-in-fact is not clear. For example, it appears evident that a bribe to an employee of a corporation that is nationalized would be a payment to a government employee; if, however, the government owns 50 percent or less of the corporation, the answer is unclear. In addition, a payment made by an agent of the taxpayer that benefits the taxpayer will receive similar treatment (Treas. Reg. Sec. 1.162-18(a)(2)).

Boycotts

Section 999 specifies certain activities that constitute participation in or cooperation with an international boycott. The income related to these activities is treated as international boycott-related income. The sanctions imposed for such participation or cooperation are loss of the foreign tax credit, constructive repatriation of boycott-related income of foreign corporations, and deemed distributions of boycott-related income of a DISC.

Income is *boycott-related* when a person agrees[1] to refrain from the following actions as a condition of doing business directly or indirectly within a country or with the government, a company, or a national of a country:

1. Doing business with a specified country or with companies or nationals of that country[2]
2. Doing business with other U.S. companies that do business with a specified country or companies or nationals of that country[3]
3. Hiring employees (or having directors) of a particular nationality, religion, or race[4]
4. Doing business with any company whose ownership or management is made up of individuals of a particular nationality, race, or religion[5]
5. Shipping the product on a carrier or insuring that product with a company that does not observe the above-specified boycott rules[6]

Income is not boycott-related, however, under the following circumstances: (1) if the taxpayer participates in a boycott that U.S. law or regulations or an executive order sanctions participation in or cooperation with, (2) if the taxpayer complies with a prohibition on importing goods produced in any country that is the object of an international boycott, and (3) if the taxpayer complies with a prohibition imposed by a country on the export of products obtained in such country to any country that is the object of an international boycott (section 999(b)(4)).

Reduction of the Foreign Tax Credit

If a person or a member of a controlled group participates in or cooperates with an international boycott during the taxable year, the amount of credit allowable under section 901 to such person (or sections 902 or 960 to U.S. shareholders) for foreign taxes paid during the year is reduced. The method of reducing the foreign tax credit depends on whether the international boycott factor is applied or the reduction is specifically attributable to taxes and income as provided by section 999(c)(2).

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[1]IRS Notice, *Guidelines on International Boycotts*, 1978-1 C.B. 521, sec. H.

[2]*Ibid.*, Sec. I.

[3]*Ibid.*, Sec. J.

[4]*Ibid.*, Sec. L.

[5]*Ibid.*, Sec. K.

[6]*Ibid.*, Sec. M.

If the international boycott factor must be used because income and taxes cannot be traced to specific operations, the reduction of the foreign tax credit under section 908 is computed by using the following method: First, the foreign tax credit is determined under section 901 as if section 908 had not been enacted. The section 901 credit also includes sections 902 and 960 credits after the sections 904 and 907 limitations. Second, the credit is reduced, using the following formula, the components of which will be explained subsequently.

Reduction of credit allowable under sections 901, 902, or 960 on account of boycott activities	=	Amount of credit under section 901 after the sections 904 and 907 limitations	×	International boycott factor

If a taxpayer is denied any credits under these provisions, a gross-up under section 78 will not be made, and the taxpayer can deduct those taxes denied credit (section 908(b)). The foreign tax credit limitation is not recomputed on account of the deduction of taxes denied credit.

Denial of Deferral of International Boycott Amounts

If a person or a member of a controlled group is a "U.S. shareholder" of a controlled foreign corporation that participated in, or cooperated with, an international boycott during the taxable year, subpart F income must be recognized in an amount equal to the product of the income of the controlled foreign corporation (CFC) (other than income included in the gross income of a U.S. shareholder under section 951 and income effectively connected with a U.S. trade or business) multiplied by the international boycott factor (section 952(a)(3)). This formula is expressed algebraically as follows:

Subpart F income from boycott activities	=	Income from the CFC less section 951 income and section 952(b) income	×	International boycott factor

Effect of Boycott Activities on FSC or Small-FSC Benefits

If an FSC, small FSC, or any member of the FSC's controlled group participates in or cooperates with an international boycott, the FSC's exempt foreign trade income is reduced by an amount equal to the

product of the exempt foreign trade income multiplied by the international boycott factor. A taxpayer who can clearly demonstrate that the income earned for the taxable year is attributable to specific operations will reduce the amount specifically attributable to those operations in lieu of using the international boycott factor (Temp. Treas. Reg. Sec. 1.927(e)-2T)).

Effect of Boycott Activities on DISC Benefits

A DISC that participates in, or cooperates with, an international boycott during the taxable year is denied DISC benefits on boycott income. The shareholders of the DISC must recognize a deemed distribution of the boycott-connected amount. The deemed distribution is calculated as follows:
DISC taxable income less:

1. Interest from producer's loans
2. Gains from sale of nonqualified export property
3. Gains from sale of qualified export property
4. Fifty percent of the taxable income of the DISC for the year attributable to military property
5. The taxable income attributable to qualified export receipts that exceed $10 million

The resulting amount is multiplied by 16/17, and this amount is multiplied by the international boycott factor.

International Boycott Factor

Section 999(c) defines *international boycott factor* as a fraction. The numerator reflects that part of a person's or a controlled group's worldwide operations that are associated with an international boycott in that taxable year. The denominator reflects that person's or group's worldwide operations exclusive of U.S. operations. The boycott factor may be expressed as follows:

$$\text{International boycott factor} = \frac{\text{Total foreign operations associated with boycott activities}}{\text{Total worldwide operations excluding U.S. operations}}$$

Operations associated with boycott activities means (1) operations carried on in whole or part in a boycotting country; (2) operations carried on outside the boycotting country, either for or with the government, a company, or a national of a country; or (3) operations outside a boycotting country with a nonboycotting country if there is reason to know that specific goods or services produced by the operation are intended for use in a boycotting country or for the government, a company, or a national of a boycotting country.[7] For these purposes, the term *operations* encompasses all forms of business or commercial activities whether or not they are productive of income. *Worldwide operations* means operations in or related to countries other than the United States (section 999(c)(3)).

Three factors are used for computing the international boycott factor: purchases, sales, and payroll. To determine total foreign operations associated with boycott activities, the sum of the following must first be made:

1. Purchases made from all boycotting countries associated in carrying out a particular international boycott
2. Sales made to or from all boycotting countries associated in carrying out a particular international boycott
3. Payroll paid or accrued for services performed in all boycotting countries

This sum—less purchases, sales, and payroll attributable to clearly separate and identifiable operations not associated with a boycott—constitutes the numerator of the fraction. The denominator of the fraction is the sum of purchases, sales, and payroll from operations other than in the United States (Temp. Treas. Reg. Sec. 7.999-1).

Purchases from a boycotting country means the gross amount paid, in a particular country, in connection with the purchase, use, or right to use (1) tangible personal property, including money, from a stock of goods located in that country; (2) intangible property, other than securities, in that country; (3) securities by a dealer to the beneficial owner who is a resident of that country if the dealer knows or has reason to know of the residence; (4) real property located in that country; and (5) services performed in that country and their end products, except payroll paid to an officer or employee of the payor.

[7] *Ibid.*, B-1.

Sales made to a boycotting country means the gross receipts from the sale, exchange, disposition, or use of (1) tangible personal property, including money, for direct use, consumption, or disposition in that country; (2) services performed in that country; (3) the end product of services, wherever performed, for direct use, consumption, or disposition in that country; (4) intangible property other than securities in that country; (5) securities by a dealer to a beneficial owner who is a resident of that country if the dealer knows or has reason to know of the residence; and (6) real property located in that country.

Sales from a boycotting country means the gross receipts from the sale, exchange, disposition, or use of (1) tangible personal property, including money, from a stock of goods located in that country; (2) intangible property other than securities in that country; and (3) services performed in that country and their end products.

Payroll paid or accrued for services performed in a boycotting country means the total amount paid or accrued as compensation to officers and employees for services performed in that country. When applied to a person who is a member of a controlled group, the international boycott factor is computed on a separate company basis by each member of the controlled group during each member's own taxable year that ends with or within the controlled group's taxable year. If a person is a member of two or more controlled groups, the purchases, sales, and payroll of that person and of all other members of the controlled groups must be included in the numerator and denominator (Temp. Treas. Regs. Secs. 7.999-1(c)(3) and 7.999-1(d)).

Specific Taxes and Income

If a taxpayer demonstrates that the foreign taxes paid and the income earned for the taxable year are attributable to specific boycott-related operations, then, in lieu of applying the international boycott factor, the actual amount of credit disallowed, the additional subpart F income, and the deemed distribution of DISC income shall be the amount specifically attributable to the operations under section 999(b)(1) (section 999(c)(2)).

Reporting Requirements

Any U.S. person (as defined in section 7701(a)(30)) who either claims the benefit of the foreign tax credit under section 901 or owns stock of a DISC is required to report under section 999(a) if the following condi-

tions exist in or related to a country that is on the list maintained under section 999(a)(3) or in which the U.S. person has operations while knowing or having reason to know that such country requires participation in or cooperation with an international boycott:[8]

1. It has operations.
2. It is a member of a controlled group, a member of which has operations.
3. It is a U.S. shareholder of a foreign corporation that has operations.
4. It is a partner in a partnership that has operations.
5. It is treated under section 671 as the owner of a trust that has operations.

A taxpayer must also report whether he or she, a foreign corporation of which the taxpayer is a U.S. shareholder, or any member of a controlled group that includes the taxpayer or the foreign corporation (1) has participated in or cooperated with an international boycott at any time during the taxable year or (2) has been requested to participate in or cooperate with such a boycott and, if so, the nature of any operation in connection with the request or participation (section 999(a)(2)).

If the person or member of a controlled group participates in or cooperates with an international boycott in the taxable year, all the operations of the taxpayer or group in any country that requires such participation or cooperation will be treated as boycott activities unless the person can demonstrate that a particular operation is clearly separate and identifiable from boycott-related operations (section 999(b)(1)).

If such a person willfully fails to report boycott-related operations, in addition to other penalties provided by law, such person will be fined not more than $25,000, imprisoned for not more than one year, or both (section 999(f)).

Member of a Controlled Group

For the purposes of section 993(a)(3), the term *controlled group* is defined by section 1563(a), but the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent." In general, every member of a controlled group of corporations is required to report under section 999(a) if

[8] *Ibid.*, A-1.

any member has operations in or related to a boycotting country. There are two exceptions to this rule. First, a common parent may file a report on behalf of all the members of a controlled group that join with the common parent in filing a consolidated income tax return. Second, the requirement that each member of the controlled group file a report is waived for those members who satisfy the four requirements in section A-3 of the guidelines on international boycotts. [9]

U.S. Shareholder of a Foreign Corporation

A *U.S. shareholder* is a U.S. person who owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote in such corporation (section 951(b)). Each U.S. shareholder must file Form 5713 even if the foreign corporation is not a controlled foreign corporation.[10] Even if one shareholder of a foreign corporation files Form 5713, all other U.S. shareholders must file with respect to the activities of that corporation unless two or more U.S. shareholders of the foreign corporation are included in the same consolidated return. In this case, only one report need be filed for all U.S. shareholders included in the return.[11]

Partnerships and Partners

If a partnership has operations in a boycotting country, each partner who is a U.S. person will generally be required to file Form 5713. If a partnership files Form 5713 with its information return and has no operations for the taxable year that constitute participation in or cooperation with an international boycott, then the requirement that each partner file Form 5713 will be waived, provided that each partner has no additional operations in or related to a boycotting country or with the government, a company, or a national of a boycotting country.[12]

Reporting Form 5713

Form 5713, The International Boycott Report Form, should be filed in duplicate by all reporting taxpayers. One copy is filed with the taxpayer's

[9] *Ibid.*, A-3.
[10] *Ibid.*, A-2.
[11] *Ibid.*, A-4.
[12] *Ibid.*, A-17.

tax return, and the other is sent to the IRS service center in Philadelphia.[13] The reports receive the same confidential treatment as any other information contained in an income tax return.[14]

List of Countries

Notice 95-65[15] specified the countries that require or may require participation in or cooperation with an international boycott:

Bahrain	Qatar
Iraq	Saudi Arabia
Kuwait	Syria
Lebanon	United Arab Emirates
Libya	Republic of Yemen
Oman	

Reason to Know

A person will be deemed to know or have reason to know that a country requires participation in or cooperation with an international boycott if that person receives what could be interpreted as an official request to participate in or cooperate with an international boycott or if that person knows that others have received such requests. An "official request" need not come from the government. Whether a request is interpreted as an official request depends on the facts and circumstances surrounding it.[16]

Clearly Separate and Identifiable Operations

If a person or a member of a controlled group enters into an agreement that constitutes participation in or cooperation with an international boycott, all operations of that person or group in that country in connection with which the agreement is made and operations in any other country that requires participation in or cooperation with that boycott will be considered as operations in connection with participation or cooperation with an international boycott.

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[13]*Ibid.*, A-7.

[14]*Ibid.*, A-6.

[15]IRS Notice 95-65, 1995-2, C.C. 342.

[16]IRS Notice, *Guidelines on International Boycotts*, 1978-1 C.B. 521, secs. H-4 and H-5.

The taxpayer may rebut this presumption by demonstrating that a particular operation is clearly separate and identifiable from the boycott-related operation and that no boycott agreement was made with respect to the separate operation.[17]

The taxpayer can determine what constitutes a clearly separate and identifiable operation by applying a facts-and-circumstances test. The following are some of the factors that may be considered:

- The operations are conducted by different corporations, partnerships, or other business entities.
- The operations are supervised by different management personnel.
- The operations involve distinctly different products or services.
- The operations were undertaken pursuant to separate and distinct contracts.
- The transactions were separately negotiated and performed if the business operations were not continuous over time.[18]

Incidental Contact

If business operations provide incidental contacts between the nationals or business enterprises of boycotting countries and persons from other countries, an individual's or corporation's obligation to report these incidental contacts will be waived, provided that the contacts satisfy all the following criteria:

1. All aspects of the operations contemplated by the parties are carried on outside a boycotting country.
2. The operation does not contemplate any agreement that would constitute participation in or cooperation with an international boycott.
3. No request for such an agreement is actually made or received by any party to the operation.
4. There is no such agreement in connection with the operation.
5. The operation does not involve (a) the importation of property, funds, or services from or produced in a boycotting country (and the individual or corporation does not know or have reason to know that the property, funds, or services will be used, consumed, or disposed of

[17]*Ibid.*, D-1.
[18]*Ibid.*, D-3.

in a boycotting country), or (b) a value of the property, funds, or services furnished or obtained that exceeds $5,000.

Agreement to Participate in or Cooperate With a Boycott

Entering into a written[19] or oral[20] contract that includes a provision requiring such action as described in section 999(b)(3)(A) constitutes an agreement according to section 999(b)(3). If a person signs a contract that states the laws of a country will apply to the performance of the contract and the laws include boycott provisions, such a contract does not constitute an agreement.[21] If, however, the contract states that the person will comply with the laws, such a contract constitutes an agreement.[22]

Entering into a written contract that requires participation in boycott activities is an agreement even though the person fully abides, partially abides, or does not abide by the boycott provisions.[23]

[19] *Ibid.*, H-1.
[20] *Ibid.*, A-6.
[21] *Ibid.*, H-3.
[22] *Ibid.*, H-4.
[23] *Ibid.*, H-18.

14

U.S. Possessions

The economic policies of the United States toward its possessions have historically been favorable and have been specifically directed toward promoting U.S. trade with its possessions and encouraging business development in the possessions. Until 1996, some of these policies were intended to be influenced by provisions in the U.S. Internal Revenue Code, specifically, sections 931 through 936.

Prior to the Tax Reform Act of 1986, because of various acts, the local income tax laws of Guam, the Commonwealth of the Northern Mariana Islands, the U.S. Virgin Islands, and American Samoa mirrored the income tax laws of the United States.[1] In addition, possessions corporations and certain U.S. corporations of the Virgin Islands were, in general, effectively tax-exempt. Individuals who satisfied requirements with respect to possessions income were taxed only on income from U.S. sources and amounts received in the United States. The possessions of the United States in which these requirements could be satisfied

[1]The Organic Act of 1950 (Guam); Naval Appropriations Act of 1922 (Virgin Islands). American Samoa generally adopted the Internal Revenue Code even though it has the power to modify it if it chooses. The Commonwealth of the Northern Mariana Islands was required to implement a mirror system similar to that in Guam as of January 1, 1985.

included for these purposes Puerto Rico, Guam, American Samoa, Wake Island, Midway Island, Palmyra, Johnston Island, Jarvis Island, Kingman Reef, Howland Island, Baker Island, the Northern Mariana Islands, the U.S. Virgin Islands, and other U.S. islands, cays, and reefs that were not part of the fifty states.

The Tax Reform Act of 1986 modified some of these rules so that Guam, the Commonwealth of the Northern Mariana Islands, and American Samoa could develop a tax system more suited to their local revenue and administrative needs. There was recognition that the Code was designed primarily for a highly developed U.S. economy and may not be suited for these island economies. On the other hand, Congress did not believe that a possession should be free to become a tax haven, and if this occurs, Congress may again impose the mirror system on the errant possession.

Guam, the Commonwealth of the Northern Mariana Islands, and American Samoa have authority to tax the income of a resident of any of these three possessions from sources within, or effectively connected with the conduct of a trade or business within, any of these three possessions as long as an implementing agreement is in effect between the possession and the United States. Such income will be excluded from U.S. taxation. The implementing agreement must provide the following:

1. The elimination of double taxation of income by the United States and the possession
2. The establishment of rules for the prevention of evasion or avoidance of U.S. tax
3. The exchange of information between the possession and the United States for purposes of tax administration
4. The resolution of other problems arising in connection with the administration of the tax laws of such possession and the United States

At this time, only American Samoa has signed the implementing agreement.

Under current law, for purposes of section 931, the term *possession of the United States* now includes only Guam, American Samoa, and the Northern Mariana Islands (section 931(c)). For corporations qualifying under section 936, the term *possession of the United States* includes Puerto Rico and the Virgin Islands (section 936(d)(1)).

Section 931 prescribes treatment for income from sources within Guam, American Samoa, or the Northern Mariana Islands. Sections 932 and 934 coordinate United States and Virgin Islands income taxation, and section 933 prescribes the treatment of income from sources within Puerto Rico.

An individual benefits from doing business in a U.S. possession and satisfying the provisions of sections 931, 932, or 933 in that gross income from sources within a possession of the United States is excluded from gross income for purposes of U.S. taxation. Not only income from sources within the possession but also income from sources without the United States will be excluded.

Both individuals and corporations may benefit from the policies of U.S. possessions, especially Puerto Rico and the U.S. Virgin Islands, which encourage business development by providing tax and other incentives for businesses engaged in specified activities. Puerto Rico, for one, has enacted several special tax exemption laws, in particular, a comprehensive incentive program enacted in 1998. This law eliminated the double tax structure established under the 1987 Tax Incentives Act, which applied an income tax at the corporate level (usually at an effective tax rate of 4.5 percent) coupled with a 10 percent tollgate on distributions of dividends. The 1998 Act reduced tax rates, provides for credits for individual shareholders of exempt businesses, provides property tax and municipal taxes exemptions during a start-up period, and provides a number of special deductions.

Possessions Corporations: Transition Rules

The Small Business Job Protection Act of 1996 retroactively repealed the possessions tax credit for business income and qualified possessions source investment income, effective for taxable years beginning after December 31, 1995. Qualified possession-source investment income earned after June 30, 1996 is not eligible for the credit. Existing credit claimants receive temporary relief until tax years beginning after December 31, 2005 and are able to claim credits during this transition period. There are two separate transition rules, one for operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Sec. 936(j)(8)). The other transitions rules are used for corporations with operations in Johnston Island, the Marshall Islands,

Midway Island, Wake Island, the U.S. Virgin Islands, and Puerto Rico if the *applicable percentage limitation* is used (Sec. 936(j)(2)). In addition, Section 30A provides a credit determined under the economic activity limit for business income from Puerto Rico. The credit is computed under the rules with respect to the possession tax credit determined under the economic activity limit. Section 30A applies to taxable years beginning after December 31, 1995 and before January 1, 2006. Also, there is a cap on a corporation's possession business income that is eligible for the Puerto Rico and possession tax credit after 2001 under the economic activity limit or after 1997 under the applicable percentage limit. The cap is computed based on the corporation's possession business income for the base period years, called *average adjusted base period possession business income*.

For taxable years beginning after December 31, 1995, the Puerto Rico and possession tax credit applies only to a corporation that qualified as an existing credit claimant. A corporation is an existing credit claimant if the corporation was engaged in the active conduct of a trade or business within the possession on October 13, 1995 and had a possessions tax credit election in effect for its taxable year that included October 13, 1995 (Sec. 936(j)(9)). The determination of whether a corporation was an existing credit claimant was made separately for each possession (Sec. 936(j)(10)). A change in the ownership of a corporation does not affect its status as an existing credit claimant.

A corporation that adds a substantial new line of business after October 13, 1995 loses its benefits as an existing credit claimant as of the beginning of the taxable year during which the such new line of business was added (Sec. 936(j)(9)(B)). A corporation was treated as engaged in the active conduct of a trade or business within a U.S. possession on October 13, 1995 if the corporation was engaged in the active conduct of this trade or business before January 1, 1996 and had in effect a binding contract for the acquisition of assets to be used in, or the sale of property to be produced in that trade or business on October 13, 1995 (Sec. 936(j)(9)(C)).

Cap on Possession Business Income Eligible for the Possession Tax Credit

The cap on a corporation's possession business income that is eligible for the Puerto Rico and possession tax credit is computed based on the corporation's possession business income for the base period years (average

adjusted base period possession business income). Average adjusted base period possession business income is the average of the adjusted possession business income for each of the corporation's base period years. In this computation, the corporation's possession business income for a base period year is adjusted for inflation from the year in the base period to 1995. In addition, a real growth factor of 5 percentage points is added to the inflation factor compounded for each year from each year in the base period to the corporation's first taxable year beginning on or after October 14, 1995 (Sec. 936(j)(4)(D)).

The corporation's base period years generally were three of the corporation's five most recent years ending before October 14, 1995. From the five most recent years, the highest and lowest adjusted possession business income years were eliminated. For purposes of this computation, only years in which the corporation had significant possession business income were taken into account. Significant possession business income means that such income must exceed 2 percent of the corporation's possession business income for each of the six taxable years ending with the first taxable year ending on or after October 14, 1995. If the corporation had significant possession business income for only four of the five most recent taxable years ending before October 14, 1995, the base period years are determined by disregarding the year in which the corporation's possession business income was lowest. If the corporation has significant possession business income for three years or fewer of such five years, then the base period years are all such years. If there is no year of such five taxable years in which the corporation has significant possession business income, then the corporation is permitted to use as its base period its first taxable year ending on or after October 14, 1995. For this purpose, the amount of possession business income taken into account was annualized for the portion of the year ended September 30, 1995 (Sec. 936(j)(5)(B)).

The corporation could have also elected to use its taxable year ending in 1992 as its base period (with the adjusted possession business income for such year constituting its cap). Alternatively, the corporation could have elected to use as its cap the annualized amount of its possession business income for the first ten months of calendar year 1995 (Sec. 936(j)(5)(C)).

Economic Activity Limit

Under the economic activity limit, the amount of credit with respect to possessions income cannot exceed an amount equal to the sum of the following three components:

1. Sixty percent of the taxpayer's qualifying wage and fringe benefit expenses,
2. Specified percentages of the taxpayer's depreciation allowances with respect to qualifying tangible property, and, in certain cases,
3. The taxpayer's qualifying possession income taxes.

The credit calculated under the economic activity limit is often referred to as the *wage credit*.

For corporations that are existing credit claimants that use the economic activity limit, the possession tax credit attributable to business income from the possession is determined as under section 936 prior to the enactment of the Small Business Job Protection Act of 1996 for taxable years beginning after December 31, 1995 and before January 1, 2002. For taxable years beginning after December 31, 2001 and before January 1, 2006, the corporation's possession business income that is eligible for the economic activity limit is subject to a cap. For taxable years beginning in 2006 and thereafter, the credit attributable to possession business income is eliminated.

Applicable Percentage Limit

As an alternative, the taxpayer may elect to apply a limit equal to the applicable percentage of the credit that would otherwise be allowable with respect to possession business income. The applicable percentage was phased down to 50 percent in 1996, 45 percent for 1997, and 40 percent for 1998 and thereafter. The credit calculated under the applicable percentage limit is often referred to as the *income credit*. For taxable years beginning in 2006 and thereafter, the credit attributable to possession business income using the applicable percentage limit is eliminated.

New Lines of Business

If a possessions corporation that is an existing credit claimant adds a substantial new line of business during a taxable year, or has a new line of business that becomes substantial during the taxable year, it loses its status as an existing credit claimant that year. It cannot claim the Puerto Rico and possession tax credit on its return for the taxable year in which the substantial new line of business is added or a new line of business becomes substantial.

A *new line of business* is any business activity of the possessions corporation that is not closely related to a pre-existing business of the pos-

sessions corporation. The following eight factors provide guidance in determining whether a new activity is closely related to a pre-existing business activity of the possessions corporation.

1. The activity provides products or services very similar to the products or services provided by the preexisting business;
2. The activity markets products and services to the same class of customers as that of the preexisting business;
3. The activity is of a type that is normally conducted in the same business location as the preexisting business;
4. The activity requires the use of similar operating assets as those used in the preexisting business;
5. The activity's economic success depends on the success of the preexisting business;
6. The activity is of a type that would normally be treated as a unit with the preexisting business in the business' accounting records;
7. If the activity and the preexisting business are regulated or licensed, they are regulated or licensed by the same or similar governmental authority; and
8. The United States Bureau of the Census assigns the activity the same six-digit North American Industry Classification System (NAICS) code or four-digit Industry Number Standard Identification code (SIC code) as the preexisting business (Temp. Treas. Reg. Sec. 1.936-11T(b)(1)).

A *safe harbor rule* provides that an activity is closely related to a preexisting business and thus is not a new line of business if it satisfies any of the following three conditions.

1. The activity is within the same six-digit NAICS code (or four-digit SIC code).
2. Both the preexisting business activity and the new activity are within the same five-digit NAICS code (or three-digit SIC code) and the facts relating to the new activity satisfy at least three of the factors listed above.
3. If the preexisting business is making a component product or end-product form and the new business activity is making an integrated product, or an end-product form with fewer excluded components, that is not within the same six-digit NAICS code (or four-digit SIC code) as the preexisting business solely because the component prod-

uct and the integrated product (or two end-product forms) have different end-uses (Temp. Treas. Reg. Sec. 1.936-11T(b)(2)(ii)).

If all the assets of a preexisting business of an existing credit claimant are acquired by an existing credit claimant that carries on the business activity of the acquired business, the acquired business activity will be treated as a preexisting business of the acquiring corporation. If all of the assets of a preexisting business of an existing credit claimant are acquired by a corporation that is not an existing credit claimant, then the acquiring corporation will be treated as an existing credit claimant for the year of acquisition and the activity will be considered a preexisting business of the acquiring corporation (Temp. Treas. Reg. Sec. 1.936-11T(b)(3)).

A new line of business is considered to be substantial as of the earlier of the taxable year in which the possessions corporation satisfies the gross income test or the assets test. The gross income test is satisfied by the corporation if more than 15 percent of its gross income is from that new line of business. The assets test is satisfied if the taxable year in which the possessions corporation directly uses in that new line of business more than15 percent of its assets. A new line of business of a possessions corporation will not be treated as substantial as a result of meeting the assets test if an event that is not reasonably anticipated (casualty) causes assets used in the new line of business of the possessions corporation to exceed 15 percent of the adjusted tax basis of the possession corporation's total assets (Temp. Treas. Reg. Sec. 1.936-11T(c)).

Example 14.1. X Corporation is a pharmaceutical corporation which manufactured bulk chemicals (a component product). In March 1997, X Corporation began to also manufacture pills (e.g., finished dosages or an integrated product). The new activity provides products very similar to the products provided by the preexisting business. The new activity is of a type that is normally conducted in the same business location as the preexisting business. The activity's economic success depends on the success of the preexisting business. The manufacture of bulk chemicals is in NAICS code 325411, Medicinal and Botanical Manufacturing, while the manufacture of the pills is in NAICS code 325412, Pharmaceutical Preparation Manufacturing. Although the products have a different end-use, may be marketed to a different class of customers, and may not use similar operating assets, they are within the same five-digit NAICS code. The manufacture of the pills by X Corporation will be considered closely related to the manufacture of the bulk chemicals. Therefore, X Corporation did not add a new line of business because it falls within the safe harbor rule (Temp. Treas. Reg. Sec. 1.936-11T(d), example 1).

Example 14.2. X Corporation currently manufactures printed circuit boards in a U.S. possession. As a result of a technological breakthrough, X Corporation could produce the printed circuit boards more efficiently if it modified its existing production methods. Because demand was high, X Corporation expanded its facilities to support the production of its current products when it modified its production methods. After these modifications to the facilities and production methods, the products produced through the new technology were in the same six-digit NAICS code as products produced previously by X Corporation. Therefore, X Corporation will not be considered to have added a new line of business (Temp. Treas. Reg. Sec. 1.936-11T(d), example 2).

Example 14.3. X Corporation has manufactured Device A in Puerto Rico for a number of years and began to manufacture Device B in Puerto Rico in 1997. Device A and Device B are both used to conduct electrical current to the heart and are both sold to cardiologists. There is no significant change in the type of activity conducted in Puerto Rico after the transfer of the manufacturing of Device B to Puerto Rico. Similar manufacturing equipment, manufacturing processes, and skills are used in the manufacture of both devices. Both are regulated and licensed by the Food and Drug Administration. The economic success of Device B is dependent upon the success of Device A only to the extent that the liability and manufacturing prowess with respect to one reflects favorably on the other. Depending upon the heart abnormality, the cardiologist may choose to use Device A, Device B, or both in treating a patient. Both devices are within the same business sector of the taxpayer's business. The manufacture of Device A is covered in the six-digit NAICS code 339112, Surgical and Medical Instrument Manufacturing. The manufacture of Device B is in the six-digit NAICS code 334510, Electromedical and Electrotherapeutic Apparatus Manufacturing. (The manufacture of Device A is covered in the four-digit SIC code 3845, Electromedical and Electrotherapeutic Apparatus. The manufacture of Device B is covered in the four-digit SIC code 3841, Surgical and Medical Instruments and Apparatus.) The safe harbor rule applies because the two activities are within the same three-digit SIC code and X Corporation satisfies the other requirements in the regulations (Temp. Treas. Reg. Sec. 1.936-11T(d), example 3).

Possessions Corporations: Continuing Requirements for Existing Credit Claimants

To qualify for the benefits of section 936, the taxpayer must satisfy the following requirements: (1) A corporation must be a domestic corporation, (2) 80 percent or more of gross income from the three-year period pre-

ceding the close of the taxable year must be derived from sources within a possession of the United States, and (3) at least 75 percent of gross income for the same period must be derived from the active conduct of a trade or business within a possession. Amounts received in the United States, regardless of geographical source, are included in gross income for purposes of U.S. income taxation unless the amounts received are from an unrelated person and are attributable to the active conduct of a trade or business within a possession (section 936(b)).

For these purposes the term *possession of the United States* includes the Commonwealth of Puerto Rico and the Virgin Islands.

The Gross Income Test

Section 936(a)(2)(A) requires that 80 percent or more of the gross income of the domestic corporation, for the three-year period preceding the close of the taxable year must be derived from sources within a possession of the United States, determined without regard to section 904(f), which prescribes the treatment for the recapture of foreign losses.

For purposes of the 80-percent test, a possession of the United States also includes, under section 936(d)(1), Puerto Rico and the U.S. Virgin Islands. Income from one possession may be added to the income from another in determining if 80 percent or more of gross income is derived from within a possession of the United States.[2]

Gross income and gross revenues are synonymous when services are sold.[3] *Gross income* for manufacturing, merchandising, and mining businesses is computed by reducing gross revenues by cost of goods sold (Treas. Reg. Sec. 1.61-3(a)). There may be many situations in which determining whether a particular activity is service or manufacturing is critical.

> *Example 14.4.* A domestic corporation doing business in a possession of the United States has gross revenues of $100,000, of which $80,000 is from sources within the U.S. possession and $20,000 from other sources. Expenses related to the $80,000 gross revenues reduce this amount to $30,000. If the activity of the corporation is deemed to be services, the taxpayer will satisfy the 80-percent requirement. If the activity is deemed manufacturing and a pro rata portion of the $50,000 is allocable to the $80,000

[2] Rev. Rul. 71-13, 1971-1 C.B. 217.

[3] Rev. Rul. 70-344, 1970-2 C.B. 155.

gross receipts to arrive at gross income, the taxpayer will not satisfy the 80-percent requirement.

Whether a particular activity is service or manufacturing is based on facts and circumstances. For example, a wholly owned subsidiary that assembles, inspects for quality, packages, and performs shipping services to distribution centers in the United States for parts manufactured and owned by the parent is deemed a service activity and not manufacturing for gross income determination. Gross income therefore includes gross revenue derived from the performance of services without reduction for any expenses incurred in the production of that income.

The Active-Conduct-of-a-Trade-or-Business Test

Section 936(a)(2)(B) requires that 75 percent of gross income must be derived from the active conduct of a trade or business within a possession. Satisfying the percentage requirement is not as mechanical as summing passive income, such as investment interest, to determine whether this sum is more than, equal to, or less than 25 percent of total gross income. Manufacturing, storage, and shipping activities by a contract manufacturer in a U.S. possession was held to be only a de minimus business function of the corporation with a section 936 election.[4]

Distribution to Meet the Qualification Requirements

If a corporation does not satisfy one or both of the percentage requirements of section 936(a)(2) as a consequence of the exclusion of intangible property income included in shareholders' income, the section 936 corporation will be deemed to satisfy these conditions if it makes a pro rata distribution of property to its shareholders after the close of the year (section 936(h)(4)(C)). If the 80-percent test of section 936(a)(2)(A) was not satisfied, the distribution must be equal to the amount that caused the section 936 corporation to fail the test. If the corporation did not satisfy the active trade or business requirement of section 936(a)(2)(B), the distribution must be equal to an amount that caused the corporation to fail this percentage test. If the corporation failed both of these tests, then an amount that will enable the corporation to satisfy both of the section 936(a)(2) percentage requirements must be distrib-

[4]PLR 9633003

uted. Distributions are denied in case of fraud or willful neglect (section 936(b)(4)(C)). A shareholder who is a nonresident alien or that is a foreign corporation, trust, or estate that receives a distribution to meet qualification requirements will be treated as receiving income that is effectively connected with the conduct of a trade or business conducted through a permanent establishment within the United States (section 936(h)(4)(B)).

The Three-Year Period

Section 936 requires that the percentage-of-gross-income requirements must be satisfied for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable). In section 936 the three-year period means a period of thirty-six months immediately preceding the close of the taxable year.

Amounts Received in the United States

Section 936(b) provides that regardless of the source of income, amounts received in the United States are included in gross income for purposes of U.S. taxation. Excepted from this treatment is active business income received from unrelated parties. For nonactive business income, amounts must be received by the taxpayer or the taxpayer's agent outside of the United States to escape the section 936(b) consequences.

The Section 936 Credit

In general, a possessions corporation is allowed a limited credit under section 936 in the amount of its active possession business income. The limitation is determined under one of two methods: the *economic activity limitation* and the *percentage limitation*. These limitations also apply for purposes of determining the credit with respect to income from the sale or exchange of the assets used in the possessions business. The option of which limitation to apply is left to the taxpayer. In order to use the percentage limitation, a corporation must have elected to use that limitation for the first year beginning after 1993 for which it claimed a section 936 credit. Once a possessions corporation elected to use the percentage limitation, it was required to compute its section 936 credit under that limitation for all subsequent taxable years unless the election

is revoked. All affiliated possessions corporations must utilize the same alternative limitation (section 936(a)(4)(B)(iii)).

Economic Activity Limitation

Under the economic activity limitation, the credit allowed a possessions corporation against its tax on its business income in any taxable year may not exceed the sum of the following three components:

1. Sixty percent of qualified compensation plus the allocable employee fringe benefit expenses.
2. An applicable percentage of depreciation deductions claimed for regular tax purposes by the corporation for the taxable year with respect to qualified tangible property.
3. If the corporation does not elect the profit split method for computing its income, a portion of the possession income taxes it incurs during the taxable year (section 936(a)(4)).

To compute the U.S. tax liability on the active business income of a possessions corporation selecting the economic activity limitation, the sum of the three components is subtracted from precredit U.S. income tax that would be owed if taxable income of the possessions corporation were grossed up by qualified possession compensation and depreciation on qualified tangible property. In other words, the credit is determined under section 936(a)(1) (for example, the tax which is attributable to the sum of the taxable income from without the United States from a possession's trade or business, sale of substantially all of the assets used in that trade or business and qualified possession source investment income), and is limited by the section 936(a)(4) amount, that is, a percentage of qualified possession compensation and depreciation on qualified tangible property.

Qualified compensation generally is the sum of the aggregate amount of the possessions corporation's qualified possession wages and its allocable employee fringe benefit expenses for the taxable year. *Qualified possession wages* are defined as wages paid or incurred by the possessions corporation during the taxable year to any employee for services performed in a possession, but only if the services are performed while the principal place of employment is within that possession (section 936(i)(1)(A)). The term *wages* refers to the Federal Unemployment Tax Act (FUTA) definition of wages (section 936(i)(1)(D)). Qualified possession wages do not include

any wages paid to employees who are assigned by the employer to perform services for another person, unless the employer's principal trade or business is providing temporary employees (section 936(i)(1)(C)). The cumulative amount of wages for each employee that are taken into account for the taxable year in computing the credit limitation may not exceed 85 percent of the maximum earnings subject to tax under the OASDI portion of Social Security (section 936(i)(1)(B)).

Allocable employee fringe benefit expenses are equal to the aggregate amount allowable to the possessions corporation as a deduction for the taxable year multiplied by the following fraction:

$$\frac{\text{Aggregate amount of the corporation's qualified possession wages}}{\text{Aggregate amount of the corporation's wages}}$$

The corporation's allocable employee fringe benefit expenses for the taxable year cannot exceed 15 percent of the aggregate amount of its qualified possession wages for that year (section 936(i)(2)(A)). Fringe benefit expenses that are taken into account for purposes of determining the credit limitation are as follows:

1. Employer contributions under a stock bonus, pension, profit sharing, or annuity plan
2. Employer provided coverage under any accident or health plan for employees
3. The cost of life or disability insurance provided to employees (section 936(i)(2)(B))

Fringe benefits do not include any amount that is treated as wages.

Depreciation deductions taken into account in determining the economic activity limitation are as follows:

Depreciation Categories	*Percentage Taken Into Account*
Short-life qualified tangible property-3-year or 5-year property under section 168(e)	15%
Medium-life qualified tangible property-7-year or 10-year property under section 168(e)	40%
Long-life qualified tangible property—all other qualified property to which section 168 applies	65%

In the case of a possessions corporation that does not elect the profit-split method, taxes paid or accrued to a possession are also included in the economic activity calculation. Possession income taxes paid in excess of a 9-percent effective rate of tax are not included for purposes of determining the limitation (section 936(i)(3)(A)(ii)). Also, only the portion of taxes satisfying the effective-rate requirement that is allocable to nonsheltered income is taken into account. The portion of possession income taxes allocated to nonsheltered income is determined by computing the ratio of two hypothetical U.S. tax amounts. This is done by multiplying the possession's income tax by the ratio, the numerator of which is the tax liability under the "new" section 936 and the denominator of which is the tax liability without the section 936 credit (section 936(i)(3)(A)).

A possessions corporation that utilizes the profit-split method for determining its income for the taxable year is allowed a deduction for possession income taxes paid or accrued during that taxable year calculated by multiplying the possession income taxes by the ratio, the numerator of which is the tax liability under the "new" section 936 and the denominator of which is the tax liability without the section 936 credit (section 936(i)(3)(B)).

Percentage Limitation

Under the percentage limitation, the section 936 credit allowed to a possessions corporation against U.S. tax on income derived from the active conduct of a possession-based business, or from the sale of assets used in such business is limited to a specified percentage of the credit that would otherwise be available. Now that it is fully phased in, the applicable percentage is 40 percent of the otherwise available credit. Under the five-year phase in, the applicable percentage was as follows (section 936(a)(4)(B)(ii)):

Taxable Years Beginning in	*Applicable Percentage*
1994	60%
1995	55%
1996	50%
1997	45%
1998 and thereafter	40%

A taxpayer that utilizes the percentage limitation is permitted a deduction for a portion of its possession income taxes paid or accrued dur-

ing the taxable year. The portion of the taxes deductible is the portion allocated on a pro rata basis to the corporation's taxable income computed before taking into account any deduction for the possession tax, the tax on which is not offset by the section 936 credit as a result of the limitation (section 936(a)(4)(B)).

A corporation that elects section 936 is taxed on worldwide income but receives a credit subject to either of the two alternative limitations against U.S. tax on taxable income from the active conduct of a trade or business within a U.S. possession and from the sale or exchange of substantially all the assets used by the taxpayer in the active conduct of such a trade or business.

Income from the sale or exchange of any asset that has a carryover basis from another person will not be considered qualified taxable income for section 936 credit purposes unless sections 931, 936, or 957(c) applied during the holding period by that other person (section 936(d)(3)). In other words, the qualified income of a corporation receives a tax credit whether or not any tax is actually paid to the possession. The section 936 credit replaces the ordinary foreign tax credit under section 901 and any deduction for income tax paid to the possession. A credit is allowed under section 901 for taxes on the income from outside the possession.

The section 936 credit is allowed against income taxes but, under section 936(a)(3), is not allowed to be taken as a credit against the following:

1. Environmental tax (section 59A)
2. Tax on accumulated earnings (section 531)
3. Personal holding company tax (section 541)
4. Taxes related to recoveries of foreign expropriation losses (section 1351)

Dividends From a Possessions Corporation

A domestic corporation receiving dividends from a qualifying possessions corporation is eligible for the 70-percent, 80-percent, or 100-percent dividends-received deduction under section 243(b)(1). In the case of the corporation eligible for the dividends-received deduction, any taxable income received as a dividend from a possessions corporation is foreign-source income, not effectively connected income, and is to be included in the computation of the section 901 foreign tax credit limitation. Foreign taxes paid with respect to such distributions are not available to

the shareholder for credit or deduction (section 901(g)). These rules apply regardless of when the earnings from which the dividends were paid were accumulated.

There is also a separate foreign tax credit limitation basket for computing the alternative minimum foreign tax credit. This category includes the portion of dividends received from a possessions corporation for which the dividends received deduction is disallowed, and is included in alternative minimum taxable income.

Other Provisions

A corporation may not qualify for section 936 benefits if during the taxable year it was a domestic international sales corporation (DISC) or former DISC, foreign sales corporation (FSC) or former FSC, or owned stock in a DISC or former DISC or FSC or former FSC (section 936(f)).

A corporation qualifying for the section 936 credit will not be liable for the accumulated earnings tax on any income entitled to that credit (section 936(g)(1)). In addition, the definition of *reasonable needs* of the business includes assets that produce income eligible for the credit (section 936(g)(2)).

Tax Treatment of Intangible Property Income

Section 936(h) subjects U.S. shareholders of possessions corporations to tax on section 936 company income that is attributable to intangibles from the United States, unless the section 936 corporation elects to use a cost-sharing or profit split method of computing taxable income. The provision in section 936(h) was enacted because of techniques that had been used by domestic corporations to reduce taxable income by transferring intangible property developed or acquired in the United States to a possessions corporation. Income earned by such corporations from the U.S. intangible property was generally free from tax, and in some cases no allocation of income was made from the possessions corporation to the parent corporation incurring the costs associated with the intangible property.

Income Attributable to Shareholders

The intangible property income of a section 936 corporation is required to be included on a pro rata basis in the gross income of all qualifying

shareholders and to be treated as U.S.-source income (section 936(h)(1)(A)) unless an election is made under section 936(h)(5) to use the cost-sharing or profit split method of computing taxable income. Intangible property income means the gross income of a corporation attributable to any intangible property licensed to a corporation after 1947 and in use by the corporation on September 3, 1982 (section 936(h)(3)). The intangible property income included in the gross income of a shareholder is excluded from the gross income of the section 936 corporation (section 936(h)(1)(B)). This provision does not apply to any shareholder who is not a U.S. person or who is not subject to any income tax on intangible property income (section 936(h)(2)(A)). The intangible property income not included in the gross income of a non-U.S. shareholder will be treated as income from U.S. sources for the possessions corporation but will not be taken into account for purposes of satisfying the percentage tests of section 936(a)(2) (section 936(h)(2)(B)).

Intangible Property

Intangible property means any of the following or any similar items that have substantial value independent of the services of any individual (section 936(h)(3)(B)):

1. Patent, invention, formula, process, design, pattern, or know-how
2. Copyright or literary, musical, or artistic composition
3. Trademark, trade name, or brand name
4. Franchise, license, or contract
5. Method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data

Intangible property income does not include a reasonable profit (1) on direct and indirect costs income from the sale, exchange, or other disposition of any product or (2) from section 936 corporation income from rendering services when the secretary determines that such income is a reasonable profit on the direct and indirect costs incurred by the section 936 corporation (section 936(h)(3)(C)).

Related Persons and a Controlled Group of Corporations

For purposes of determining if a person is a related person or if a controlled group of corporations exists, the following rules apply: (1) A per-

son must bear a relationship to another person as specified in section 267(b) or section 707(b)(1) except that a 10-percent ownership requirement applies instead of a 50-percent one, and section 267(b)(3) applies without regard to whether the person is a personal holding company or a foreign personal holding company (FPHC) (section 936(h)(3)(D)); and (2) the related person and other persons must be members of the same controlled group of corporations. Controlled group of corporations has the same meaning as in section 1563(a) except that the more-than-10-percent rule is substituted for the 80-percent and 50-percent tests along with other modifications to section 1563 as specified in section 936(h)(3)(E)(ii).

Intangible Income Election

A section 936 corporation may elect to treat income attributable to certain intangible property as income eligible for the section 936 credit under two options, the cost-sharing method and the profit-split method. This election may be made only if the electing corporation has a significant business presence in a possession with respect to a product or type of service that utilizes such intangible property. The election remains in effect only as long as the electing corporation maintains a significant business presence in a possession with respect to this product or type of service in a subsequent taxable year; this election is revoked on the first day of the taxable year this presence is not maintained (section 936(h)(5)(B)).

An election must be made on or before the due date (including extensions) of the tax return for the electing corporation's first taxable year beginning after December 31, 1982. An election may be voluntarily revoked only with the consent of the secretary; once revoked, a new election may not be made without the consent of the secretary. All section 936 affiliates controlled within the meaning of section 482 and producing products or rendering types of services in the same product area will be required to elect the same option for that product except that the method used for bona fide export sales may be different from that applicable to other sales (section 936(h)(5)(F)).

Significant Business Presence. A U.S. subsidiary or affiliate operating in a U.S. possession cannot elect cost sharing or the profit-split method for a product or type of service unless it has and maintains a significant business presence in the possession with respect to a particular product

or type of service. This test is intended to require real and significant business activity in the possession. In addition, for products produced, in whole or in part, by the possessions corporation, the profit-split method is available only if the possessions corporation manufactures or produces the product in the possession within the meaning of section 954.

The significant-business-presence test may be satisfied in several alternative ways. In the first alternative, the total production costs (other than direct material costs and certain interest) incurred by the electing corporation in the possession in producing units of that product sold or otherwise disposed of during the taxable year by the affiliated group to members who are not members of the affiliated group are not less than 25 percent of the difference between (1) the gross receipts from sales or other dispositions during the taxable year by the affiliated group to persons who are not members of the affiliated group of such units of the product produced and (2) the direct material costs of the purchase of materials for such units of that product by all members of the affiliated group from persons who are not members of the affiliated group (section 936(h)(5)(B)(ii)(I)).

In the second alternative, no less than 65 percent of the direct labor costs of the affiliated group for units of the product produced during the taxable year in whole or in part by the electing corporation, or for the type of service rendered by the electing corporation during the taxable year, are incurred by the electing corporation and are compensation for services performed in the possession (section 936(h)(5)(B)(ii)(II)).

In the third alternative, with respect to purchases and sales by an electing corporation of all goods not produced in whole or in part by any member of the affiliated group and sold by the electing corporation to persons other than members of the affiliated group, no less than 65 percent of the total direct labor costs of the affiliated group in connection with all purchases and sales of such goods sold during the taxable year by such electing corporation are incurred by such corporation and its compensation for services performed in the possession (section 936(h)(5)(B)(ii)(III)).

In the fourth alternative, no less than 50 percent of the direct labor costs of the affiliated group for units of the product produced, in whole or in part, during the taxable year by the possessions corporation, or for the type of service rendered by the possessions corporation during the taxable year, are incurred by the possessions corporation as compensation for services performed in the possession and the direct labor costs of the posses-

sions corporation for units of the product produced or the type of service rendered, plus the base period construction costs are no less than 70 percent of the sum of such base period construction costs and the direct labor costs of the affiliated group for such units of the product produced or the type of service rendered (Treas. Reg. Sec. 1.936-5(b)(8)).

In the fifth alternative, with respect to *startup operations* (that is, products not produced and types of services not rendered in the possession before September 3, 1982), a transition period is established for the purpose of satisfying the 25-percent value-added test or the 65-percent direct labor test. The 25-percent value-added test and 65-percent labor test need not be satisfied until the third taxable year in which the product is first sold or the service rendered by the possessions corporation (Treas. Reg. Sec. 1.936-5(b)(7)). During the transition period, the applicable percentages for these tests are as follows:

	Any Year After 1982		
	1	2	3
Value-added text	10	15	20
Labor test	35	45	55

If the significant-business-presence test is not satisfied for the product or type of service within the product area covered by the election, no intangibles income attributable to that product or type of service will be eligible for the credit. In general, the figures to be used for these calculations will be those used by the U.S. subsidiary or affiliate operating in a U.S. possession in their required inventory calculations.

Cost-Sharing Method of Computing Taxable Income

A mainland affiliate will be permitted to transfer certain manufacturing intangibles to its possessions corporation provided that the possessions corporation shares, through a cost-sharing payment, in the annual product area research expenditures of the mainland affiliate and has a significant business presence in the possession. Satisfying these conditions will deem the possessions corporation owner of the manufacturing intangibles, and it will be entitled to the full returns with respect to its products produced or services rendered (section 936(h)(5)(C)(i)(II)). In addition, manufacturing intangibles developed solely by the possessions corporation in the possession and owned by it or acquired by the possessions corporation from an unrelated party will also be treated as owned by the possessions corporation for purposes of the pricing rules. Rules similar to

those in the section 482 regulations will be provided for purposes of determining when the possessions corporation will be considered to have developed an intangible. An intangible developed under a cost-sharing agreement will not qualify as developed solely by the possessions corporation. All other intangibles will not be treated as owned by the possessions corporation (section 936 (h)(5)(C)(i)(II)).

Manufacturing and Nonmanufacturing Intangibles. *Manufacturing intangibles* include patents, formulas, processes, designs, patterns, and know-how related to the products produced or services rendered by the possessions corporation. Even when nonmanufacturing intangibles (trademarks, trade names, etc.) are closely associated with a specific manufacturing intangible, the return on the intangible cannot be claimed by the possessions corporation.

Cost-Sharing Payment. The cost-sharing payment of the possessions corporation for research shall not be less than the same proportion of 110 percent of the cost of such product area research that the possession sales bears to the amount of total sales of the affiliated group, determined as follows:

$$\text{Cost-sharing payment} = \frac{\text{Possession sales}}{\text{Worldwide sales in the same product area}} \times \text{110 percent of product area research expenditures}$$

In the case of a patent, invention, formula, process, design, pattern, or know-how that the electing corporation owns, the payment required cannot be less than what would be required under section 482 or section 367(d)(2)(a)(ii) (the so-called super-royalty provision).

Product-area and product-area research expenditures will be defined by reference to the three-digit Standard Industrial Classification (SIC) code or any other system the secretary may prescribe, including the possibility of grouping SIC categories. If the cost-sharing election is made, payment of the required amount must be made by the possessions corporation no later than the due date of the tax return for that taxable year (including extensions). To the extent the payment is not timely, the required payment is increased by an amount computed by reference to the interest rate applicable to income tax deficiencies. If the failure to make a timely payment is due, in whole or in part, to fraud or willful neglect,

the cost-sharing method is deemed revoked as of the first day of the year to which the payment relates (section 936(h)(5)(C) (i)(III)(a)).

For U.S. tax purposes, the cost-sharing payment will not result in additional gross income to the U.S. affiliate or affiliates, but it will instead reduce the U.S. affiliates' deductions for product area research expenditures and, to the extent necessary, other tax deductions (section 936(h)(5)(C)(i)(IV)(a)).

If a foreign country or possession imposes a tax on the cost-sharing payment, no foreign tax credit or deduction will be allowed for that tax (section 936(h)(5)(C)(i)(III)(b)). The amount of qualified research expenses under section 30 will not be reduced by reason of cost sharing (section 936(h)(5)(C)(i)(III)(c)).

Possession Sales. Possession sales consist of sales of products in the same product area as the research expenditures, produced in whole or in part by the possessions corporation, and services rendered and sold by the possessions corporation to third parties. It also includes (1) sales of products produced and (2) services rendered by the possessions corporation and sold by any U.S. or foreign affiliate to third parties. Interaffiliate sales are eliminated (section 936(h)(5)(C)(i)(I)(c)).

The term *product* means an item of property that is the result of a manufacturing process. It includes component products, integrated products, and end product forms (Treas. Reg. Sec. 1.936-5(a)). *Total sales* consist of all sales to third parties in the same product area as the research expenditures by the possessions corporation and all U.S. and foreign affiliates. For this purpose interaffiliate sales are eliminated (section 936(h)(5)(C) (i)(I)(d)).

Product Area Research Expenditures. The product area research expenditures category is broad and includes direct and indirect expenses and a proper allowance of amounts expended for (1) the use of manufacturing intangibles, (2) the performance of research and development by another person, and (3) the development and purchase of research-and-development-related computer software. Product area research expenditures will be determined on the basis of the product area for each activity in which the possessions corporation conducts operations (section 936(h)(5)(C) (i)(I)(a)).

Product area research expenditures are computed on an annual basis and include those incurred by the possessions corporation and all U.S. and foreign affiliates. Product area research expenditures incurred solely

by the possessions corporation in a taxable year will be offset against the amount of the cost-sharing payment required to be made by the possessions corporation for that year. This offset amount, however, excludes amounts paid directly or indirectly to, or on behalf of, related persons and excludes amounts paid under any cost-sharing agreement with related persons.

> *Example 14.5.* Carib, Inc. is a wholly owned subsidiary of UB Corporation, has a section 936 election in effect, and has significant business presence in a possession. UB and Carib, Inc. have annual product research expenditures of $120,000 and $13,000, respectively, for product S. Carib has a cost-sharing agreement with UB and elects to be treated under the cost-sharing provisions of section 936. Sales of product S by Carib, Inc. totaled $2.4 million. Total worldwide sales of product S by all affiliates of UB totaled $14.4 million. The cost-sharing payment that Carib must make to UB is computed as follows (using the formula provided in the previous section titled Cost-Sharing Payment):
>
> $$[(\$2{,}400{,}000/\$14{,}400{,}000) \times \$120{,}000] \times 110\% = \$22{,}000$$
>
> The $22,000 is then reduced by the $13,000 product S research expenditures incurred solely by Carib for a net cost-sharing payment of $9,000.

Pricing. If the cost-sharing payment is made, the possessions corporation will be treated as the owner of, and entitled to the full return on, its manufacturing intangibles covered by this election and connected with the product produced, in whole or in part, or the type of service rendered in the possession. The possessions corporation will compute its intercompany price under any of the applicable pricing rules set forth by Treas. Reg. Sec. 1.482.

Use of the resale price method will not be denied merely because the U.S. affiliate reseller added more than an insubstantial amount to the value of the nonmanufacturing intangibles, and any other functions that add value will be reflected in the resale margin (section 936(h)(5)(C)(i)(IV)(b)). The use of the resale price method could be denied for other reasons, such as when the return on manufacturing intangibles is minor and no comparable sales can be found for determining an appropriate markup percentage under the resale price method.

After implementing the rules specified in Treas. Reg. Sec. 1.482, a cost-plus method may be applied in appropriate cases as long as an additional profit amount, representing the return on manufacturing intangibles covered by this election, is permitted the possessions corporation.

The IRS will not be precluded from applying section 482 to other aspects of the intercompany relationship. The regulations under section 482 and other IRS procedures will continue to apply except to the extent modified by the election.

Profit-Split Method of Computing Taxable Income

Section 936 allows an election that provides for a split in income between the possessions corporation and its U.S. affiliates for products produced, in whole or in part, in the possession. If an election is made, the possessions corporation will be entitled to 50 percent of the combined taxable income from the sale of products produced or services rendered in a possession by the possessions corporation and sold to third parties or foreign affiliates by the possessions corporation or its U.S. affiliate. The remainder of the combined taxable income for a product will be allocated to the mainland affiliates. This method is often called the fifty-fifty method (section 936(h)(5)(C) (ii)(I)).

Combined Taxable Income. *Combined taxable income* is the difference between the gross receipts from the sale of a product produced, in whole or in part, in the possession and the total of such costs incurred by the possessions corporation and its U.S. affiliate. Combined taxable income is computed on a product-by-product basis (section 936(h)(5)(C)(ii)(II)).

Costs that are treated as related to a product produced, in whole or in part, in a possession are all direct and indirect expenses, losses, and other deductions incurred in its production and sale (including marketing expenses). Product area research expenditures properly allocable or apportionable to income from sales of such a product may not be less than the same proportion of the amount of the share of product area research, in the product area that includes this product or type of service, that this gross income from the product or service bears to the gross income from all products and types of services within this product area, produced or rendered, in whole or part, by the electing corporation in a possession. However, if the possessions corporation would not be required to share costs under the cost-sharing election (possibly because of the absence of product area research expenditures) the profit-split option may still be elected.

The amount of income allocated to the U.S. affiliate under the combined taxable income method may exceed the possessions corporation's

share of the income from the product if the amount of proportionate product area research expenditures, determined under cost sharing, is in excess of the amount allocable to the cost-sharing formula. The use of this formula is not intended to allow a deduction to any U.S. affiliate that would not otherwise be allowable.

Example 14.6. A possessions corporation, S, is engaged in the manufacture of microprocessors. S obtains a component from a U.S. affiliate, O. S sells its production to another U.S. affiliate, P, which incorporates the microprocessors into central processing units (CPUs). P transfers the CPUs to a U.S. affiliate, Q, which incorporates them into computers for sale to unrelated customers. S chooses to define the possession product as the CPUs. The combined taxable income for the CPUs is computed below on the basis of the given production, sales, and cost data:

Production costs (excluding costs of materials)

1. O's costs for the component	$ 100
2. S's costs for the microprocessors	500
3. P's costs for the CPUs	200
4. Q's costs for the computers	400
5. Total (add lines 1 through 4)	$ 1,200
6. Combined production costs for the CPUs (add lines 1 through 3)	$ 800
7. Ratio of production costs for the CPUs (the possession product) to the production costs for the computers	0.667

Determination of combined taxable income for computers
Sales:

8. Total possession sales of computers to unrelated customers and foreign affiliates	$ 7,500

Total costs of O, S, P, and Q incurred in the production of the computer:

9. Production costs (line 5)	$ 1,200
10. Material costs	100
11. Total costs (line 9 plus line 10)	$ 1,300
12. Combined gross income from the sale of computers	$ 6,200

Expenses of affiliated group (other than foreign affiliates)

13. Expenses (other than research expenses)	$ 980
14. Total sales in the three-digit SIC Code	$12,500

15.	Possession sales of the computers (line 8)	$ 7,500
16.	Cost-sharing fraction (divide line 15 by line 14)	0.6
17.	Research expenses incurred by the affiliated group in the three-digit SIC code multiplied by 120 percent	$ 700
18.	Cost-sharing amount (multiply line 16 by line 17)	420
19.	Research of the affiliated group (other than foreign affiliates allocable and apportionable under 1.861-17(e)(3) and 1.861-14T(e)(2) to the computers	300
20.	Greater of line 18 or line 19	$ 420

Computation of combined taxable income of the computer and the CPU

21.	Combined taxable income attributable to the computer (line 12 minus line 13 and line 20)	4,800
22.	Combined taxable income attributable to the CPUs (multiply line 21 by line 7)	3,200
23.	Share of combined taxable income apportioned to S (50 percent of line 22)	$ 1,600

Share of combined taxable income apportioned to affiliates of S:

24.	Adjustments for research expenses (line 18 minus line 19 multiplied by line 7)	80
25.	Adjusted combined taxable income (line 22 plus line 24)	$ 3,280

(Treas. Reg. Sec. 1.936-6(b)(1), A-12(iv), example).

Sections 931, 932, and 933

An individual who is a bona fide resident of Guam, American Samoa, or the Northern Mariana Islands during the entire taxable year is subject to taxation in the same manner as a U.S. resident, except that gross income for U.S. tax purposes does not include income derived from sources within any specified possession and income effectively connected with the conduct of a trade or business by such individual within any specified possession (section 931(a)). Deductions (other than personal exemptions) and credits allocated and apportioned to the excluded income are not allowed for U.S. tax purposes. A resident of Guam, American Samoa, or the Northern Mariana Islands is required to file a U.S. tax return and pay taxes on income received from sources outside the possessions if

the amount of nonpossession income is greater than minimum-filing-requirement amounts for U.S. taxation. U.S. taxes paid on possessions income will be transferred to the treasuries of the applicable possession where the recipient resides, thus providing the possession with the same amount of revenue it currently receives.

Government Employees

Compensation paid to employees of the United States or a U.S. agency is not excluded from gross income under section 931 (section 931(d)(1)). It is not always readily apparent, however, when a person is employed by an agency of the United States. For example, the government of American Samoa is considered a U.S. agency. Since substantially all kindergartens on foreign armed forces installations are now operated as a part of the Department of Defense Overseas Dependents Education Program. These kindergartens are integral parts of an agency or instrumentality of the United States. In addition, U.S. armed forces exchanges, commissioned and noncommissioned officers' messes, and motion picture services are instrumentalities of the United States and constitute a U.S. agency.

Income From Sources Within Puerto Rico

A U.S. citizen who is a bona fide resident of Puerto Rico for an entire taxable year may exclude from gross income for U.S. tax purposes income from sources within Puerto Rico. Salary received for services as an employee of the United States or any U.S. agency and income from sources outside Puerto Rico are subject to U.S. taxation. It will be recalled that section 931 provides an exclusion on income from sources within the specified possessions of Guam, American Samoa, or the Northern Mariana Islands and income effectively connected with the conduct of trade or business by an individual within that specified possession, while section 933 provides an exclusion on income from sources within Puerto Rico.

The exclusion of section 933 is available only when the U.S. citizen has been a resident of Puerto Rico for a full taxable year. A U.S. citizen who is not a bona fide resident of Puerto Rico for the full taxable year in which residency is established is not entitled to a partial exclusion (Treas. Reg. Sec. 1.933-1(a)).

A U.S. citizen who has been a bona fide resident of Puerto Rico for two years and then changes his or her residency from Puerto Rico is enti-

tled to an exclusion of gross income from sources within Puerto Rico attributable to Puerto Rican residency. Income received after the taxable year Puerto Rican residency is terminated may not be excluded.

Example 14.7. A U.S. citizen terminated residency in the United States and established residency in Puerto Rico on July 15, 1997. He remained a continuous resident of Puerto Rico until March 31, 2000 (ninety days in 2000), at which date U.S. residency was reestablished. His yearly salary was $60,000 for 1997 and 1998 and $75,000 during 1999 and 2000. All income received during his period of Puerto Rican residency was from services performed in Puerto Rico. The taxpayer may not exclude any of the $60,000 for 1997. He may exclude $60,000 for 1998 and $75,000 for 1999. For 2000 the taxpayer may exclude $18,493 [90/(365 × $75,000)].

Deductions allocable to or chargeable against excluded gross income under the provisions of section 933 are not allowed, nor are any credits allowed. Personal exemptions may be deductible in full, regardless of the amount excluded from gross income.

Example 14.8. Taxpayer, a single U.S. citizen with no dependents who satisfies the provisions of section 933, had income and deductions of the following sources and amounts:

	Gross Income	*Deductions*
Puerto Rico	$100,000	$20,000
United States	30,000	5,000
Personal exemption		2,800

Her taxable income for U.S. tax purposes is as follows:

Gross income		$30,000
Less		
Deductions	$5,000	
Personal exemption	2,800	7,800
Taxable income		$22,000

Coordination of U.S. and Virgin Islands Income Taxes

An individual qualifying as a bona fide resident of the Virgin Islands as of the last day of the taxable year will pay tax to the Virgin Islands under the mirror system on worldwide income. A Virgin Islands income tax return is a form that reports all income from all sources and identifies the source of each item of income. For U.S. income tax purposes, gross income will not include any amount included in gross income on the Virgin Islands income tax return (section 932(c)).

A citizen or resident of the United States, not a bona fide Virgin Islands resident, who derives income from sources within the Virgin Islands or income effectively connected with a trade or business in the Virgin Islands, will not be liable to the Virgin Islands for any tax determined under the Virgin Islands "mirror code" (section 932(a)(1)). The tax liability to the Virgin Islands of such person will be a fraction of the U.S. income tax liability. This fraction is the ratio of the adjusted gross income derived from Virgin Islands sources to worldwide adjusted gross income (section 932(b)(2)). Identical tax returns will be filed to the United States and the Virgin Islands, and any amounts of income taxes paid to the Virgin Islands will be credited against U.S. tax liability (section 932(a)(2)). Virgin Islands local income taxes are treated as state and local income taxes and deducted.

When a joint return is filed and only one spouse qualifies as a resident of the Virgin Islands, then residency status of both spouses will be determined on the basis of the residency of the spouse with the greater adjusted gross income for the taxable year (section 932(d)).

The Virgin Islands have the authority to reduce or rebate Virgin Islands taxes on certain income. The authority of the Virgin Islands to reduce or rebate Virgin Islands tax liability extends to income derived from sources within the Virgin Islands or effectively connected with the conduct of a trade or business in the Virgin Islands. No reductions or rebates can be given on any liability payable to the Virgin Islands by a citizen or resident of the United States. In addition, no reductions or rebates may be given for tax liability attributable to income that is derived from sources outside the United States and that is not effectively connected with the conduct of a trade or business within the United States of a foreign corporation that is less than 10 percent owned by U.S. persons. As for U.S. persons, and corporations that are 10 percent or more owned by U.S. persons, the Virgin Islands can reduce or rebate tax only on income from Virgin Islands sources or income effectively connected with a Virgin Islands trade or business.

Regulations will be issued to prevent abuses that could arise if a mainland resident moved to the Virgin Islands while owning appreciated property such as corporate stock or precious metals and sold that property in the Virgin Islands in an attempt to avoid both U.S. and Virgin Islands taxes (section 934(b)(4)).

15

Formation, Reorganization, and Disposition of Foreign Corporations

Prior to passage of section 1248 in 1962 and section 112(i) of the 1939 Internal Revenue Code (now section 367), a taxpayer could escape U.S. taxation on a variety of transactions involving the formation, reorganization, or disposition of a foreign corporation. For example, appreciated assets could be transferred to a corporation organized in a foreign country in exchange for stock of the foreign corporation, in a tax-free exchange. The foreign corporation could then sell any appreciated assets without the payment of foreign or U.S. taxes. A taxpayer could also organize a foreign corporation to do business abroad, accumulate profits free from U.S. taxes, pay taxes at a low foreign effective rate, and then eventually sell or liquidate the corporation, with the resulting gain taxed at low U.S. capital gains rates.

Sections 367 and 1248 have a purpose similar to that of subpart F, that is, to ensure that certain income arising directly or indirectly from

foreign operations will not escape U.S. taxation or will not be subject to lower taxes than would be paid in comparable domestic operations. Sections 367 and 1248 serve as a "backstop" for subpart F by providing that earnings not previously taxed by the United States will be taxed if a transaction falls under one of these sections. In addition, section 367 provides for immediate recognition of certain realized gains in otherwise nontaxable exchanges, where subsequently realized gains may not be subject to U.S. taxation or if the taxpayer has received a U.S. tax benefit from a prior deduction of foreign losses. The rules of section 367 do not, however, allow for recognition of loss.

This chapter examines the U.S. tax aspects of forming, reorganizing, and disposing of stock of a foreign corporation. Significant tax differences may be realized depending on the manner in which the transaction is effected, ranging from full exemption from current taxation on the transaction to current taxation of certain ordinary income amounts or capital gain.

Section 1248

Normally, when a U.S. person sells shares in a corporation, the recognized gain is capital in nature. Section 1248, however, requires a U.S. person selling or exchanging stock in certain foreign corporations to report a portion of any recognized gain as a dividend. Under section 1248, selling or exchanging stock in a corporation that, at any time during the five-year period prior to such sale, was a controlled foreign corporation (CFC) in which the seller was a "U.S. shareholder" (see chapter 8) requires that a portion of any recognized gain be treated as dividend income. The dividend portion is limited to the CFC's post-1962 earnings and profits attributable to the shares sold and generated while it was a CFC.

Section 1248 applies to sales and exchanges of stock in a foreign corporation. For this purpose, a U.S. person is treated as having sold or exchanged any stock if that person is treated as realizing gain from the sale or exchange of that stock.

A domestic corporation satisfying the stock ownership requirements in a foreign corporation that distributes such CFC stock in a transaction to which sections 311(a), 355(c)(1), 361(c)(1), or 337 apply must include in gross income an amount equal to the excess of the fair market value of the CFC stock over the domestic corporation's adjusted basis in

the CFC stock, to the extent that earnings and profits accumulated in taxable years beginning after December 31, 1962, are attributed to the CFC stock (section 1248(f)). Section 1248(f) provides that regulations may be issued exempting certain transactions. The domestic corporation need not recognize income if the distribution is to another domestic corporation that acquires the distributing corporation's holding period and satisfies the section 1248 ownership requirements. In addition, gain need not be recognized on a section 337 distribution if (1) throughout the periods that the stock of the foreign corporation was held by the domestic corporation, all the domestic corporation stock was owned by U.S. persons who satisfied the 10-percent stock ownership requirements, and (2) the general rule of section 1248(a) applies to the proceeds of the sale and also applies to all transactions of section 1248(e)(1). Section 1248(e)(1) deals with the sale or exchange of stock of a domestic corporation formed or availed of principally for holding, directly or indirectly, stock of one or more foreign corporations.

A transfer at death will not trigger section 1248 treatment. Nor does section 1248 apply (1) to a distribution under section 303 relating to a redemption of stock to pay death taxes, (2) to gain relating to receipt of additional consideration in certain reorganizations to which section 356 applies for exchanges before March 1, 1986, or (3) to any other amounts that would otherwise be treated as ordinary income, such as dividends (other than dividends under section 1248(f)), and gains from the sale of noncapital assets or short-term capital gains (section 1248(g)).

When stock to which section 1248 applies is sold or exchanged and the taxpayer is permitted to elect the installment method of recognizing the gain,[1] income on each installment payment received (or is deemed to have been received because of the allocable installment indebtedness rules under section 453C) is deemed to consist of a section 1248 dividend until all such dividends are accounted for. Capital gains will not be recognized until all section 1248 dividend income is recognized (Treas. Reg. Sec. 1.1248-1(f)).

If a shareholder of a 10 percent corporate shareholder of a foreign corporation exchanges stock in the 10 percent corporate shareholder for stock in the foreign corporation, the gain is recognized to the 10 percent corporate shareholder. In addition, the transaction is treated as a distri-

[1]Installment treatment is not permitted for stock or securities that are traded on an established securities market (section 453(j)(2)(A)).

bution of the foreign corporation's stock by the U.S. corporation to its shareholders. The 10 percent shareholder's gain recognized is limited to the amount treated as a dividend under section 1248 (section 1248(i)). Ownership is measured by voting power.

Earnings and Profits

Dividend income must be recognized to the extent of certain earnings and profits accumulated for taxable years beginning after December 31, 1962, but not in excess of the fair market value of the stock sold or exchanged over the basis of such stock in the hands of the transferor (section 1248(a)(2)). Undistributed earnings and profits of foreign corporations controlled by the foreign corporation are also included in the earnings and profits of such foreign corporation. In general, these earnings and profits are calculated using the same rules applicable to domestic corporations. Depreciation deductions are imputed at the same rates as are allowable under the accelerated cost recovery system (ACRS) rules or modified accelerated cost recovery system rules (MACRS) for foreign situs property (sections 168(g)(1)(A) and 168(g)(2)).

The following are other exclusions from earnings and profits under section 1248:

1. Amounts that have previously been included in the income of a U.S. shareholder under section 951 (section 1248(d)(1))
2. Gains on the sale or exchange of property pursuant to a section 337 liquidation (section 1248(d)(2))
3. Income effectively connected with a trade or business in the United States (section 1248(d)(4))
4. Amounts included in gross income under section 1247 (section 1248(d)(5))
5. Income taxed under foreign personal holding company (FPHC) provisions (Treas. Reg. Sec. 1.1248-3(e)(3))
6. Amounts that were accumulated during any taxable year beginning before January 1, 1976, while the foreign corporation was a less-developed-country corporation (LDCC) under section 902(d), in effect before the Tax Reduction Act of 1975 (section 1248(d)(3))
7. Foreign trade income of an FSC other than foreign trade income that is nonexempt income or would not be treated as exempt foreign trade income under section 923 (section 1248(d)(6))

In general, the above adjustments to earnings and profits reduce the amount of potential dividend because these amounts have been previously taxed to U.S. shareholders.

Example 15.1. R. Greer, a U.S. citizen, sold his 55-percent interest in R.G., Ltd., a foreign corporation, on December 31, 1999. R.G., Ltd. has been a CFC since its inception and was an LDCC during 1969. Greer purchased 5 percent of the voting stock at the beginning of 1968, 10 percent more at the beginning of 1969, and an additional 40 percent at the beginning of 1970. R.G., Ltd.'s earnings and profits are as follows:

1963–1967	$ 45,000
1968	20,000
1969	15,000
1970–1999	250,000

The shares were sold for $400,000. Greer's basis was $70,000 for a realized gain of $330,000. None of the earnings and profits for 1963 through 1967 is attributable to Greer's shares, since he did not own any of the voting stock of R.G., Ltd. during this period. Even though he did not own 10 percent of the voting stock during 1968, his ownership of 10 percent or more of the voting power during 1969 through 1999 requires inclusion of the 1968 earnings and profits as section 1248(a) dividend income. The earnings and profits for 1969, accumulated while R.G., Ltd. was an LDCC, are excluded. The earnings and profits attributable to Greer's shares are as follows:

1968	5% × $20,000 =	$ 1,000
1970–1999	55% × $250,000 =	137,500
		$138,500

Of the total gain of $330,000 realized on the sale of R.G., Ltd. stock, $138,500 is treated as a dividend under section 1248 and $191,500 will be treated as a long-term capital gain.

In a section 1248 sale or exchange, earnings, and profits include earnings and profits of subsidiaries of the foreign corporation whose stock is sold or exchanged in a section 1248 transaction (section 1248(c)(2)), that were accumulated after December 31, 1962 during periods when the first-tier corporation was a CFC and the person subject to section 1248 owned the stock of the first-tier foreign corporation.

Section 1248 earnings and profits are attributable only to stock owned by a U.S. person who held 10 percent or more of the combined voting power of all classes of stock entitled to vote at any time during the five-year period ending on the date of the sale. Ownership is determined under the rules at section 958. Earnings and profits attributable to the

stock are not taken into account to the extent they exceed the potential gain related to those shares. Stated differently, section 1248 relates only to the characterization of a realized gain and has no impact on the amount of gain realized. There are two alternative ways of allocating earnings and profits to shares, the simple case and the complex case.

In the simple case, if certain conditions are satisfied with respect to a block of stock, the earnings and profits attributable to that block are computed and added to the earnings and profits from lower-tier corporations attributable to that block (Treas. Reg. Sec. 1.1248-2(a)). Five conditions must be satisfied in order to use the simple-case method.

1. On each day the block of stock was held after December 31, 1962, the foreign corporation was a CFC and during this time was neither a foreign personal holding company (defined in section 552) nor a foreign investment company (defined in section 1246(b)).
2. The foreign corporation had only one class of stock, and the same number was outstanding at all times after December 31, 1962.
3. The foreign corporation was not an LDCC.
4. The foreign corporation did not pay dividends out of earnings and profits accumulated after December 31, 1962, to the person who held the block while the corporation was a CFC.
5. The foregoing four requirements are satisfied with respect to a lower-tier foreign corporation that would be subject to section 1248 treatment if sold or exchanged and if it were a first-tier corporation (Treas. Reg. Sec. 1.1248-2(c)).

If the foregoing conditions are not satisfied, the rules applicable to complex cases are used. There are three steps prescribed in the regulations for determining the earnings and profits attributable to stock in the complex case. In the first step, the earnings and profits are calculated using the rules prescribed in Treas. Reg. Sec. 1.964-1, as adjusted for U.S. income described in Treas. Reg. Sec. 1.1248-3(b)(2), and adjustments for dividend distributions described in Treas. Reg. Sec. 1.1248-3(b)(3).

If the stock in the corporation is sold or exchanged before Treas. Reg. Sec. 1.964-1(c) elections with respect to accounting methods are made, earnings and profits are calculated as if no elections were made. The second step requires calculating the person's ratable share of the lower-tier corporation's earnings and profits, if any. In the third step, the amount of earnings and profits attributable to the share calculated in the first step is added to the amount calculated in the second step. These calculations are

made on a per-share basis, except that if a group of shares constitutes a block of stock, the computation may be made with respect to the block.

Example 15.2. A U.S. corporation owns 100 percent of CFC1, CFC1 owns 100 percent of CFC2 and CFC2 owns 80 percent of CFC3. CFC3 was formed as a joint venture on January 1, 1981, with a foreign corporation. CFC2 and the foreign corporation each owned 50 percent, and CFC2 did not become a controlled foreign corporation until January 1, 1985, when CFC2 purchased 30 percent of CFC3 stock from the foreign corporation. Earnings and profits of CFC1, CFC2, and CFC3 are as follows.

Years	*CFC1*	*CFC2*	*CFC3*
Pre-1963	$200,000	$170,000	$ 0
1963–1980	500,000	190,000	0
1981–1984	400,000	340,000	100,000
1985–1999	300,000	200,000	150,000

The section 1248 amount attributable to the stock that the U.S. corporation owns is $2.05 million computed as follows: The $370,000 pre-1963 earnings and profits of CFC1 and CFC2 are excluded under section 1248(c)(2)(D). The $100,000 earnings and profits of CFC3 for 1980–1984 are excluded because CFC3 was not a controlled foreign corporation during that time period. Of the $150,000 earnings and profits of CFC3 accumulated in 1985–1999, 80 percent ($120,000) is attributable to the stock owned by CFC1. Therefore, the earnings and profits amount attributable to the ownership by the U.S. corporation is $2.05 million ($500,000 + 190,000 + 400,000 + 340,000 + 300,000 + 200,000 + 120,000). The section 1248(c)(2) amount, which only includes the earnings and profits of lower-tier controlled foreign corporations, is $850,000 ($190,000 + 340,000 + 200,000 + 120,000).

If a taxpayer sells or exchanges stock in a foreign corporation and the Commissioner determines that the taxpayer has not established the amount of earnings and profits of the corporation attributable to the stock, all of the gain from the sale or exchange will be treated as a dividend (Treas. Reg. Sec. 1.1248-7). The taxpayer is considered to have established the amount of earnings and profits if a schedule is attached to his or her timely filed income tax return (including extensions) and the correctness of the schedule is established. The schedule attached to the taxpayer's income tax return for the taxable year in which the stock is sold or exchanged must show the taxpayer's name, address, and identifying number. The schedule shall also show the amount of earnings and profits attributable to the stock and additional information necessary to

support the computation of this amount as required by Treas. Reg. Sec. 1.1248-7(b).

Limitation on Tax Applicable to Individuals

Section 1248(b) establishes a limit on the amount of tax applicable to the dividend amount included in gross income. The tax will not be greater than the amount by which the shareholder's pro rata share of hypothetical tax (U.S. income taxes that would have been paid on the foreign corporation's income had it been taxed as a domestic corporation) exceeds the taxes already paid on the earnings and profits, plus the amount of capital gains tax on the difference between the section 1248 dividend and this excess. The difference between the hypothetical U.S. tax and foreign taxes is analyzed on a year-by-year basis (Treas. Reg. Sec. 1.1248-4(e)(1)).

Example 15.3. J. Willard, a single U.S. citizen with $500,000 taxable income from various sources, sold his 60-percent interest in W.J., Ltd., a CFC, to R. Johnson on January 1, 1999, for $3 million. W.J., Ltd. was incorporated by Willard and Johnson under the laws of foreign country D in 1980. Willard's basis in his 60-percent interest was $50,000. From incorporation until the date of sale, W.J., Ltd. had income of $2,962,000, on which country D levied a tax of $592,400. Earnings and profits were $2,369,600. The hypothetical U.S. tax was $948,207. None of the income was from U.S. sources or subject to U.S. taxes, none was subpart F income, and earnings and profits equals aftertax income.

The limit on the taxes Willard must pay under the limitations of section 1248(b) is as follows:

Excess of U.S. hypothetical tax over foreign taxes paid	$ 355,807	
Willard's share of "excess" U.S. taxes ($355,807 × 60%)	213,484	
Section 1248 dividend income:		
Lesser of		
Earnings and profits ($2,369,600 × 60%)	1,421,760	
or		
Gain on sale of stock	2,950,000	
Dividend under section 1248		1,421,760
Difference between hypothetical U.S. tax and total taxes actually paid		$ 213,484
Amount taxed as a capital gain		1,208,276

Maximum tax on section 1248(a) dividend:		
Difference between hypothetical U.S. tax and actual foreign and U.S. taxes paid	213,484	
Tax on capital gains ($1,208,276 × 20%)	241,655	
Limitation on income tax attributable to section 1248(a) dividend included in gross income		455,139
Tax on remaining long-term capital gains ($1,528,240 × 20%)		305,648
Total tax on sale of W.J., Ltd. stock		$ 760,787

Since in this case the limitation amount is less than the maximum tax on the sale of $868,665 [1,421,760 × 39.6%) + (1,528,240 × 20%)] that could possibly apply, the limitation amount will not apply and the tax is $760,789. As the rate differential between capital gains and dividend income becomes greater, the limitation may apply.

Section 367

Section 367 provides that in certain types of exchanges that would ordinarily qualify for nonrecognition treatment if one of the parties is a foreign corporation, that corporation is not considered to be a corporation for purposes of determining the gain that shall be recognized on the exchange. This hypothetical denial of corporate status to a foreign corporation renders taxable what would normally be a nontaxable exchange. For example, a transfer to a corporation controlled by a transferor under section 351 is generally a nontaxable exchange. But if the corporation is deemed not to be a corporation, the transferor could be required to recognize gain. However, since section 367 applies only to gains, losses would remain nondeductible, as with a nontaxable exchange.

Section 367 covers five categories of property transfers: (1) outbound transactions, that is, transfers of property from the United States (section 367(a)); (2) other transfers, including transfers into the United States and those that are exclusively foreign (section 367(b)); (3) transactions treated as exchanges (section 367(c)); (4) transfers of intangibles (section 367(d)); and (5) section 355 distributions and section 332 liquidations. For all these transfers, the Secretary of the Treasury has or will prescribe regulations concerning the treatment of a sale or exchange of stock or securities in a foreign corporation by a U.S. person and the circumstances under which (1) gain is recognized currently or amounts are included in gross income currently as a dividend or both, (2) gain or other

amounts may be deferred from inclusion in the gross income of a shareholder (or his or her successor in interest) at a later date, and (3) adjustments are to be made to earnings and profits, the basis of stock or securities, and the basis of assets. In addition, in case of any liquidation under section 332, except as provided by regulations, sections 337(a) and 337(b)(1) will not apply when the 80-percent distributee is a foreign corporation (section 367(e)(2)).

Transfers of Property From the United States

Section 367(a) provides that in any exchange described in sections 332, 351, 354, 356, and 361 when there is a property transfer by a U.S. person to a foreign corporation, in order to determine how much gain (but not how much loss) is recognized on the transfer, a foreign corporation is not considered to be a corporation. The gain required to be recognized cannot exceed the gain that would have been recognized on a taxable sale if the assets were sold individually and without offsetting individual losses against gains. Losses cannot be recognized under section 367 (Temp. Treas. Reg. Sec. 1.367(a)-1T(b)(3)). The character of the gain is determined by the character of the individual assets. If the gain recognized is greater than the gain on the individual assets (which is possible because an additional amount of income is required to be recognized because of the recapture of foreign losses), the limitation is imposed by making proportionate reductions in the amounts of ordinary income and capital gain, regardless of the character of gain that would have been recognized on a taxable sale of the property. The character and source of the gain is determined as if the property had been disposed of in a taxable exchange with the transferee foreign corporation. Earnings and profits, basis, and any other affected items will be taken into account because of any gain recognized (Temp. Treas. Reg. Sec. 1.367(a)-1T(b)(4)).

Example 15.4. Domestic corporation DC transfers inventory with a fair market value of $1 million and adjusted basis of $800,000 to foreign corporation FC in an exchange for stock of FC in a section 351 transaction.

Title passes within the United States. Under section 367(a), DC is required to recognize a gain of $200,000 upon the transfer. This gain is treated as ordinary income from sources within the U.S. arising from a taxable exchange with FC. Adjustments to earnings and profits, basis, etc. are made as if the transfer were subject to section 351.

DC's basis in the FC stock received, and FC's basis in the transferred inventory, will each be increased by the $200,000 gain recognized by DC (Temp. Treas. Reg. Sec. 1.367(a)-1T(b)(4)(ii), example).

There are several situations in which gain recognition under section 367(a) will not apply because a foreign corporate transferee will be considered to be a corporation: (1) on the transfer of stock or securities of a foreign corporation that is a party to the exchange or a party to the reorganization as defined in section 368(b), (2) on the transfer of property to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States, and (3) on certain other transfers of property (Temp. Treas. Reg. Sec. 1.367(a)-1T(b)(2)).

There is an exception to section 367 for transfers of certain property to a foreign corporation used in the active conduct of a trade or business outside the United States. The following assets, however, cannot be transferred tax free: (1) inventory and copyrights; (2) installment obligations, accounts receivable, or similar property; (3) foreign currency or other property denominated in foreign currency; (4) intangible property defined in section 936(h)(3)(B); and (5) property that is leased to someone other than the transferee (section 367(a)(3)(B)).

Transfers of branch assets to a foreign corporation will trigger gain to the extent that the branch had losses that were deductible by the taxpayer in excess of any taxable income of the branch, as well as any recapture of gains under section 904(f), that relates to recharacterizing foreign source income as U.S. source income for foreign tax credit purposes. Income recognized will have the same character as the branch losses (section 367(a)(3)(C)). Transfer of a partnership interest to a foreign corporation is treated as a transfer of each person's pro rata share of the assets of the partnership (section 367(a)(4)). In addition, the secretary may exempt other transactions from gain recognition in order to carry out the congressional intent of section 367(a) (section 367(a)(5)).

In addition to the more common exchanges described in the foregoing Internal Revenue Code section involving a U.S. transferor, transfers of property from the United States include indirect and constructive transfers, as follows:

1. Mergers described in sections 368(a)(1)(A) and (a)(2)(D). A U.S. person exchanges stock or securities of a corporation (the acquired corporation) for stock or securities of a foreign corporation that controls the acquiring corporation in a reorganization described in sections 368(a)(1)(A) and (a)(2)(D).
2. Mergers described in sections 368(a)(1)(A) and (a)(2)(E). A U.S. person exchanges stock or securities of a corporation (the acquiring corporation) for stock or securities in a foreign corporation that

controls the acquired corporation in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E).

3. Triangular reorganizations described in section 368(a)(1)(B). A U.S. person exchanges stock of the acquired corporation for voting stock of a foreign corporation that is in control (as defined in section 368(c)) of the acquiring corporation in connection with a reorganization described in section 368(a)(1)(B).
4. Triangular reorganizations described in section 368(a)(1)(C). A U.S. person exchanges stock or securities of a corporation (the acquired corporation) for voting stock or securities of a foreign corporation that controls the acquiring corporation in a reorganization described in section 368(a)(1)(C).
5. Reorganizations described in sections 368(a)(1)(C) and (a)(2)(C). A U.S. person exchanges stock or securities of a corporation (the acquired corporation) for voting stock or securities of a foreign acquiring corporation in a reorganization described in sections 368(a)(1)(C) and (a)(2)(C) (other than a triangular section 368(a)(1)(C) reorganization described above).
6. Successive transfers of property to which section 351 applies. A U.S. person transfers property (other than stock or securities) to a foreign corporation in an exchange described in section 351, and all or a portion of such assets transferred to the foreign corporation by such person are, in connection with the same transaction, transferred to a second corporation that is controlled by the foreign corporation in one or more exchanges described in section 351 (Treas. Reg. Sec. 1.367(a)-3(d)).
7. A transfer by a foreign or domestic partnership to a foreign corporation to the extent that the partnership property transferred is attributable to partnership interests held by one or more U.S. persons is considered a transfer to which section 367(a)(1) applies (Temp. Treas. Reg. Sec. 1.367(a)-1T(c)(3)).
8. A transfer by a domestic trust or estate to a foreign corporation is considered a transfer to which section 367(a)(1) applies irrespective of whether the beneficiaries of the trust or estate are U.S. persons or foreign persons (Temp. Treas. Reg. Sec. 1.367(a)-1T(c)(4)(i)).
9. A transfer of a portion or all of the assets of a foreign or domestic trust by a grantor trust to a foreign corporation in an exchange described in section 367(a)(1) is considered a transfer by a U.S. person who is treated as owner of any such portion or all the assets of the trust (Temp. Treas. Reg. Sec. 1.367(a)-1T(c)(4)(ii)).

10. Section 367(a) applies to the constructive reorganization and transfer of property from a domestic corporation to a foreign corporation upon the termination of an election under section 1504(d). The election under section 1504(d) permits treatment of certain contiguous country corporations as domestic corporations (Temp. Treas. Reg. Sec. 1.367(a)-1T(c)(5)).
11. When a foreign entity is classified as an entity other than an association taxable as a corporation for U.S. tax purposes, and subsequently a change is made in the governing documents, articles, or agreements of the entity so that the entity is thereafter classified as an association taxable as a corporation, the change in classification is considered a transfer of property to a foreign corporation (Temp. Treas. Reg. Sec. 1.367(a)-1T(c)(6)).
12. Transfer of property as contributions of capital to a foreign corporation that the transferor controls is treated as an exchange to which section 367(a)(1) applies (Temp. Treas. Reg. Sec. 1.367 (a)-1T(c)(7)).

Exception for Transfers of Property for Use in the Active Conduct of a Trade or Business. Section 367(a)(1) does not apply to property transferred to a foreign corporation if the property is transferred for use by that corporation in the active conduct of a trade or business outside of the United States and the U.S. person transferring the property complies with the reporting requirements of section 6038B (Temp. Treas. Reg. Sec. 1.367(a)-2T(a)).

Property qualifies for the exception provided that four factual determinations are satisfied: (1) whether the activities of a foreign corporation constitute a trade or business, (2) whether a trade or business is actively conducted, (3) whether the foreign corporation conducts a trade or business outside of the United States, and (4) whether property is used or held for use in a trade or business (Temp. Treas. Reg. Sec. 1.367(a)-2T(b)(2) to (5)).

Property Transferred Not Subject to the Trade or Business Exception. Regardless of their use in an active trade or business, section 367(a)(1) applies to the transfer of—

1. Stock in trade or inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business (Temp. Treas. Reg. Sec. 1.367(a)-5T(b)(1)).
2. A copyright; a literary, musical, or artistic composition; or a letter, memorandum, or similar property held by a taxpayer whose personal

efforts created it or (in the case of a letter, memorandum, or similar property) a taxpayer for whom such property was prepared or produced. In the case of a copyright, letter, etc., described above, if a taxpayer must determine the basis of such property for determining gain from the sale or exchange by reference to the basis of such property in the hands of the taxpayer who created it or for whom such property was prepared, then the character of the property must be similarly determined (Temp. Treas. Reg. Sec. 1.367(a)-5T(b)(2)).

3. Installment obligations, accounts receivable, or similar property, but only to the extent that the principal amount of any such obligation has not previously been included by the taxpayer in its taxable income (Temp. Treas. Reg. Sec. 1.367(a)-5T(c)).
4. Foreign currency or other property denominated in foreign currency, including installment obligations, futures contracts, forward contracts, accounts receivable, or any other obligation entitling its payee to receive payment in a currency other than U.S. dollars (Temp. Treas. Reg. Sec. 1.367(a)-5T(d)(1)). If transferred property denominated in a foreign currency is denominated in the currency in which the transferee foreign corporation is organized and was acquired in the ordinary course of business of the transferor that will be carried on by the transferee foreign corporation, then gain recognized is limited to the net gains and losses realized on the transfer of the foreign currency-denominated assets (Temp. Treas. Reg. Sec. 1.367(a)-5T(d)(2) and (3)).
5. Intangible property, unless it constitutes foreign goodwill or going-concern value (Temp. Treas. Reg. Sec. 1.367(a)-5T(e)).
6. Tangible property with respect to which the transferor is a lessor at the time of the transfer unless the transferee was the lessee of the property at the time of the transfer and the property will not be leased to third persons, or if the transferee satisfies the active-trade-or-business requirements of Temp. Treas. Reg. Sec. 1.367(a)-4T(c)(1) or (2) in the case of property to be leased to third persons (Temp. Treas. Reg. Sec. 1.367(a)-5T(f)).

Transfer of Foreign Branch Assets With Previously Deducted Losses. In general, when a foreign branch with previously deducted losses transfers assets, such losses must be recaptured by the recognition of gain realized on the transfer. The term *foreign branch* means an integral business operation carried on by a U.S. person outside the United States. Evidence under the facts and circumstances whether a branch exists includes

(1) the existence of a separate set of books and records and (2) the existence of an office or other fixed place of business used by employees or officers of the U.S. person carrying out business activities outside the United States. If the activities constitute a permanent establishment under the terms of the income tax treaty between the United States and the country in which the activities are carried out, this activity will be considered a branch.

If the taxpayer has more than one branch, each branch transferred to a foreign corporation is treated separately. Previously deducted losses of one branch may not be offset against the gain required to be recognized under section 367(a) by income of another branch that is also transferred to a foreign corporation. Furthermore, losses of one branch are not recaptured upon the transfer of the assets of a separate branch. A branch is considered separate from another branch if a particular group of activities is sufficiently integrated to constitute a single business that could be operated as a separate enterprise.[2] The activities of each of two domestic corporations outside the United States will be considered to constitute a single foreign branch if (1) the two corporations are members of the same consolidated group of corporations and (2) the activities of the two corporations in the aggregate would constitute a single foreign branch if conducted by a single corporation. Upon the transfer of the two branches to a foreign corporation, gains arising in a year in which that corporation did not file a consolidated return with a second domestic corporation may be applied to reduce losses of the foreign branch of the first corporation, but not the previously deducted losses of a foreign branch of the second corporation. This is the case even if the two domestic corporations file a consolidated return for the year in which the transfer occurs and the two branches are considered at that time to constitute a single foreign branch (Temp. Treas. Reg. Sec. 1.367(a)-6T(g)(3)).[3]

It is not relevant to the determination of the previously deducted losses of the branch subject to recapture if property of a foreign branch is not transferred.. If the activities with respect to untransferred property constitute part of the branch operations, the losses generated by those activities are subject to recapture (Temp. Treas. Reg. Sec. 1.367(a)-6T(g)(4)).[4]

[2]See Rev. Rul. 81-82, 1981-1 C.B. 127.

[3]See Rev. Rul. 81-89, 1981-1 C.B. 129.

[4]See Rev. Rul. 80-247, 1980-2 C.B. 129, for the treatment when property was abandoned by the taxpayer.

If a U.S. person transfers property of a foreign branch to a domestic corporation for the principal purpose of avoiding the recognition of gain, and the domestic corporation and later transfers the property of the foreign branch to a foreign corporation, then the steps in these transactions will be ignored and the U.S. person will be deemed to have transferred the property directly to the foreign corporation. A principal purpose (rebuttable) to avoid tax is deemed to exist if the property is transferred to the domestic corporation less than two years prior to the domestic corporation's transfer of the property to the foreign corporation (Temp. Treas. Reg. Sec. 1.367(a)-6T(h)).

Losses Must Be Recaptured if Gain Is Realized on the Transfer. Regardless of whether the assets of the foreign branch are transferred for use in the active conduct of trade or business outside the United States, if a U.S. person transfers any assets of a foreign branch to a foreign corporation in a section 367(a)(1) exchange, gain must be recognized equal to the sum of the previously deducted branch ordinary losses (as adjusted) and the sum of the previously deducted branch capital losses (as adjusted).

Character of, and Limitations on, Gain Required to Be Recognized. On the transfer of property to which section 367(a)(1) applies, the amount of gain recognized will not exceed the gain that would have been recognized on a taxable sale of those items of property if sold individually but without offsetting individual losses against individual gains. No losses are recognized under section 367. If section 367 requires recognition of gain in excess of the gain on the individual assets (because of branch loss recapture), the limitation is imposed by making proportionate reductions in the amount of ordinary income and capital gain, regardless of the character of the gain that would have been recognized on a taxable sale of the property. In addition, gain realized on the transfer of foreign goodwill and going-concern value related to the business of the foreign branch, and intangible property that is an asset of the foreign branch, is taken into account in computing the limitation on loss recapture (Temp. Treas. Reg. Sec. 1.367(a)-6T(c)).

Previously Deducted Losses. The previously deducted branch ordinary losses for each branch are the total ordinary loss and the total capital loss that were realized by the branch in that taxable year prior to the transfer and that were reflected on the U.S. income tax return of the transferor. The previously deducted ordinary loss for each branch loss year is reduced by expired net ordinary loss. The previously deducted capital loss for each

loss year is reduced by expired net capital losses. For each branch loss year, the remaining previously deducted branch ordinary loss and the remaining previously deducted capital loss are then reduced, on a LIFO basis, to reflect expired foreign tax credits and investment tax credits (Temp. Treas. Reg. Sec. 1.367(a)-6T(d)(1)).

An expired net ordinary loss exists to the extent that (1) the transferor incurred a net operating loss that was available for carryback to the branch loss year that has neither given rise to a net operating loss deduction for any taxable year of the transfer nor given rise to a reduction of any previously deducted branch ordinary loss of any foreign branch of the transferor upon a previous transfer to a foreign corporation and (2) the period during which the transferor may claim the net operating loss deduction for that net operating loss has expired (Temp. Treas. Reg. Sec. 1.367(a)-6T(d)(2)). Expired net capital losses arising in years other than the branch loss year reduce the previously deducted branch capital loss for the branch loss year only to the extent that the previously deducted branch capital loss exceeds the net capital loss, if any, incurred by the transferor in the branch loss year on a LIFO basis (Temp. Treas. Reg. Sec. 1.367(a)-6T(d)(3)). For each branch loss year, expired foreign tax credit loss equivalents are applied to reduce the previously deducted branch loss for that year in the order in which the expired foreign tax credits arose. A foreign tax credit loss equivalent exists with respect to a branch loss year if (1) the transferor paid, accrued, or is deemed under section 902 or 960 to have paid creditable foreign taxes in a taxable year; (2) the creditable foreign taxes were paid, accrued, or deemed paid in the branch loss year or were available for carryover to the branch loss year; (3) the credits, which are expired, could not be taken at the time they arose because of a foreign tax credit limitation; and (4) the taxes have not given rise to a reduction of any previously deducted branch loss of the foreign branch for a prior taxable year or of any previously deducted branch losses of any foreign branch of the transferor upon a prior transfer to a foreign corporation (see Temp. Treas. Reg. Sec. 1.367(a)-6T(f)(i) for a comprehensive example of these principles). See Temp. Treas. Reg. Sec. 1.367(a)-6T(d)(5) for the treatment of expired investment credit loss equivalents.

There are five amounts that reduce the sum of the previously deducted branch ordinary and capital losses before recognition of gain is required because of previously deducted branch losses: (1) taxable income of the foreign branch recognized through the close of the taxable year of the transfer, (2) amounts recaptured under section 904(f)(3) on account of the transfer, (3) gain recognized under section 367(a), (4) amounts

previously recaptured under section 904(f)(3), and (5) amounts previously recognized under section 367.

Example 15.5. X, a U.S. corporation, is a calendar year taxpayer. On January 1, 1994, X established a branch in foreign country A to manufacture and sell X's products in country A. On July 1, 1999, X organized corporation Y, a country A subsidiary, and transferred to Y all of the assets of its country A branch, including goodwill and going concern value. During the period from January 1, 1994, through July 1, 1999, X's country A branch earned income and incurred losses in the following amounts:

Country A Branch

Year	*Ordinary Income (Loss)*	*Capital Gain (Loss)*
1994	(200)	0
1995	(300)	(100)
1996	(400)	0
1997	200	0
1998	(100)	0
1999	50	0

At the time of the transfer of X's country A branch assets to Y, those assets had a fair market value of $2,500 and an adjusted basis of $1,000. For each of the assets, fair market value exceeded adjusted basis. X had no net capital loss or unused investment credit during any taxable year of the transfer. In 1996, X incurred a net operating loss of $400, $200 of which was carried back to prior years. An additional $50 of the 1996 net operating loss was carried over to 1997. The remaining $150 of the 1996 net operating loss was not used in any year prior to the transfer. In 1992, X paid creditable foreign taxes of $330 that could not be claimed as a credit in that year or any earlier year because of section 904. Of those foreign taxes, $100 were carried over and claimed as a credit in 1997, but the remaining $230 were not used in any year prior to the transfer. X was not required to recognize any gain under section 904(f)(3) on account of the 1999 transfer or any prior transfer. X was not required to recognize gain upon the transfer under section 367(a).

The previously deducted losses of X's country A branch are $576 of ordinary losses and $100 of capital losses, computed as follows. Initially, the branch has previously deducted ordinary losses of $1,000 ($200 + $300 + $400 + $100), and previously deducted capital losses of $100.

There are no reductions for expired net ordinary losses or expired net capital losses. However, the previously deducted losses are reduced proceeding from the first branch loss year to the last branch loss year to

reflect the expired foreign tax credit from 1992. The amount of the foreign tax credit loss equivalent with respect to 1994 is $676 ($230/0.34). It reduces the previously deducted losses for 1994 from $200 to $0, for 1995 ordinary loss of $300 to $0 and capital loss from $100 to $0, and for 1996 from $400 to $324 (based on Temp. Treas. Reg. Sec. 1.367(a)-6T(e)(b), example).

Transfers of Stock or Securities to Foreign Corporations

The transfer of stock or securities by a U.S. person to a foreign corporation in an exchange described in sections 351, 354, 356 or section 361(a) or (b) is subject to section 367 and in general is treated as a taxable exchange. Certain foreign reorganizations described in section 354 are not transfers to a foreign corporation subject to section 367(a) (Treas. Reg. 1.367(a)-3(a)).

Transfers by U.S. Persons of Stock or Securities of Foreign Corporations to Foreign Corporations. Except for certain section 361 transactions described in section 367(a)(5), a transfer of stock or securities of a foreign corporation by a U.S. person to a foreign corporation is not subject to section 367(a)(1) if either the following is present. A U.S. person owns less than 5 percent of both the total voting power and total value of the stock of the transferee foreign corporation immediately after the transfer or the U.S. person enters into a five-year gain recognition agreement (see Treas. Reg. 1.367(a)-8) with respect to the transferred stock or securities (Treas. Reg. Sec. 1.367(a)-3(b)).

Transfers by U.S. Persons of Stock or Securities of Domestic Corporations to Foreign Corporations. Except for certain transactions described in section 367(a)(5), a transfer of stock or securities of a domestic corporation by a U.S. person to a foreign corporation is not subject to section 367(a)(1) if the domestic corporation (the U.S. target company) complies with the reporting requirements and if each of the following four conditions is met.

1. If the amount of stock received does not exceed the 50-percent ownership threshold;
2. If there is no control group after the transfer, that is, 50 percent or less of each of the total voting power and the total value of the stock of the transferee foreign corporation is owned, in the aggregate, by U.S.

persons that are either officers or directors of the U.S. target company or that are 5-percent target shareholders immediately after the transfer;

3. Either the U.S. person is not a 5-percent transferee shareholder or the U.S. person is a five-percent transferee shareholder and enters into a five-year agreement to recognize gain with respect to the U.S. target company stock or securities it exchanged in the proper form (see Treas. Reg. Sec. 1.367(a)(8); and
4. The active trade or business test (see Treas. Reg. Sec. 1.367(a)-3(c)(3)) is satisfied (Treas. Reg. Sec. 1.367(a)-3(c)).

Indirect Stock Transfers in Certain Nonrecognition Transfers. A U.S. person who exchanges, under section 354 (or section 356), stock or securities in a domestic or foreign corporation for stock or securities in a foreign corporation in connection with certain transactions described subsequently are treated as having made an indirect transfer of such stock or securities to a foreign corporation that is subject to section 367 (Treas. Reg. Sec. 1.367(a)-3(d)).

1. A U.S. person exchanges stock or securities of a corporation (the acquired corporation) for stock or securities of a foreign corporation that controls the acquiring corporation in a triangular "A" reorganization.

Example 15.6. F, a foreign corporation, owns all the stock of Newco, a domestic corporation. A, a domestic corporation, owns all of the stock of W, also a domestic corporation. A and W file a consolidated federal income tax return. A does not own any stock in F. In a triangular "A" reorganization, Newco acquires all of the assets of W, and A receives 40 percent of the stock of F in an exchange described in section 354. The reorganization is subject to the indirect stock transfer rules. F is treated as the transferee foreign corporation, and Newco is treated as the transferred corporation. Provided that the requirements explained above are satisfied, including the requirement that A enter into a five-year gain recognition agreement as described in Treas. Reg. Sec. 1.367(a)-8, A's exchange of W stock for F stock under section 354 will not be subject to section 367(a)(1). If F disposes of all (or a portion) of Newco's stock within the five-year term of the agreement (and A has not made a valid election to include the required amount in the year of the triggering event) (see Treas. Reg. Sec. 1.367(a)-8(b)(1)(vii)), A is required to file an amended return for the year of the transfer and include in income, with interest, the gain realized but not recognized on the initial section 354 exchange. If A has made a valid election under Treas. Reg.

Sec.1.367(a)-8(b)(1)(vii) to include the amount subject to the gain recognition agreement in the year of the triggering event, A would instead include the gain on its tax return for the taxable year that includes the triggering event, together with interest (based on Treas. Reg. Sec. 1.367(a)-3(d)(3), example 1).

2. A U.S. person exchanges stock or securities of a corporation (the acquiring corporation) for stock or securities in a foreign corporation that controls the acquired corporation in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E) (a reverse triangular "A" reorganization).
3. A U.S. person exchanges stock of the acquired corporation for voting stock of a foreign corporation that is in control of the acquiring corporation in connection with a reorganization described in section 368(a)(1)(B) (a "B" reorganization).

Example 15.7. F, a foreign corporation, owns all the stock of S, a domestic corporation. U, a domestic corporation, owns all of the stock of Y, also a domestic corporation. U does not own any of the stock of F. In a triangular "B" reorganization, S acquires all the stock of Y, and U receives 10 percent of the voting stock of F. U's exchange of Y stock for F stock will not be subject to section 367(a)(1) including the requirement that U enter into a five-year gain recognition agreement. F is treated as the transferee foreign corporation and Y is treated as the transferred corporation. The gain recognition agreement would be triggered if F sold all or a portion of the stock of S, or if S sold all or a portion of the stock of Y (based on Treas. Reg. Sec. 1.367(a)-3(d)(3), example 4).

4. A U.S. person exchanges stock or securities of a corporation (the acquired corporation) for voting stock or securities of a foreign corporation that controls the acquiring corporation in a reorganization described in a triangular "C" reorganization.

Example 15.8. F, a foreign corporation, owns all of the stock of R, a domestic corporation that operates an historical business. V, a domestic corporation, owns all of the stock of Z, also a domestic corporation. V does not own any of the stock of F. In a triangular "C" reorganization, R acquires all of the assets of Z, and V receives 30 percent of the voting stock of F. The consequences of the transfer are similar to those described in example 15.6. V is required to enter into a five-year gain recognition agreement under Treas. Reg. Sec. 1.367(a)-8 to secure nonrecognition treatment under section 367(a). F is treated as the transferee foreign corporation and R is treated as the transferred corporation (based on Treas. Reg. Sec. 1.367(a)-3(d)(3), example 5).

5. A U.S. person exchanges stock or securities of a corporation (the acquired corporation) for voting stock or securities of a foreign acquiring corporation in a "C" or triangular "C" reorganization.
6. A U.S. person transfers property (other than stock or securities) to a foreign corporation in a section 351 exchange, and all or a portion of such assets transferred to the foreign corporation by such person are, in connection with the same transaction, transferred to a second corporation that is controlled by the foreign corporation in one or more section 351 exchanges.

Example 15.9. D, a domestic corporation, owns all the stock of X, a controlled foreign corporation that operates an historical business, which owns all the stock of Y, a controlled foreign corporation that also operates an historical business. The properties of D consist of Business A assets, with an adjusted basis of $50 and a fair market value of $90, and Business B assets, with an adjusted basis of $50 and a fair market value of $110. Assume that the Business B assets qualify as property used in the active conduct of a trade or business, but that the Business A assets do not so qualify. In a section 351 exchange, D transfers the assets of Businesses A and B to X, and, in connection with the same transaction, X transfers the assets of Business B to Y in another exchange described in section 351.

This transaction is treated as an indirect stock transfer for purposes of section 367(a), but the transaction is not recharacterized for purposes of section 367(b). The assets of Businesses A and B that are transferred to X must be tested under the exception for transfers of property used in the active conduct of trade or business. The Business A assets, which were not transferred to Y, are subject to the general rules of section 367(a), and not the indirect stock transfer rules. D must recognize $40 of income on the outbound transfer of Business A assets. The transfer of the Business B assets is subject to both the asset transfer rules and the indirect stock transfer rules. Thus, D's transfer of the Business B assets will not be subject to section 367(a)(1) if D enters into a five-year gain recognition agreement with respect to the stock of Y. X will be treated as the transferee foreign corporation and Y will be treated as the transferred corporation for purposes of applying the terms of the agreement. If X sells all or a portion of the stock of Y during the term of the agreement, D will be required to recognize a proportionate amount of the $60 gain that was realized by D on the initial transfer of the Business B assets. (based on Treas. Reg. Sec. 1.367(a)-3(d)(3), example 10)

Rules Applicable to Specified Transfers of Property

There are rules for determining the applicability of section 367(a)(1) to specified transfers of property. There are rules requiring the recapture of depreciation upon the transfer abroad of property previously used in the

United States and rules for determining whether certain types of property are transferred for use in the active conduct of a trade or business outside of the United States and to FSCs (Temp. Treas. Reg. Sec. 1.367(a)-4T(a)).

A U.S. person transferring U.S. depreciated property to a foreign corporation in a section 367(a) exchange must include in gross income for the taxable year in which the transfer occurs ordinary income equal to the recapture amount that would be recognized had the property been sold at its fair market value. *U.S. depreciated property* subject to these rules is any property that is either mining property, section 1245 property, section 1250 property, farm land, or oil, gas, or geothermal property; and has been used in the United States or has qualified as section 38 property prior to its transfer (Temp. Treas. Reg. Sec. 1.367(a)-4T(b)).

If U.S. depreciated property has been used partly within and partly without the United States, then the amount required to be included in ordinary income is reduced to an amount determined from the following formula:

$$\text{Amount required to be included in ordinary income} = \text{Full recapture amount} \times \frac{\text{U.S. use}}{\text{Total use}}$$

U.S. use is the number of months that the property either was used within the United States or qualified as section 38 property and was subject to depreciation by the transferor or a related person. *Total use* is the total number of months that the property was used (or available for use), and subject to depreciation, by the transferor or a related person (Temp. Treas. Reg. Sec. 1.367(a)-4T(b)(3)).

Tangible property transferred to a foreign corporation that will be leased to other persons by the foreign corporation must be considered to be transferred for use in the active conduct of a trade or business outside of the United States only if the following are satisfied:

1. If the transferee's leasing of the property constitutes the active conduct of a leasing business;
2. The lessee of the property is not expected to, and does not, use the property in the United States; and
3. The transferee has need for substantial investment in assets of the type transferred.

The active conduct of a leasing business requires that the employees of the foreign corporation perform substantial marketing, customer service, repair and maintenance, and other substantial operational activities with

respect to the transferred property outside of the United States. Tangible property subject to these rules includes real property located outside of the United States (Temp. Treas. Reg. Sec. 1.367(a)-4T(c)(1)).

Tangible property transferred to a foreign corporation that will be leased to other persons by the foreign corporation and that otherwise does not satisfy the conditions above will be considered to be transferred for use in the active conduct of a trade or business if either—

1. The property transferred will be used by the transferee foreign corporation in the active conduct of a trade or business but will be leased during occasional brief periods when the property would otherwise be idle, such as an airplane leased during periods of excess capacity; or
2. The property transferred is real property located outside the United States and the property will be used primarily in the active conduct of a trade or business of the transferee foreign corporation and not more than ten percent of the square footage of the property will be leased to others (Temp. Treas. Reg. Sec. 1.367(a)-4T(c)(2)).

Property will not be considered to be transferred for use in the active conduct of a trade or business and a transfer of stock or securities will not be excepted from recognition treatment under section 367(a)(1) if, at the time of the transfer, it is reasonable to believe that, in the reasonably foreseeable future, the transferee will sell or otherwise dispose of any material portion of the transferred stock, securities, or other property other than in the ordinary course of business (Temp. Treas. Reg. Sec. 1.367(a)-4T(d)).

Property is presumed to be transferred for use in the active conduct of a trade or business outside of the United States, if the property was previously in use in the country in which the transferee foreign corporation is organized and the transfer is either legally required by the foreign government as a necessary condition of doing business in that country or compelled by a genuine threat of immediate expropriation by the foreign government (Temp. Treas. Reg. Sec. 1.367(a)-4T(f)).

Transfers of Certain Property to FSCs. The general provisions of section 367(a) and (d) and the underlying regulations do not apply to a transfer of property by a U.S. person to a foreign corporation that constitutes an FSC, if—

1. The transferee FSC uses the property to generate exempt foreign trade income;

2. The property is not excluded property; and
3. The property consists of a corporate name or tangible property that is appropriate for use in the operation of an FSC office.

This general rule will not apply if, within three years after the original transfer, the original transferee FSC (or a subsequent transferee FSC) disposes of the property other than in the ordinary course of business or through a transfer to another FSC. The U.S. transferor may recognize gain in the taxable year in which the original transfer occurred through the application of section 367 (Temp. Treas. Reg. Sec. 1.367(a)-4T(h)).

Agreement to Recognize Gain

A transferor's agreement to recognize gain must be attached to, and filed by the due date (including extensions) of, the transferor's income tax return for the taxable year that includes the date of the transfer. The agreement to recognize gain must be signed under penalties of perjury by a responsible party. The agreement must set forth the following information, with the heading "Gain Recognition Agreement Under Section 1.367(a)-8," and with the following information:

1. A statement that the document submitted constitutes the transferor's agreement to recognize gain;
2. A description of the property transferred;
3. The transferor's agreement to recognize gain;
4. A waiver of the period of limitations;
5. An agreement to file with the transferor's tax returns for the five full taxable years following the year of the transfer a certification;
6. A statement that arrangements have been made in connection with the transferred property to ensure that the transferor will be informed of any subsequent disposition of any property that would require the recognition of gain under the agreement; and
7. A statement as to whether, in the event all or a portion of the gain recognition agreement is triggered, the taxpayer elects to include the required amount in the year of the triggering event rather than in the year of the initial transfer. If the taxpayer elects to include the required amount in the year of the triggering event, the statement must be included with all of the other information required, and filed by the due date (including extensions) of the transferor's income tax return for the taxable year that includes the date of the transfer.

If a U.S. transferor is required to recognize gain on the disposition by the transferee foreign corporation of the transferred property, then in determining for U.S. income tax purposes any gain or loss recognized by the transferee foreign corporation upon its disposition of the property, the transferee foreign corporation's basis in such property must be increased (as of the date of the initial transfer) by the amount of gain required to be recognized by the U.S. transferor. In the case of a deemed disposition of the stock of the transferred corporation, the transferee foreign corporation's basis in the transferred stock deemed disposed of must be increased by the amount of gain required to be recognized by the U.S. transferor. If a U.S. transferor is required to recognize gain, then the U.S. transferor's basis in the stock of the transferee foreign corporation is increased by the amount of gain required to be recognized.

The U.S. transferor must file with its income tax return for each of the five full taxable years following the taxable year of the transfer a certification that the property transferred has not been disposed of by the transferee in a transaction that is considered to be a disposition. The U.S. transferor must include with its annual certification a statement describing any taxable dispositions of assets by the transferred corporation that are not in the ordinary course of business. The annual certification must be signed under penalties of perjury by a person who would be authorized to sign the agreement.

Other Transfers

Section 367(b) provides that in the case of any exchange described in sections 332, 351, 354, 355, 356, or 361 that is not an outbound transaction, a foreign corporation will be considered a corporation except to the extent provided in the regulations. These transactions fall into three principal categories: liquidations, reorganizations, and section 1504(d) elections. The liquidation transactions include a foreign corporation liquidated into a domestic parent and a foreign corporation liquidated into a foreign parent. There are numerous forms of qualifying reorganizations, the tax consequences of which turn on the identity of the exchanging shareholder (U.S. or foreign) and the character of the stock received (U.S. corporation, CFC, or a foreign corporation that is not a CFC). An election by a domestic corporation under section 1504(d) to treat a corporation organized under the laws of a contiguous foreign corporation as a domestic corporation is considered a section 367(b) transfer.

A person who is required by section 6012 to file an income tax return and who realized gain or other income for an exchange to which section 367(b) applies must file a notice of the exchange on or before the last day for filing a federal income tax return (including extensions) for the taxable year in which the gain or other income is realized. The notice must be filed with the appropriate district director. The information required in the notice is described in Temp. Treas. Reg. Sec. 7.367(b)-1(c)(2).

Earnings and Profits

Among the items of information required to be filed with the notice to the appropriate district director is a statement that describes any amount of earnings and profits attributable to stock owned by any U.S. person; and any corporation whose earnings and profits are required to be adjusted must keep records adequate to establish the adjustment. The following breakdown of the earnings and profits account may be necessary.

Section 1246 Amount. In the case of an exchange of stock in a foreign investment company, the term *section 1246* amount means the earnings and profits of the foreign investment company that would have been attributable under section 1246 to the stock exchanged if the stock had been sold in a transaction to which section 1246 applied (Temp. Treas. Reg. Sec. 7.367(b)-2(c)).

Section 1248 Amount. The term *section 1248* amount with respect to stock in a foreign corporation means the net positive earnings and profits (if any) that would have been attributable to such stock and includable in income as a dividend under section 1248 and the regulations under that section if the stock were sold by the shareholder (Treas. Reg. Sec. 1.367(b)-2(d)).

Section 1248(c)(2) Amount. In the case of an exchange of stock in a lower-tier foreign corporation to which section 367(b) applies and that is made by another foreign corporation, the term *section 1248(c)(2)* amount means the earnings and profits or deficits in earnings and profits attributable under section 1248(c)(2) to the stock of the foreign corporation exchanged (Temp. Treas. Reg. Sec. 7.367(b)-2(e)).

All Earnings and Profits Amount. The term *all earnings and profits amount* with respect to stock in a foreign corporation means the net positive earnings and profits (if any) and attributable to the stock. The all earn-

ings and profits amount must be determined without regard to the amount of gain that would be realized on a sale or exchange of the stock of the foreign corporation. The earnings and profits of a foreign corporation for any taxable year are determined according to principles substantially similar to those applicable to domestic corporations (Treas. Reg. Sec. 1.367(b)-2(f)).

Additional-Earnings-and-Profits Amount. The term *additional-earnings-and-profits amount* means the earnings and profits, or deficits, for taxable years beginning before January 1, 1963 that are attributable under section 1248(d). The determination is made as if there was no distinction between earnings and profits accumulated before and after December 31, 1962 (Temp. Treas. Reg. Sec. 7.367(b)-2(g)).

Example 15.10. P, a domestic corporation, owns 100 percent of the stock of F1, a foreign corporation. F1 owns 80 percent of the stock of F2, a foreign corporation. F1 acquired a 60-percent interest in F2 when F2 was formed in 1960 and an additional 20 percent on January 1, 1972. The earnings and profits of F1 and F2 are as follows:

Earnings and Profits	*F1*	*F2*
Taxable years beginning before January 1, 1963	$ 60,000	$18,000
Taxable years beginning after December 31, 1963, but before January 1, 1972	140,000	29,000
Taxable years beginning after December 31, 1971	$115,000	$36,000

The section 1248 amount, the all-earnings-and-profits amount, and the additional-earnings-and-profits amount are as follows:

	F1	*F2*
Section 1248 amount	$301,200[1]	N/A
Section 1248(c)(2) amount	N/A	$46,200[2]
All-earnings-and-profits amount	315,000[3]	57,000[4]
Additional-earnings-and-profits amount	60,000	10,800[5]

[1]$140,000 + $115,000 + (60% × $29,000) + (80% × $36,000) = $301,200
[2](60% × $29,000) + (80% × $36,000) = $46,200
[3]$60,000 + $140,000 + $115,000 = $315,000
[4](60% × $18,000) + (60% × $29,000) + (80% × $36,000) = $57,000
[5](60% × $18,000) = $10,800

Complete Liquidation of a Foreign Corporation

Liquidation Into a Foreign Parent Corporation. When a foreign subsidiary is liquidated into a foreign parent corporation, the regulations provide for

no immediate tax liability and the foreign transferee corporation will be treated as a corporation for purposes of section 332 (Temp. Treas. Reg. Sec. 7.367(b)-5(c)).

Example 15.11. F, F1, and F2 are foreign corporations that were organized on January 1, 1960. At all times since this date, A, a domestic corporation, has owned 100 percent of the outstanding stock in F, F has owned 100 percent of the outstanding stock in F1, and F1 has owned 100 percent of the outstanding stock in F2. For each taxable year since organization, F, F1, and F2 each has earnings and profits of $1,000. On January 1, 1999, F1 is liquidated into F in a section 332 exchange. Under section 381(a)(1) F succeeds to F1's earnings and profits of $34,000. These earnings and profits retain their character as pre-1963 ($3,000) and post-1962 ($31,000) earnings and profits. F's basis in the stock in F2 and other assets received in the liquidating distribution is determined under section 334(b)(1) (based on Temp. Treas. Reg. Sec. 7.367(b)(13), example (1)).

Liquidation Into a Domestic Parent Corporation. When a foreign corporation is liquidated into a domestic parent corporation, the regulations require the domestic parent corporation to include in gross income its pro rata share of the all-earnings-and-profits amount attributable to its ownership of the stock in the foreign corporation (Temp. Treas. Reg. Sec. 7.367(b)-5(b)). In this case the foreign tax credit provisions will be applied as if the earnings and profits were distributed as a dividend by the foreign corporation to the domestic parent corporation immediately before the liquidation (Temp. Treas. Reg. Sec. 7.367(b)-3(f)). Under Temp. Treas. Reg. Sec. 7.367(b)-3(d), a domestic corporate taxpayer may elect to have earnings and profits that were accumulated while the CFC was a less-developed-country corporation (LDCC) taxed as a capital gain instead of as dividend income, which could result in a reduced tax liability when the effective foreign tax rate on the earnings and profits is low. Otherwise, the domestic corporate shareholder must include in gross income the all-earnings-and-profits amount without the benefit of the section 1248(d)(3) exclusion (Temp. Treas. Reg. Sec. 7.367(b)-3(d)).

Example 15.12. Using the facts from example 15.11, assume that on January 1, 1999, F is liquidated into A in a section 332 exchange. F has earnings and profits in the tax year 1999 of $1,000 and F's basis in its assets is $50,000. The all-earnings-and-profits amount of A with respect to F is $69,000. This amount includes $34,000 of the earnings and profits of F1 to which F succeeded under section 381(a)(1) and the $35,000 actually accumulated during the taxable years of F. It does not include the $35,000 of earnings and

profits of F2. A includes in gross income as a dividend for 1999 the all-earnings-and-profits amount of $69,000 (Based on Temp. Treas. Reg. Sec. 7.367(b)-13, example (2)(b)).

Reorganizations

Another section 367(b) exchange occurs if the exchange is described in section 354 or 356 and is a "B," "C," "D," "E," "F," or "G" reorganization and the exchanging shareholder is either a U.S. shareholder or a foreign corporation having a U.S. shareholder who is also a U.S. shareholder of the corporation whose stock is exchanged.

If an exchanging shareholder receives stock of a domestic corporation, stock of a foreign corporation that is not a CFC, or stock of a CFC as to which the exchanging U.S. shareholder is not a U.S. shareholder, then the exchanging U.S. shareholder must include in income the section 1248 amount attributable to the stock exchanged or the post-1962 lower-tier earnings and pre-1963 earnings and profits are added to the earnings and profits of the exchanging foreign parent corporation computed as if all the stock of the corporation whose stock is exchanged is owned by a U.S. shareholder (Treas. Reg. Sec. 1.367(b)-7(c)). If the stock received is of the type above, then the foreign corporation whose stock is received will be considered a foreign corporation for purposes of section 354 or 356. The amount added to (or deducted from) earnings and profits of the exchanging foreign corporation increases (or decreases) the basis of stock received by the exchanging shareholder. Any increase in basis attributable to the section 1248(c)(2) amount may be made only if all U.S. shareholders agree to treat that amount as a consent dividend (Temp. Treas. Reg. Sec. 7.367(b)-7(c)(1)(iv)).

Example 15.13. A U.S. parent corporation (USP) owns all of the stock of a foreign corporation (CFC1), which in turn owns all of the stock of a second foreign corporation (CFC2), which in turn owns all of the stock of a third foreign corporation (CFC3). USP also owns all of the stock of a U.S. subsidiary (Subsidiary). CFC2 and CFC3 have accumulated earnings and profits or accumulated deficits in earnings and profits. Subsidiary acquires all of the stock of CFC2 from CFC1 in exchange for stock of Subsidiary in a reorganization described in section 368(a)(1)(B). CFC1 will not recognize gain on the exchange. Moreover, CFC2's and CFC3's accumulated earnings and profits or accumulated deficits in earnings and profits will remain in CFC2 and CFC3, respectively, and will not be added to the earnings and profits or deficits in earnings and profits of CFC1 (Treas. Reg. Sec. 1.367(b)-7, example (1)).

A U.S. person must include in gross income the all-earnings-and-profits amount if, pursuant to a "C," "D," or "F" reorganization, assets of a foreign corporation are acquired by a domestic corporation and the exchanging U.S. person is a domestic corporation that receives stock of a domestic corporation in exchange for its stock in the acquired corporation (Temp. Treas. Reg. Sec. 7.367(b)-7(c)(2)).

Temp. Treas. Reg. Sec. 7.367(b)-4 prescribes the treatment of certain exchanges described in more than one Code provision. It provides that the "B" reorganization provision overrides section 351 or 361 in an overlap situation where the exchanging U.S. person controls the foreign transferee corporation. If an exchange of stock in a foreign corporation through reorganization is described in both sections 354 and 1036, it will generally be treated under section 1036. An "F" reorganization is treated as an outbound transfer, and no ruling or toll charge is required.[5]

Conversion of a foreign corporation to a domestic corporation pursuant to a state domestication statute is treated as an "F" reorganization, and if the corporate shareholder of the foreign corporation is a U.S. shareholder, then under Prop. Treas. Reg. Sec. 1.367(b)-(3) it must include the all-earnings-and-profits amount in income as a dividend.

Earnings and Profits in a Section 351, 354, or 356 Exchange. If the transferor corporation transfers stock in a foreign corporation of which there is a U.S. shareholder and the transferor receives stock of a CFC and all U.S. shareholders remain U.S. shareholders, then the section 1248 amount, the section 1248(c)(2) amount, the all-earnings-and-profits amount, and the additional-earnings-and-profits amount must be computed for each U.S. shareholder and for each foreign corporation as to which there is a U.S. shareholder who exchanges stock in the transaction. The earnings and profits or deficits of the corporation whose stock is received are increased under the rules at Temp. Treas. Reg. Sec. 7.367(b)-9(c). The earnings and profits or deficits of the corporation whose stock is exchanged and of any lower-tier corporation whose earnings and profits are taken into account are reduced using the rules at Temp. Treas. Reg. Sec. 7.367(b)-9(d). Adjustments to basis of stock in lower-tier corporations whose stock is exchanged are also made under Temp. Treas. Reg. Sec. 7.367(b)-9(e).

[5]Based on the general rule of Temp. Treas. Reg. Sec. 7.367(b)-1(b).

Examples

Assets of a First-Tier or Lower-Tier Foreign Corporation Acquired in Exchange for Controlled Foreign Corporation Stock. If the assets of a first-tier or lower-tier foreign corporation are acquired in exchange for CFC stock and, immediately after the exchange, all U.S. shareholders of the acquired CFC are U.S. shareholders of the acquiring corporation, there is no current toll charge (Temp. Treas. Reg. Secs. 7.367(b)-13, example (5); 7.367(b)-7(b); and 7.367(b)-9(b)(1)). Instead, the section 1248 amount, the earnings and profits of subsidiaries, the all-earnings-and-profits amount, and the additional-earnings-and-profits amount are attributable to the CFC stock received by the exchanging shareholders (Temp. Treas. Reg. Sec. 7.367(b)-9(b)(1)). If an election is made, the basis of the stock of the acquiring CFC may be increased by the amount of earnings and profits attributed to such stock (Temp. Treas. Reg. Sec. 7.367(b)-9(e)).

> *Example 15.14.* F, F1, and F2 are foreign corporations that were organized on January 1, 1960. At all times since this date, A, a domestic corporation, has owned 60 percent of the outstanding stock in F and X, an unrelated foreign corporation, has owned the remaining 40 percent. F has owned 100 percent of the outstanding stock in F1 and F1 has owned 100 percent of the outstanding stock in F2. On January 1, 1999, foreign corporation Y acquired all the assets of F in a "C" reorganization and F is liquidated. After the exchange, Y is not a CFC. Since A is not a U.S. shareholder, A includes in income the section 1248 amount. No other gain is recognized by A. Y succeeds to the earnings and profits of F. A's basis in the Y stock received is the basis of stock in F plus the dividend amount recognized under section 1248 (Temp. Treas. Reg. Sec. 7.367(b)-13, example (5)(a)(ii)).

Stock of a Controlled Foreign Corporation Received. If an exchanging shareholder receives stock in a controlled foreign corporation in a "B," "C," or "D" reorganization and, immediately after the exchange, the exchanging shareholder is a U.S. shareholder of that CFC, or all of the U.S. shareholders of the exchanging foreign corporate shareholder are U.S. shareholders of that CFC, then the section 1248 amount, the section 1248(c)(2) amount, the all-earnings-and-profits amount, and the additional-earnings-and-profits amount of the acquired corporation are attributed to the CFC stock received by the exchanging shareholders. In addition, earnings and profits or deficits of the corporation whose stock is received in the exchange must be increased as required by Temp. Treas. Reg. Sec. 7.367(b)-9(c).

Other Stock Received. If an exchanging shareholder receives stock of a domestic corporation, or stock of a foreign corporation which is not a CFC, or stock of a CFC as to which the exchanging U.S. shareholders or any U.S. shareholder of the exchanging foreign corporation is not a U.S. shareholder, then the exchanging U.S. shareholder must include in gross income the section 1248 amount attributable to the stock exchanged, to the extent that the fair market value of the stock exchanged exceeds its adjusted basis. There must be added to the earnings and profits or deficits of the exchanging foreign corporation, the section 1248(c)(2) amount and the additional-earnings-and-profits amount of the exchanging foreign corporation, computed as if all the stock of the corporation whose stock is exchanged is owned by a U.S. shareholder. The amount added is not considered a dividend (Temp. Treas. Reg. Sec. 7.367(b)-7(c) and Treas. Reg. Sec. 1.367(b)-7(c)(1)).

If all the U.S. shareholders of the acquired foreign corporation make a consent dividend election, the increase in post-1962 earnings and profits can be treated as a taxable dividend with a corresponding increase in basis of the shares owned (Temp. Treas. Reg. Sec. 7.367(b)-7(c)(iv)).

> *Example 15.15.* A, a domestic corporation, owns 100 percent of the outstanding stock in F, a foreign corporation. F owns all of the outstanding stock in F1, a foreign corporation. Y, an unrelated foreign corporation exchanges 40 percent of its voting stock with F1 in exchange for all of its assets in a "C" reorganization. The stock of Y is distributed to F upon the liquidation of F1. Y is not a CFC after the exchange. Since Y is not a CFC, an addition must be made to F's earnings and profits of F1's section 1248(c)(2) amount and the additional-earnings-and-profits amount. A may increase its basis in the F stock if F recognizes F1's earnings-and-profits increase as a dividend.

Exchange of Stock by Certain Domestic Corporations. A U.S. person must include in gross income the all-earnings-and-profits amount if assets of a foreign corporation are acquired by a domestic corporation in a C, D, or F reorganization, the exchanging U.S. person is a domestic corporation, and this U.S. person receives stock of a domestic corporation in exchange for its stock in the acquired corporation (Temp. Treas. Reg. Sec. 7.367(b)-7(c)(2)).

Stock of a First-Tier or Lower-Tier Foreign Corporation Acquired in Exchange for Controlled Foreign Corporation Stock. If stock of a first-tier or lower-tier foreign corporation is acquired in exchange for stock of a

CFC, and immediately after the exchange all U.S. shareholders (direct and indirect) of the acquired foreign corporation become U.S. shareholders of the acquiring corporation, there is no current toll charge (Temp. Treas. Reg. Sec. 7.367(b)-7(b)). However, the section 1248 amount, the section 1248(c)(2) amount, the all-earnings-and-profits amount, and the additional-earnings-and-profits amount of the acquired corporation are attributed to the CFC stock received by the exchanging shareholders (Temp. Treas. Reg. Sec. 7.367(b)-9(b)(1)). These rules do not apply if a U.S. shareholder owns more than 50 percent of the total voting power or value of the stock of both the corporation whose stock is received in the exchange and the corporation whose stock is exchanged (Temp. Treas. Reg. Sec. 7.367(b)-9(b)(4)).

Example 15.16. A U.S. parent corporation owns all of the stock of CFC1 and CFC2. CFC1 has accumulated earnings and profits. CFC2 acquires all of the stock of CFC1 from the U.S. parent corporation in a "B" reorganization. CFC2 will not succeed to the earnings and profits (or deficit) of CFC1 (Treas. Reg. Sec. 1.367(b)-9, example (1)).

Corresponding adjustments are made to the CFC's earnings and profits, the earnings and profits of the acquired foreign corporation and its lower-tier subsidiaries, the stock basis of the lower-tier subsidiaries of the acquired foreign corporation, and the stock basis of lower-tier subsidiaries of the CFC (Temp. Treas. Reg. Sec. 7.367(b)-9(e)).

Example 15.17. F, F1, and F2 are foreign corporations that were organized on January 1, 1975. At all times since this date, A, a domestic corporation, has owned 100 percent of the outstanding stock in F; F has owned 90 percent of the outstanding stock in F1; X, an unrelated foreign corporation, has owned 10 percent of the outstanding stock in F1; and F1 has owned 100 percent of the outstanding stock in F2. For each taxable year since their date of organization, F, F1, and F2 have earnings and profits of $1,000. On January 1, 1999, F exchanges in a "B" reorganization all of its stock in F1 for 20 percent of the voting stock in Y. X retains its stock in F1. Because of other U.S. shareholders in Y, Y is a CFC after the exchange. A's section 1248(c)(2) amount from F1 and F2 is attributable to the Y stock received in the exchange (Temp. Treas. Reg. Sec. 7.367(b)-9(b)(1)). The earnings and profits of Y are increased by 90 percent of the earnings and profits of F1 and F2 while the earnings and profits of F1 and F2 are reduced by a like amount. An optional consent dividend that would provide an increase in the basis under Temp. Treas. Reg. Sec. 7.367(b)-9(e) could be made by all U.S. shareholders (Temp. Treas. Reg. Sec. 7.367(b)-13, example (10)).

Transfers of Assets by a Foreign Corporation in a Section 351 Exchange. Section 367(b) applies to a transfer of property in a section 351 exchange, regardless of whether the transaction is described in section 361, if a foreign corporation transfers property and, in the case of a transfer also described in section 361, the transferor remains in existence immediately after the transaction. Carryover of earnings and profits described in section 381(c)(2) will not apply (Temp. Treas. Reg. Sec. 7.367(b)-8(b)).

If the transferor corporation transfers stock in a foreign corporation of which there is a U.S. shareholder immediately before the exchange and the transferor receives stock of a CFC of which all U.S. shareholders of the transferor corporation remain U.S. shareholders, then the section 1248 amount, the section 1248(c)(2) amount, the all-earnings-and-profits amount, and the additional-earnings-and-profits amount must be computed with respect to each U.S. shareholder and to each foreign corporation in which there is a U.S. shareholder who exchanges stock in the transaction. The earnings and profits or deficits of the corporation whose stock is received in the exchange are increased, and the earnings and profits or deficits of the corporation whose stock is exchanged and of any lower-tier corporation whose earnings and profits are taken into account under section 1248(c)(2) are reduced (Temp. Treas. Reg. Sec. 7.367(b)-8(c)(1)).

If the transferor corporation transfers stock in a foreign corporation of which there is a U.S. shareholder immediately before the exchange and the transferor receives stock of a domestic corporation, of a foreign corporation that is not a CFC, or of a CFC as to which a U.S. shareholder of the transferor is not a U.S. shareholder, then the section 1248(c)(2) amount and the additional-earnings-and-profits amount of the exchanging foreign corporation, computed as if all stock of the corporation whose stock is exchanged is owned by a U.S. shareholder, are added to the earnings and profits or deficit of the exchanging foreign corporation. This amount is not considered a dividend (Treas. Reg. Sec. 1.367(b)-8(c)(2)).

> *Example 15.18.* A U.S. parent corporation (USP) owns all of the stock of a foreign corporation (CFC1), which in turn owns all of the stock of a second foreign corporation (CFC2). CFC1 and CFC2 have accumulated earnings and profits or accumulated deficits in earnings and profits. CFC1 transfers its CFC2 stock to a newly organized foreign corporation (Newco) that is not a CFC, in a section 351 exchange. CFC1 receives 20 percent of the Newco stock in exchange for its CFC2 stock. Persons unrelated to USP and CFC1 receive the remaining 80 percent of the Newco stock. CFC2's accumulated

earnings and profits or accumulated deficits in earnings and profits will be added to CFC1's earnings and profits or deficits in earnings and profits (Treas. Reg. Sec. 1.367(b)-8(c)(2), example (1)).

Treatment of Section 355 Distributions by U.S. Corporations to Foreign Persons. A domestic corporation that makes a section 355 distribution of stock or securities of a domestic or foreign corporation to a person who is not a qualified U.S. person must recognize gain (but not loss) on the distribution under section 367(e)(1). Gain is not recognized with respect to a distribution to a qualified U.S. person of stock or securities that qualifies for nonrecognition under section 355. A *qualified U.S. person* is a citizen or resident of the United States and a domestic corporation (Temp. Treas. Reg. Sec. 1.367(e)-1T(b)(1)).

The *gain recognized by the distributing corporation* is equal to the excess of the fair market value of the stock or securities distributed to nonqualified U.S. persons (determined as of the time of the distribution) over the distributing corporation's adjusted basis in the stock or securities distributed to such distributees. The *distributing corporation's adjusted basis in each unit of each class of stock or securities distributed* is equal to the distributing corporation's total adjusted basis in all of the units of the respective class of stock or securities owned immediately before the distribution, divided by the total number of units of the class of stock or securities owned immediately before the distribution (Temp. Treas. Reg. Sec. 1.367(e)-1T(b)(2)).

Even though the distributing corporation may recognize gain on the distribution, if the distribution otherwise qualifies for nonrecognition under section 355, each distributee is considered to have received stock or securities in a distribution qualifying for nonrecognition under section 355. The distributee is not considered to have received a dividend or a redemption distribution. The basis of the distributed domestic or foreign corporation stock in the hands of the foreign distributee is the basis of the distributed stock determined under section 358 without any increase for any gain recognized by the domestic corporation on the distribution. An exception to this rule is in the situation where section 897(e)(1) cause gain to be recognized by the distributee (Temp. Treas. Reg. Sec. 1.367(e)-1T(b)(3)).

Stock or securities owned by or for a partnership (whether foreign or domestic) are considered to be owned proportionately by its partners. This is determined from the partner's distributive share of gain that would be realized by the partnership from a sale of stock of the distributing cor-

poration immediately before the distribution, determined under the partnership rules of sections 701-761. Stock or securities owned by or for a trust or estate (whether foreign or domestic) are considered to be owned proportionately by the persons who would be treated as owning such stock or securities under the section 318 attribution rules (Temp. Treas. Reg. Sec. 1.367(e)-1T(b)(5)).

If a domestic corporation is directly or indirectly formed or availed of by one or more foreign persons to hold the stock of a second domestic corporation for a principal purpose of avoiding the application of section 367(e)(1), any distribution of stock or securities to which section 355 applies by such second domestic corporation will be treated as a distribution to such foreign person or persons, followed by a transfer of the stock or securities to the first domestic corporation (Temp. Treas. Reg. Sec. 1.367(e)-1T(b)(6)).

Gain is not recognized by a domestic corporation making a distribution that qualifies for nonrecognition under section 355 of stock or securities of a domestic controlled corporation to a person who is not a qualified U.S. person if two conditions are both satisfied:

1. Immediately after the distribution, both the distributing and controlled corporations are U.S. real property holding corporations.
2. The distributing corporation attaches to its timely filed federal income tax return for the taxable year in which the distribution occurs a statement titled "Section 367(e)(1)—Reporting of Section 355 Distribution by U.S. Real Property Holding Corporation," signed under penalties of perjury by an officer of the corporation, disclosing that the distribution is a qualifying distribution and a description of the transaction in which one U.S. real property holding corporation distributes the stock of another U.S. real property holding corporation in a transaction that is described under section 355.

Gain is not recognized by a domestic publicly traded corporation making a distribution that qualifies for nonrecognition under section 355 of stock or securities of a domestic controlled corporation to a person who is not a qualified U.S. person if both of the following conditions are satisfied:

1. Stock of the domestic controlled corporation with a value of more than 80 percent of the outstanding stock of the corporation is distributed with respect to one or more classes of the outstanding stock of the distributing corporation that are regularly traded on an estab-

lished securities market located in the United States. Stock is considered to be regularly traded if it is regularly quoted by brokers or dealers making a market in such interests. A broker or dealer is considered to make a market only if the broker or dealer holds himself or herself out to buy or sell interests in the stock at the quoted price.

2. The distributing corporation satisfies the reporting requirements in Treas. Reg. Sec. 1.367(e)-1T(c)(2)(iii). (Temp. Treas. Reg. Sec. 1.367(e)-1T(c)(2)(i)).

If, at the time of the distribution, the distributing corporation knows or has reason to know that any distributee who is not a qualified U.S. person owns, directly, indirectly, or constructively (under the constructive ownership rules of sections 897(c)(3) and (c)(6)(C), more than 5 percent (by value) of a class of stock or securities of the distributing corporation with respect to which the stock or securities of the controlled corporation is distributed (a 5-percent shareholder), the distributing corporation will qualify for nonrecognition if, with respect to such 5-percent shareholder, either the distribution qualifies for nonrecognition because it is a distribution of certain domestic stock to 10 or fewer qualified foreign distributees or the distributing corporation recognizes gain (but not loss) on the distribution (Temp. Treas. Reg. Sec. 1.367(e)-1T(c)(2)(ii)).

Gain will not be recognized by a domestic corporation making a distribution that qualifies for nonrecognition under section 355 of stock or securities of a domestic controlled corporation with respect to ten or fewer qualified foreign distributees, provided that each of the conditions for nonrecognition (specified below) is satisfied. A *qualified foreign distributee* is a foreign person or entity that during the entire period of a gain recognition agreement is either an individual or corporation, resident in a U.S. treaty country with an exchange of information agreement. If one or more foreign distributees are not treated as qualified foreign distributees, the distributing corporation must recognize a percentage of the gain realized on the distribution, equal to the percentage of its stock owned immediately before the distribution, directly or indirectly, by foreign distributees who are not qualified foreign distributees (Temp. Treas. Reg. Sec. 1.367(e)-1T(c)(3)(i)).

A distribution of stock or securities to a qualified foreign distributee will not result in the recognition of gain if each of the following six conditions are satisfied:

1. If more than ten foreign distributees, at any time during the entire term of the gain recognition agreement, are eligible to be qualified

foreign distributees, the distributing corporation must designate the foreign distributees to be considered qualified foreign distributees.

2. Immediately after the distribution and on each testing date beginning after the distribution and during the period that a gain recognition agreement is in effect, the value of the distributing corporation (that is, the fair market value of the assets of the distributing corporation, less all liabilities of the distributing corporation) must exceed the amount of gain that the distributing corporation realized, but did not recognize (on or after the distribution), as a consequence of the distribution with respect to qualified foreign distributees. This requirement is satisfied for any testing date upon which the adjusted basis of the distributing corporation's assets, less all liabilities of the distributing corporation, exceeds the amount of the deferred gain. A *testing date* is the last day of any taxable year of the distributing corporation during which the agreement to recognize gain is in effect; and any date upon which the distributing corporation distributes property to its shareholders under section 301(a).
3. At all times until the close of the 120-month period following the end of the taxable year of the distributing corporation in which the distribution was made, all qualified foreign distributees must continue to own, directly or indirectly, all of the stock and securities of the distributing and controlled corporations that the qualified foreign distributee owned, directly or indirectly, immediately after the distribution (including any stock and securities of the distributing or controlled corporation later acquired from the distributing or controlled corporation for which the distributee has a holding period determined under section 1223 by reference to the stock or securities).
4. The distribution of stock or securities must not be a distribution pursuant to which the distributing corporation goes out of existence.
5. The distributing corporation must file an agreement to recognize gain, and the controlled corporation must agree to be secondarily liable in the event that the distributing corporation does not pay the tax due upon a recognition event. The agreement is filed by the distributing corporation with its federal income tax return for its taxable year in which the distribution is made.
6. For each of the taxable years of the distributing corporation, beginning with the taxable year of the distribution and ending with the taxable year that includes the close of the 120-month period following the end of the taxable year of the distributing corporation in

which the distribution was made, all qualified foreign distributees and the controlled corporation must provide to the distributing corporation the annual certifications, and the distributing corporation must file the certifications with its tax return (Temp. Treas. Reg. Sec. 1.367(e)-1T(c)(3)(ii)).

The agreement to recognize gain required must be prepared by or on behalf of the distributing corporation and signed under penalties of perjury by an authorized officer of the distributing corporation. An authorized officer of the controlled corporation must also sign the agreement under penalties of perjury, agreeing to extend the statute of limitations and accept liability for the tax in the event that the distributing corporation fails to pay the tax upon a recognition event (Temp. Treas. Reg. Sec. 1.367(e)-1T(c)(3)(iii)). See chapter 22 for a description of the form of the agreement and the gain recognition events.

Transactions to Be Treated as Exchanges

Section 367(c)(1) provides that any distribution described in section 355 (or so much of section 356 as relates to section 355) will be treated as an exchange whether or not it is an exchange. In addition, section 367(c)(2) provides that any transfer of property to a foreign corporation as a contribution to the capital of the corporation by one or more persons who, immediately after the transfer, own stock possessing at least 80 percent of the total combined voting power of all classes of stock, will be treated as an exchange of property for stock of the foreign corporation equal to the fair market value of the property transferred.

Transfers of Intangibles

Section 367(d)(1) provides that for any transfers of intangible property, directly or indirectly, to any foreign corporation in an exchange described in section 351 or 361, section 367(a) will not apply.[6] Instead, the person transferring the property will be treated as (1) having sold such property in exchange for payments that are contingent on productivity, use, or disposition of such property and (2) receiving amounts that reasonably reflect the amounts that would have been received annually in the form

[6]The Treasury also has the regulatory authority to apply consistent provisions for transfers of intangible property to partnerships.

of such payments over the useful life of such property or, in the case of a disposition following such transfer, at the time of the disposition. This provision is the so-called superroyalty provision added by the Tax Reform Acts of 1984 and 1986, which, in effect, ignores the transaction that occurred at the time of the transfer and determines the royalties earned on the property.

These rules apply to intangible property regardless of whether the property is to be used in the United States, in connection with goods to be sold or consumed in the United States, or in connection with a trade or business outside the United States (Temp. Treas. Reg. Sec. 1.367(d)-1T(b)). Over the useful life of the property, the person that transfers the intangible must annually include in gross income an amount that represents an appropriate arm's-length charge for the use of the property. The appropriate charge shall be determined in accordance with the provisions of section 482 and its regulations. The amount of the deemed payment is reduced by any royalty or other periodic payment made or accrued by the transferee to an unrelated person during that taxable year for the right to use the intangible property. The amounts included in the transferor's income are treated as ordinary income from sources within the United States (Temp. Treas. Reg. Sec. 1.367(d)-1T(c)(1)).

For these purposes, the *useful life of intangible property* is the entire period during which the property has value, although this life cannot be considered to exceed twenty years. If intangible property derives its value from secrecy or from protections afforded by law, the useful life of such property will terminate when the property is no longer secret or no longer legally protected (Temp. Treas. Reg. Sec. 1.367(d)-1T(c)(3)).

Subsequent Transfers of Stock

If subsequent to a transfer and within the useful life of the intangible property the U.S. transferor subsequently disposes of the stock of the transferee foreign corporation to a person that is not a related person, then the U.S. transferor is treated as having simultaneously sold the intangible property to the person acquiring the stock of the transferee foreign corporation. The U.S. transferor is required to recognize gain (but not loss) from sources within the United States in an amount equal to the difference between the fair market value of the transferred intangible property on the date of the subsequent disposition and the U.S. transferor's former adjusted basis in that property (determined as of the original transfer). If the U.S. transferor's disposition of the stock of the transferee

foreign corporation is otherwise subject to U.S. tax, then the amount of gain otherwise required to be recognized with respect to the stock of the transferee foreign corporation is reduced by the amount of gain recognized with respect to the intangible property (Temp. Treas. Reg. Sec. 1.367(d)-1T(d)(1)). All income realized under section 367(d) is treated as ordinary income (section 367(d)(2)(C)).

If a U.S. person transfers intangible property and within the useful life of the transferred intangible property, that U.S. transferor subsequently transfers the stock of the transferee foreign corporation to U.S. persons that are related, then the following rules apply:

1. Each such related U.S. person shall be treated as having received (with the stock of the transferee foreign corporation) a right to receive a proportionate share of the contingent annual payments that would otherwise be deemed to be received by the U.S. transferor.
2. Each such related U.S. person shall, over the useful life of the property, annually include in gross income a proportionate share of the amount that would have been included in the income of the U.S. transferor. These amounts are treated as ordinary income from sources within the United States.
3. The amount of income required to be recognized by the U.S. transferor must be reduced to the amount determined using the following formula:

Income that would otherwise be required to be recognized by the transferor corporation × (100 percent less percentage of the transferor corporation's total deemed rights to receive contingent annual payments deemed to be transferred to related U.S. persons) (Temp. Treas. Reg. Sec. 1.367(d)-1T(e)(1)).

If a U.S. person transfers intangible property to a foreign corporation in a section 351 or section 361 exchange, and within the useful life of the transferred intangible property, that U.S. transferor subsequently transfers any of the stock of the transferee foreign corporation to one or more foreign persons that are related to the U.S. person, it must continue to include in its income the deemed payments in the same manner as if the subsequent transfer of stock had not occurred (Temp. Treas. Reg. Sec. 1.367(d)-1T(e)(2)).

If a U.S. person transfers intangible property to a foreign corporation in a section 351 or section 361 exchange, and within the useful life of the intangible property that transferee foreign corporation subsequently disposes of the intangible property to an unrelated person, then—

1. The U.S. transferor of the intangible property must recognize gain from U.S. sources (but not loss) in an amount equal to the difference between the fair market value of the transferred intangible property on the date of the subsequent disposition and the U.S. transferor's former adjusted basis in that property (determined as of the original transfer); and
2. The U.S. transferor must recognize a deemed payment for that part of its taxable year that the intangible property was held by the transferee foreign corporation (Temp. Treas. Reg. Sec. 1.367(d)-1T(f)).

A U.S. person that transfers intangible property to a foreign corporation in a transaction subject to section 367(d) may elect to recognize income if—

1. The intangible property transferred constitutes an operating intangible; or
2. The transfer of the intangible property is either legally required by the government of the country in which the transferee corporation is organized as a condition of doing business in that country, or compelled by a genuine threat of immediate expropriation by the foreign government; or
   - The U.S. person transferred the intangible property to the foreign corporation within three months of the organization of that corporation and as part of the original plan of capitalization of that corporation;
   - Immediately after the transfer, the U.S. person owns at least 40 percent but not more than 60 percent of the total voting power and total value of the stock of the transferee foreign corporation;
   - Immediately after the transfer, at least 40 percent of the total voting power and total value of the stock of the transferee foreign corporation is owned by foreign persons unrelated to the U.S. person;
   - Intangible property constitutes at least 50 percent of the fair market value of the property transferred to the foreign corporation by the U.S. transferor; and
   - The transferred intangible property will be used in the active conduct of a trade or business outside of the United States and will not be used in connection with the manufacture or sale of products in or for use or consumption in the United States (Temp. Treas. Reg. Sec. 1.367(d)-1T(g)(2)).

Section 367(d) and the related regulations do not apply in the case of an actual sale or license of intangible property by a U.S. person to a foreign corporation. If an adjustment under section 482 is required with respect to an actual sale or license of intangible property, then section 367(d) will not apply with respect to the required adjustment. If a U.S. person transfers intangible property to a related foreign corporation without consideration, or in exchange for stock or securities of the transferee in a section 351 or 361 transaction, no sale or license subject to adjustment under section 482 will be deemed to have occurred. Instead, the U.S. person shall be treated as having made a transfer of the intangible property that is subject to section 367(d) (Temp. Treas. Reg. Sec. 1.367(d)-1T(g)(4)).

Capital Contributions

If a U.S. person transfers property to a foreign corporation as paid in surplus or as a capital contribution, then to the extent provided by regulations, the transferor must treat the property transferred as sold or exchanged at fair market value (Section 367(f)).

Deemed-Paid Foreign Tax Credits

Deemed-paid foreign tax credits under section 902 are available only on the dividend portion of the gains recognized under section 1248 or 332 and not on capital gains. The deemed-paid foreign tax credit is not available to U.S. taxpayers that are not corporations. Therefore, the availability of the foreign tax credit and the effective tax rate paid to the foreign country by the foreign corporation may make one form of transaction preferable to another.

Distribution After an Inclusion of Earnings and Profits

To the extent earnings and profits of a foreign corporation are treated as a dividend to the exchanging U.S. shareholder under section 367(b) regulations, such earnings and profits may be treated as previously taxed income under section 959 upon distribution to an acquiring U.S. shareholder (Temp. Treas. Reg. Sec. 7.367(b)-12(d)).

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Citizens and Residents Abroad

When a person leaves the United States to work overseas, the compensation package required is quite different and usually far more extensive than a package for similar work in the United States. Compensation packages may include an overseas differential, a cost-of-living-allowance, a housing allowance or employer-provided housing, an education allowance in order that the employees' children attend private schools, home-leave expenses, and reimbursement for taxes levied on the additional compensation (tax equalization), which of course gives rise to compensation.

Congress has seen fit to provide some relief for U.S. persons working overseas. A U.S. citizen who receives compensation for services performed in a foreign country can elect to exclude up to $70,000 of earned income and certain housing expenses, within certain limits, from U.S. taxation, provided he or she is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year. In the case of a U.S. citizen or resident, a physical presence in a foreign country or countries for 330 full days during any twelve consecutive months may qualify that individual for these benefits.

An individual is eligible for these benefits only if his or her tax home is in a foreign country. In addition, a U.S. taxpayer qualifying under section 911 will usually pay income taxes to a foreign jurisdiction. Treatment of the deduction or credit of these taxes is covered in chapter 7.

To the extent that foreign taxes are attributable to earnings that are excluded from income under section 911, they will not be allowed as a credit or a deduction in computing U.S. tax liability. A similar provision applies to deductions attributable to excluded income.

Over the years, special treatment in the tax laws for persons working abroad has been justified on many grounds, including increasing foreign trade,[1] equalizing the tax treatment between U.S. citizens employed abroad and other foreign persons working in the same country,[2] and granting special tax relief because of hardship involved in employment abroad.[3]

Persons Qualifying Under Section 911

Section 911(d)(1) provides that *qualified individual* means an individual whose tax home is in a foreign country and who is a citizen of the United States, if using the bona fide foreign resident test, or a citizen or resident of the United States if using the physical presence test. The United States does have tax treaties with some countries that prohibit tax discrimination against any citizen of the signatory country. It is possible for a person to have a tax home in a foreign country and be a resident of that country and of the United States.[4]

The Tax-Home Requirement

Unless an individual has a tax home in a foreign country, that person will not qualify for the exclusion of foreign-earned income and housing expenses from gross income. The individual's tax home for these pur-

[1]H.R. Rep. No. 1, 69th Cong., 1st sess. 7 (1925).

[2]S. Rep. No. 781, 82nd Cong., 1st sess. 52-53 (1951).

[3]Hearings Before House Committee on Ways and Means on Revenue Revision, 69th Cong., 1st sess. 182-183 (1925).

[4]See Rev. Rul. 91-58, 1991-2 C.B. 340 for an example of this situation and a list of treaties, which contain such a nondiscrimination clause.

poses has the same meaning as under section 162(a)(2) relating to travel expenses while away from home (Treas. Reg. Sec. 1.911-2(b)). Rev. Ruls. 60-189[5] and 73-529[6] provide that an individual's tax home is considered located at his or her regular or principal place of business or, if the individual has no regular or principal place of business because of the nature of his or her trade or business, at the individual's regular place of abode in a real and substantial sense.[7] Section 162(a) provides that a new tax home is established if the taxpayer is employed away from his or her old tax home for more than a year.[8] An individual will not be treated as having a tax home in a foreign country for any period for which his or her abode is in the United States.

Foreign-Earned Income

The Concept of Earned Income

Section 911(a)(1) provides that only foreign-earned income (that is, the amount received from sources within a foreign country or countries and attributable to services rendered during the specified period) qualifies for the exclusion. Earned income includes wages, salaries, professional fees, and other amounts received as compensation for personal services (section 911(d)(2)(A)). Other amounts received as compensation for personal services would include such items as an overseas differential, a housing allowance or fair market value of housing, schooling allowances, home leave allowance, and any other amounts received that would be compensation under section 61 if the taxpayer were working in the United States.

Unearned income, not qualifying for the exclusion under section 911, includes dividends, rents, gambling gains, interest, capital gains, and certain royalties. Where an individual's personal effort is the major factor

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[5]1960-1 C.B. 60.

[6]73-529, 1973-2 C.B. 37.

[7]Rev. Rul. 73-529, 1973-2 C.B. 37. The Tax Court supports the Internal Revenue Service's (IRS's) position that the taxpayer's principal place of business is his or her tax home. Several courts of appeals have rejected or limited this interpretation of tax home and instead have interpreted it to mean abode or residence.

[8]See Rev. Rul. 93-86, 1993-1 C.B. 4 and Rev. Rul. 83-82, 1983-1 C.B. 45 for guidelines for determining whether taxpayers are away from home temporarily or for purposes of deducting travel expenses under section 162(a)(2).

in the production of property for which a royalty is received, then the royalty will generally be treated as earned income. An example is royalties received by a writer from a publisher for the transfer of the writer's property rights to its product.

Certain amounts are not included in foreign-earned income:

1. Amounts received as a pension or annuity.
2. Amounts paid by the United States or an agency thereof to an employee.
3. Amounts included in gross income under section 402(b) or 403(c).
4. Amounts received after the close of the taxable year following the taxable year in which the services were performed.

These amounts are described more fully below.

The Limitation on Foreign-Earned Income

The foreign-earned income exclusion cannot exceed the amount of foreign-earned income computed on a daily basis at an annual rate determined as follows:

Calendar Year	*Exclusion Amount*
Prior to 1998	$70,000
1998	$72,000
1999	$74,000
2000	$76,000
2001	$78,000
2002 and thereafter	$80,000*

*After 2007 the $80,000 will be increased by the cost of living adjustment and rounded to the nearest $100 (section 911(b)(2)(D)).

Sources Without the United States

Section 911 requires that income be from sources without the United States. The source rules do not differ from the general rules in sections 861 through 865. Income from services performed has its source where the services are rendered. The place where payment for personal services is received or the location of the payor is irrelevant.

A taxpayer who performs some services in the United States and some in a foreign country must allocate the salary based on the number of workdays in each location[9] according to the following formula:

[9]Rev. Rul. 69-238, 1969-1 C.B. 195.

$$\frac{\text{Number of workdays in the United States}}{\text{Total number of workdays in the taxable year}} \times \text{Annual salary} = \text{U.S.-source income}$$

Example 16.1. A taxpayer residing abroad spends 15 workdays out of 255 workdays in the United States and is paid $60,000 for the taxable year. Her U.S.-source income is calculated as follows:

$$\frac{15}{255} \times \$60{,}000 = \$3{,}529$$

With these facts, $3,529 is U.S.-source income and $56,471 is foreign-source income.

Other Situations

Following is a summary of the rules for determining earned income in certain specified cases.

Stock Options. Under certain circumstances, income realized on the sale or exchange of stock acquired under a qualified stock plan is treated as earned income. The Code and regulations do not provide clear rules for determining the source of this income. It seems reasonable to treat the source of the earned income and the service period as the place and time the taxpayer worked between the date of the grant of the option and the date of the exercise of the option.[10]

Capital as a Material Income-Producing Factor. If a taxpayer engages in a business in which both personal services and capital are material income-producing factors, the amount of income considered earned is the lesser of 30 percent of net profits or a reasonable allowance as compensation (section 911(d)(2)(B)). Capital is considered a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business, as reflected, for example, by substantial investment in inventories, the plant, machinery, or other equipment. On the other hand, capital is not considered a material income-producing factor if gross income of the business consists principally of fees, commissions, or other compensation for personal services

[10]See Rev. Rul. 69-118, 1969-1 C.B. 135; Groetzinger, 87 T.C. 533 (1986).

performed by an individual who is individually and personally responsible for such services.

In the case of professionals such as doctors, lawyers, and accountants, capital is not considered to be a material income-producing factor. The entire amount of professional fees is characterized as earned income.

> *Example 16.2.* Taxpayer operates a retail mercantile business in which capital is a material income-producing factor. Net income from the business is $50,000. The maximum amount of income that is considered earned income for purposes of section 911 is $15,000 (30% × $50,000).

> *Example 16.3.* A and B share equally in the profits and losses of AB partnership, in which capital is a material income-producing factor. Net income from the partnership is $60,000. For purposes of section 911, a maximum of $9,000 [$60,000 × (50% × 30%)] would be characterized as earned income for each individual.

Payments to a Foreign Resident Partner. Assume a taxpayer is a partner in an international firm and is paid $100,000 for managing a foreign office during the taxable year. In addition, her share of partnership gross income is $150,000, of which $50,000 was derived from foreign sources. The entity theory of partnership taxation would dictate an exclusion of $50,000. Section 707(c), however, treats a guaranteed payment to a partner as compensation, and therefore, if the $100,000 was a guaranteed payment, the $100,000 as well as the $50,000 is considered foreign-source earned income. Total foreign-source income is reduced by the exclusion allowable if the exclusion is elected. Expenses are then allocated between excluded and nonexcluded earned income.

The courts have concluded that certain payments made to foreign resident partners are considered guaranteed payments. In both A.O. *Miller*[11] and *Carey v. United States,*[12] employment contracts were written with the partnership so that the foreign resident partner received guaranteed payments regarded as payments for personal services outside the United States. In A.O. *Miller,* for example, a letter agreement between the partnership and the partner contained the following terms for guaranteed payments:

> We wish to confirm the arrangement we have made with you concerning special compensation to be paid you for your services rendered abroad while you are in charge of the Paris office of White & Case. In consideration of

[11]52 T.C. 752 (1969).

[12]427 F. 2d 763 (Ct. Cl. 1970).

your services in managing our office in Paris, France, and in performing such other services in Europe as may be requested of you by our firm, we hereby agree to pay you special compensation at the rate of $20,000 per annum, payable monthly, commencing July 1, 1960.

Amounts Not Considered Foreign-Earned Income

In addition to forms of income such as dividends, rents, interest, capital gains, and certain royalties, section 911(b)(1)(B) specifies other types of income that are not considered foreign-earned income: pensions, annuities, amounts paid by the United States or a U.S. agency to an employee, and amounts received more than a year after the year in which services were performed.

Pensions and Annuities. Under section 911(b)(1)(B)(i) amounts received as a pension or an annuity are not excludable. In addition, section 911(b)(1)(B)(iii) provides that amounts included in gross income under section 402(b), relating to taxability of a beneficiary of a nonexempt trust, or section 403(c), relating to taxability of a beneficiary under a nonqualified annuity, are not considered foreign-earned income and are not excludable.

Amounts Paid to Employees of the U.S. Government or a U.S. Agency. Amounts received from sources without the United States, paid by the United States or any U.S. government agency, will not qualify as foreign-earned income and, hence, for the exclusion (section 911(b)(1)(B)(ii)). Therefore, amounts received by armed forces personnel, foreign-service officers, members of the diplomatic corps, and other U.S. government employees will not be eligible for the section 911 exclusion no matter how long they remain abroad.[13]

Amounts Received More Than a Year After the Year in Which Services Were Performed. To determine the maximum exclusion for a particular year, taxpayers must use the accrual method; that is, amounts will be tested as if received in the taxable year in which the services were performed. In addition, the payments must be received no later than the close of the taxable year following the taxable year in which the services were performed to be eligible for any foreign-earned income exclusion (section 911(b)(1)(B)(iv)).

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[13]Rev. Rul. 85-29, 1985-1 C.B. 223. See also Sobolesky, 88 T.C. 1024 (1987).

Example 16.4. A taxpayer was a resident in a foreign country and otherwise satisfied section 911 for the taxable year of 1998. He received foreign-earned income of $65,000. He elected section 911 and properly excluded the $65,000. In March 1999 he received a bonus of $3,000 attributable to services performed in 1998. The $3,000 will be excluded from gross income for 1999 but comes out of his 1998 exclusion, since he has a $7,000 exclusion available relating to 1998 ($72,000 less $65,000 used in 1998) prior to the receipt of the bonus.

If the foregoing taxpayer had received the $3,000 bonus in a year after 1999, no exclusion would be available, since the bonus is received after the close of the taxable year following the taxable year in which the services were performed. The fact that unused exclusion amounts can be "stored up" for one year if the taxpayer has earned income that has not yet been paid allows a taxpayer, in some cases, to receive more than what would normally be considered the allowable exclusion in one year.

Bona Fide Foreign Resident

Once the taxpayer has satisfied the bona fide foreign resident status requirements for an entire taxable year, he or she may be eligible for the exclusion of foreign-earned income. The amount excluded from gross income cannot exceed an amount that is prorated according to the number of days of foreign residency there are in the taxable year. Taxpayers will often wish to establish foreign residency because their businesses may require frequent trips to the United States, in which case they may not satisfy the 330-day physical presence requirement even though they reside abroad for a period that includes an entire taxable year. If the taxpayer is a resident for a partial taxable year, as in the case of the first and last years of foreign residency, the exclusion must be prorated according to the following formula:

$$\frac{\text{Number of days in year resident of a foreign country or countries}}{\text{Number of days in the taxable year}} \times \text{Exclusion amount} = \text{Allowable exclusion partial year}$$

Example 16.5. The taxpayer, a citizen of the United States, became a resident of a foreign country as of March 1, 1998. He resided continuously in this foreign country until July 16, 2001, on which day he returned to the

United States. The taxpayer is entitled to an exclusion of the following amount of earned income if the provisions of section 911 are otherwise satisfied:

Year	*Period Relating to Exclusion*	
1998	March 1–Dec. 31, 1998	306/365 × $72,000 = $60,362
1999	Entire year	74,000
2000	Entire year	76,000
2001	Jan. 1–July 15, 2001	196/365 × $78,000 = 41,885

The Internal Revenue Code requires that one be a bona fide resident of a foreign country. *Residence* means living in a particular locality. *Domicile*, on the other hand, means living in the locality with intent to make it a fixed and permanent home. The courts[14] have provided a framework for determining the residency requirements in a foreign country with the following twelve factors:

1. Intention of the taxpayer.
2. Establishment of the taxpayer's home in the foreign country for an indefinite period.
3. Participation in the activities of his or her chosen community on social and cultural levels, identification with the daily lives of the people, and in general, assimilation into the foreign environment.
4. Physical presence in the foreign country consistent with his or her employment.
5. Nature, extent, and reasons for temporary absences from his or her temporary foreign home.
6. Assumption of economic burdens and payment of taxes to the foreign country.
7. Status of resident contrasted to that of transient or sojourner.
8. Treatment accorded the taxpayer's income tax status by his or her employer.
9. The taxpayer's marital status and the residence of his or her family.
10. Nature and duration of the taxpayer's employment—whether his or her assignment abroad could be promptly accomplished within a definite or specified time.

[14] *Sochurek v. Comm.*, 300 F. 2d 34 (CA-7, 1962), *rev'g.* 36 T.C. 131 (1961); *Scott, Jr. v. United States*, 432 F. 2d 1388 (Ct. Cl. 1970).

11. Good faith in making his or her trip abroad—whether or not for purposes of tax evasion.
12. Nature and extent of any special considerations granted the taxpayer by the foreign country that are unavailable to other residents of that country.

Although not all these factors need be present for a taxpayer to prove residency, as much evidence as possible should be provided for the taxpayer to successfully withstand an IRS challenge.

To satisfy the residency requirement, the taxpayer must be a resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year. Uninterrupted does not mean that business trips or vacations cannot be made to the United States once foreign residency is established. Visits can be made to the United States, but care should be taken not to reestablish U.S. residency during such visits. Foreign residency will not be interrupted if residency is established in one foreign country and then, at the termination of this residency, residency is immediately established in another foreign country. A calendar year begins on January 1 and ends on December 31. This rule is purely technical, with no exceptions.[15] It would probably be considered an entire taxable year, however, if the taxpayer died before the end of the year in question.[16] A taxpayer will not be considered a bona fide resident of a particular country if the taxpayer claims he or she is not a resident and is not subject as a resident to the income tax imposed by that country (section 911(d)(5); Treas. Reg. Sec. 1.911-2(c)).

The Physical Presence Test

A U.S. citizen who spends 330 full days during any twelve consecutive months in a foreign country or countries will be eligible for an exclu-

[15]In *Donald F. Dawson*, 59 T.C. 264 (1972), a claim of Australian residency was denied because the petitioner was not a resident for the entire year of 1966. The petitioner arrived in Australia on January 3, 1966. Even though services could not have been performed for the petitioner's employer because January 1 and 2 were holidays in Australia, the court denied the claim based on the Senate Finance Committee report that explicitly indicates January 1 as the start of the taxable year.

[16]In *Estate of Roodner*, 64 T.C. 67 (1975), the taxpayer left the United States in November 1970 and established residency in Argentina before January 1, 1971. He died on June 25, 1971, while still a resident of Argentina. The short period was considered an entire taxable year. But see *Witt v. United States*, 56-2 U.S.T.C. (CCH) para. 10,002 (N.D. Ga. 1956), for the opposite result in a similar situation.

sion of earned income if he or she otherwise satisfies the provisions of section 911.

Foreign Country

Foreign country means territory under the sovereignty of a government other than the United States and includes the airspace over such territory. It does not include a possession or territory of the United States. The Antarctic region is not a foreign country.[17] A ship operating on the high seas is not in a foreign country even if it operates out of a foreign port.[18] Treas. Reg. Sec. 1.911-2(h) provides that a foreign country includes the territorial waters of the foreign country, and the seabed and submarine areas that are adjacent to the territorial waters of the foreign country and over which the foreign country has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. Fish are not considered natural deposits or natural resources. Time spent by a fisherman outside territorial waters but over the continental shelf is not counted as time in a foreign country.[19]

Calculating 330 Days

The test requires that the taxpayer must be physically present in a foreign country for a full 330-day period. A *full day* is a continuous period of twenty-four hours, commencing at midnight and ending the following midnight. The 330 days need not be consecutive but must fall in any twelve-consecutive-month period. Any twelve-month period qualifies, even time prior to arrival in a foreign country or after return to the United States.

> *Example 16.6.* A taxpayer is physically present in a foreign country from the first full day of July 1, 1998, until the last full day of May 26, 1999—exactly 330 full days. The taxpayer's twelve-month period can be from July 1, 1998, to June 30, 1999; from May 27, 1998 to May 26, 1999; or any other twelve-consecutive-month period between May 27, 1998, and June 30, 1999.

If the taxpayer satisfies the physical presence requirement, the exclusion must be prorated according to the following formula:

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[17] Rev. Rul. 67-52, 1967-1 C.B. 186.
[18] William M. Bebb, 36 T.C. 170 (1961).
[19] Rev. Rul. 73-181, 1973-1 C.B. 347.

$$\frac{\text{Number of days in year physical presence requirement is satisfied}}{\text{Number of days in the taxable year}} \times \text{Exclusion amount} = \text{Allowable exclusion for partial year}$$

Waiver of the Period of Stay in a Foreign Country

An individual who is a bona fide resident of a foreign country or is physically present in a foreign country for any period may have the time requirements of foreign residency or physical presence waived if all of the following apply:

1. The individual left the foreign country after August 31, 1978, because of war, civil unrest, or similar adverse conditions that precluded the normal conduct of business.
2. The Secretary of the Treasury determines, after consultation with the secretary of state or the secretary of state's delegate, that these conditions existed.
3. The individual establishes to the satisfaction of the Secretary of the Treasury that he or she could have reasonably met the bona fide foreign resident requirements or the physical presence requirement (section 911(d)(4)).

If these conditions are met, the individual will be deemed to qualify under the bona fide foreign resident test or the physical presence test. A taxpayer may utilize the test that provides the greater benefit on a year-by-year determination.[20]

Exclusion or Deduction of Housing Costs

In addition to the exclusion of foreign-earned income, a qualifying individual may exclude employer-provided housing amounts, deduct housing cost amounts that are not provided by the employer, or both. These provisions were added to mitigate the effects of higher housing costs overseas and the tax effects of housing allowances, which are paid to compensate for such higher costs.

[20]See Rev. Proc. 97-51, 1997-45, IRB 9 for the 1996 taxable year.

The *housing cost amount* is equal to the excess of foreign housing expenses of the individual and dependents living in the foreign household over a base housing amount. The base housing amount for a full year is 16 percent of the salary for an employee of the United States for step 1, grade GS-14. (Although based on the salary of a GS-14 U.S. employee, this housing amount applies to all U.S. citizens and residents employed abroad.) The GS-14 salary for 1998 was $60,270, and the base amount was therefore $9,643. If the individual does not qualify for the full year under section 911, the base housing amount is prorated accordingly. *Housing expenses* are reasonable expenses attributable to housing (such as rent, utilities, and insurance). They do not include the following:

- The cost of house purchase, improvements, and other costs that are capital expenditures
- The cost of purchased furniture or accessories or domestic labor such as maids and gardeners
- Amortized principal on the residence mortgage
- Depreciation or amortization on the housing or capital improvements
- Interest and taxes deductible under section 163 or 164, or amounts deductible under section 216(a)
- The expenses of more than one foreign household except as allowed
- Expenses excluded from gross income under section 119
- Expenses claimed as deductible moving expenses under section 217
- The cost of a pay television subscription (Treas. Reg. Sec. 1.911-4 (b)(2))

An individual maintaining a second foreign household may consider only housing expenses incurred for the abode that bears the closest relationship to the individual's tax home. This provision is relaxed if the second household is maintained outside the United States for the individual's spouse and dependents not residing with the individual because living conditions in the tax-home country are dangerous, unhealthy, or otherwise adverse. In this case the expenses of both households are eligible for exclusion.

To the extent an individual's housing cost amount is not attributable to employer-provided amounts, a deduction from adjusted gross income can be taken in addition to the housing exclusion. In other words, an individual who receives as compensation a housing allowance less than

the housing cost amount, or an individual who is self-employed and receives no housing allowance, is allowed a deduction for some or all of the unreimbursed housing costs from adjusted gross income.

The deduction is limited to the excess of the foreign-earned income of the individual for the taxable year, over the amount of income excluded under the foreign-earned income and the housing cost amount provisions (section 911(b)(3)(B)). The individual is permitted a one-year carryover for any amounts disallowed on account of the limitation. The carryover amounts are deductible from adjusted gross income for the succeeding taxable year. The deduction of these carryover amounts cannot exceed the unused limitation for the succeeding year.

Example 16.7. During 1998 a taxpayer, a resident of a foreign country for the entire taxable year, received a salary of $80,000 that was foreign-source income. His employer also provided a housing allowance of $20,000. The taxpayer's reasonable housing expenses were $30,000. During 1998, step 1 of GS-14 was $60,270 and the section 911 exclusion was $74,000. The taxpayer excludes $74,000 of foreign-earned income and the housing allowance of $20,357 from his gross income of $100,000 ($80,000 + $20,000). His housing cost amount is $20,357, computed as follows:

Reasonable housing expenses	$30,000
Less: 16% of $60,270	9,643
	$20,357

Deductions for Taxpayers Qualifying Under Section 911

A person eligible for the section 911 exclusion is entitled to deductions and losses, as is any other U.S. taxpayer in the United States. To eliminate a potential double benefit when the taxpayer uses the earned income exclusions, he or she is not allowed to deduct expenses, losses, or otherwise deductible items that are definitely related under Treas. Reg. Sec. 1.861-8 to the excludable income. Following is the formula for calculating the nondeductible expenses:

$$\text{Nondeductible expenses} = \frac{\text{Exclusion under foreign-earned income and housing cost amount provisions}}{\text{Foreign earned income}} \times \text{Deductions definitely related to qualifying earned income}$$

Itemized deductions such as real estate taxes and interest on a personal-residence mortgage are not required to be prorated and are deductible in their entirety. Itemized deductions such as medical expenses and charitable contributions are subject to statutory limitations based on a percentage of adjusted gross income.

Example 16.8. During 1999, a U.S. citizen who satisfied the physical presence requirement and other provisions of section 911 earned $100,000, had expenses definitely related to the earned income of $8,000, and had itemized deductions and personal exemptions of $15,000. The taxable income is computed as follows:

Earned income	$90,000
Exclusion	(74,000)
Included income	$26,000
Expense attributable to included income (deductible)—($26,000/$100,000) × $8,000	(2,080)
Adjusted gross income	23,920
Other deductions	(10,000)
Taxable income	$13,920

Personal exemptions and standard deduction amounts operate in the same manner as for any U.S. taxpayer working in the United States.

Reimbursed Business Expenses With Full Accounting to Employer

If an employee has reimbursed business expenses and has accounted for them to his or her employer, the amount received up to the actual expenses is not treated as earned income and is not allocated to the excluded earned income (Treas. Reg. Sec. 1.62-2(c)(4)). If the expenses exceed the reimbursement, excess expenses must be allocated between excluded and nonexcluded income.

Example 16.9. During 1999 a taxpayer who satisfied the provisions of section 911 had a salary of $100,000 and incurred expenses of $4,000 related to his employment. She fully accounted for her expenses to her employer and was reimbursed for $3,500. The $3,500 amount received is not treated as earned income, and $3,500 of the expenses is not deductible. The excess expenses over reimbursement allocated to the excluded income are $360:

$$\frac{\$72{,}000}{\$100{,}000} \times \$500 = \$360$$

The taxpayer's miscellaneous itemized deduction account would include $140 ($500 – $360).

Reimbursed Business Expenses With No Accounting to Employer

If an employee does not account for expenses to the employer, such as in the case of an employee receiving an expense allowance, the expense allowance is earned income and expenses must be allocated between excluded and nonexcluded income (Treas. Reg. Sec. 1.62-2(c)(5)).

Example 16.10. During 1999, a taxpayer that satisfied the provisions of section 911 received an annual salary of $100,000 and an expense allowance of $300 per month. She incurred business expenses of $4,200 and did not account to her employer for these amounts. The taxpayer had earned income of $103,600 ($100,000 + $3,600), $74,000 of which was excluded. The nondeductible expense would be $3,000 [($74,000/$103,600) × $4,200] and the deductible expense would be $1,200 ($4,200 – $3,000).

Deductions of Partnerships

A taxpayer that is a member of a partnership must reduce total foreign-source earned income by the exclusion allowable and then allocate expenses incurred in earning that income between excluded and nonexcluded earned income.[21]

Example 16.11. During 1999, a taxpayer who satisfied the provisions of section 911 was a member of a partnership doing business in a foreign country in which she worked and resided. The taxpayer had a 40-percent interest in capital and profits. Capital is not a material income-producing factor. During the current year the partnership derived foreign-source gross income of $250,000 from fees and incurred expenses of $30,000 related to earning these fees. The taxpayer's adjusted gross income is calculated as follows:

[21] Rev. Rul. 75-86, 1975-1 C.B. 242. See also *Vogt v. United States*, 537 F. 2d 405 (Ct. Cl. 1976), for the opposite treatment. This case was decided after Rev. Rul. 75-86 was issued, but the tax years in question were before 1975. The decision did not declare Rev. Rul. 75-86 invalid. See also Rev. Rul. 76-163, 1976-1 C.B. 199 for the treatment of a partnership loss deductible and earned foreign income excludable. The Revenue Ruling deals with a situation where taxpayer had salary eligible for the exclusion and a foreign partnership loss.

Taxpayer's share of total earned income	$100,000
Exclusion	(74,000)
Taxpayer's expenses attributable to included income— $30,000/$100,000 × $12,000	(3,360)
Adjusted gross income	$ 22,640

Deductions If Capital Is a Material Income-Producing Factor

When a taxpayer is engaged in a trade or business in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for personal services, not in excess of 30 percent of the taxpayer's share of net profits, is considered earned income. After earned income has been determined, expenses are allocated to the excluded and nonexcluded portions of earned income.[22]

Example 16.12. During 1999, a taxpayer that satisfied the provisions of section 911 operated a business in which capital is a material income-producing factor. Total gross income was $160,000 and expenses were $50,000. A reasonable allowance for compensation was $33,000, which is 30 percent of net profits. Adjusted gross income is calculated as follows:

Total income	$160,000
Earned income exclusion	(33,000)
	127,000
Expenses attributable to included income (deductible)— $127,000/$160,000 × $50,000	39,688
Adjusted gross income	$ 87,312

Foreign Taxes—Determination of a Creditable Amount

A taxpayer qualifying for the section 911 exclusion can possibly further reduce his or her U.S. tax by the foreign tax credit. For purposes of calculating the foreign taxes potentially creditable (before limitation) or deductible, the taxpayer must allocate, or charge, a portion of the foreign taxes to the amount of excluded earned income. Therefore, only the portion of foreign taxes that relates to included earned income will be considered for foreign tax credit purposes or for deduction from such earned income. The portion of foreign taxes that is allocable to excluded earned

[22]Rev. Rul. 75-86, 1975-1 C.B. 242.

income is determined by multiplying the amount of foreign tax by a fraction. The numerator of the fraction equals excluded earned income less deductible expenses definitely related in whole or in part to excluded earned income. The denominator of the fraction is the earned income less deductible expenses allocable to earned income. If the tax on earned income is imposed under foreign law on earned income and on some other amount, the denominator equals the total of the amounts subject to foreign tax less deductible expenses allocable to all such amounts.

Example 16.13. During 1999, a taxpayer who satisfied the provisions of section 911 had foreign earned income of $100,000, had deductions definitely related to the earned income of $9,000, paid foreign income taxes of $15,000, and had other itemized deductions of $7,800 and personal and dependent exemptions of $4,900. His U.S. tax liability on his joint return is computed as follows:

Gross income		$100,000
Less		
Deductions for adjusted gross income*	$ 2,340	
Exclusion	74,000	76,340
Adjusted gross income		$ 23,660
Deductions		
Itemized deductions	15,000	
Personal exemptions	8,100	23,100
Taxable income		$ 560
Tax computation		
Tax on $560		$ 84
Foreign tax credits†		84
Net tax payable (before other credits)		$ 0

*Allocation of expenses to excluded earned income—$74,000/$100,000 × $9,000 = $6,660 and to included earned income—$9,000 − $6,660 = $2,340

†Allocation of foreign taxes paid to included earned income:

Numerator:	
Excluded earned income	$ 74,000
Deductible expenses attributable to excluded income	6,660
	$ 67,340
Denominator:	
Earned income	$100,000
Deductible expenses	9,000
	$ 91,000

Foreign tax on excluded earned income:

$$\frac{\$67,340}{\$91,000} \times \$15,000 = \$11,100$$

Foreign tax on included earned income:
$15,000 − $11,100 = $3,900

Foreign tax credit carryover:
$3,900 − $84 = $3,816

The Section 911 Election and Electing Out of Section 911

Because some foreign taxes are disallowed for foreign tax credit or deduction purposes and expenses related to excluded earned income are not allowed to be deducted, the net tax payable by using section 911 may be higher than if section 911 were not applied. The section 911 election applies to the taxable year for which it is made and all subsequent years unless it is revoked. Section 911(e) permits the taxpayer to revoke the election for any taxable year after the taxable year of the election. Once the election is revoked, the taxpayer may not reelect section 911 before the sixth year following the year of revocation without the commissioner's consent. Therefore, the long-term consequences of electing, revoking, or reelecting section 911 must be considered.

The Section 911 Election

In order to receive the section 911 exclusion, a qualified individual must elect to exclude foreign earned income under section 911(a)(1) and the housing cost amount under section 911(a)(2). This election is usually made on Form 2555. The election must be filed either with the income tax return, or with an amended return, for the first taxable year for which the election is to be effective. An election once made remains in effect for that year and all subsequent years unless revoked, as explained subsequently.

A valid election may be made with a return that is timely filed (including any extensions of time to file) or with a later return that amends a timely filed return. The election may also be made on an original return filed within one year after the due date of the return (determined without regard to any extension of time to file). A taxpayer who does not owe any federal income tax after taking into account the exclusion may make an election on a nontimely filed return with a Form 2555 attached regardless of when the IRS discovers that the taxpayer failed to elect the exclusion. A taxpayer who owes federal income tax after taking

into account the exclusion may file Form 1040 with a Form 2555 attached before the Internal Revenue Service discovers that the taxpayer failed to elect the exclusion. A taxpayer filing a return in these situations must type or legibly print the following statement at the top of the first page of the Form 1040, Filed Pursuant to Section 1.911-7(a)(2)(i)(D).

Electing Out of Section 911

Because some foreign taxes are disallowed for foreign tax credit or deduction purposes and expenses related to excluded earned income are not allowed to be deducted, the net tax payable by using section 911 may be higher than if section 911 were not applied. An individual may revoke a Section 911 election for any taxable year and the revocation must be made separately with respect to each election. The individual may revoke an election for any taxable year, for which the election was effective, by filing a statement that the individual is revoking one or more of the previously made elections. The statement must be filed with the income tax return, or with an amended return, for the first taxable year of the individual for which the revocation is to be effective. Once a revocation is made it is effective for that year and all subsequent years. If an election is revoked for any taxable year, the individual may not again make the same election until the sixth taxable year following the taxable year for which the revocation was first effective, without the consent of the Commissioner of Internal Revenue. Facts that the commissioner may use in determining whether to consent to the reelection include a period of United States residence, a move from one foreign country to another foreign country with differing tax rates, a substantial change in the tax laws of the foreign country of residence or physical presence, and a change of employer.

An individual does not have to make an election in order to claim the housing cost amount deduction. However, the commissioner must be provided with information sufficient to determine the individual's correct amount of tax. This information must include the individual's name, address, and Social Security Number; the name of the individual's employer; the foreign country in which the individual's tax home was established; the status under which the individual claims the deduction; the individual's qualifying period of residence or presence; the individual's foreign earned income for the taxable year; and the individual's housing expenses.

Community Income

Section 911(b)(2)(C) requires that the income exclusion be computed without regard to community property laws. Income earned by one spouse is treated as if it is not community property income. In the absence of this provision, a husband and wife domiciled in a community property state, but either living abroad as bona fide residents or physically present for the requisite period, would be able to increase the exclusion if only one worked, since one-half of all earned income is attributable to each spouse. Under section 911(b)(2)(C), however, if the taxpayer earned income and the taxpayer's spouse earned nothing, only one exclusion and not two would be available. If the taxpayer and the taxpayer's spouse had each earned income, then each would be entitled to an exclusion.

A U.S. citizen who is a bona fide resident of a community property foreign country and married to a nonresident alien would be taxed on one-half of community income earned by the nonresident spouse unless section 879 prescribes a different treatment. Section 879 requires that in the case of a U.S. citizen or resident who is married to a nonresident alien and who has community income under foreign community property laws, such income will be treated as follows:

1. Earned income other than income from a trade or business and a partner's distributive share of partnership income is treated as income of the spouse who rendered the personal services.
2. Trade or business income is treated as income of the husband unless the wife exercises substantially all the management and control of the business, in which case it is treated as income of the wife.
3. A partner's distributive share of partnership income is not treated as community property income but as income of the spouse who is a member of the partnership.
4. Community income derived from separate property is treated as income of the spouse who owns the property.
5. All other community income is treated as provided in the applicable foreign community property law.

Example 16.14. Jane Santos, a U.S. citizen, is a bona fide resident of Brazil, where she resides with her husband, a Brazilian citizen. Mr. Santos owns and operates an export business, the income of which is community property income under Brazilian law. Mrs. Santos does not participate in the business, which earned $150,000 in 1998. None of Mrs. Santos's one-half of the $150,000 income will be subject to U.S. taxation.

Married Couples—Both Qualifying Spouses

Treas. Reg. Sec. 1.911-5 provides special rules regarding the computation of excluded earned income and the housing cost amount for married couples whom both qualify under the provisions of section 911.

The amount of excludable foreign income is determined separately for each spouse. If the spouses file separate returns, each may exclude the amount of his or her foreign earned income attributable to services performed by each, subject to the lesser-of-earned-income-or-exclusion amount. If a joint return is filed by the spouses, the sum of the foreign earned income amounts for each spouse may be excluded, again subject to separate calculations of the exclusion amount. For example, if in 1998 a married couple are employed abroad and one spouse earns $200,000 and the other spouse earns $50,000, the total exclusion amount on their joint return is $122,000—$72,000 for the spouse with earned income of $200,000 and $50,000 for the spouse with earned income of $50,000.

If spouses reside together and file a joint return, they may compute their housing cost amount either jointly or separately. If the spouses reside together and file separate returns, they must compute their housing cost amounts separately. If these amounts are computed separately, the spouses may allocate the housing expense to either of them or between them for the purpose of calculating separate housing cost amounts. Each spouse claiming a housing cost amount exclusion or deduction must use his or her full base housing amount in this computation. If the spouses compute their housing cost amount jointly, only one spouse may claim the housing cost exclusion or deduction (Treas. Reg. Sec. 1.911-5(a)(3)(i)).

If the spouses do not reside together, both spouses may exclude or deduct their housing cost amount if the spouses are not within reasonable commuting distance of each other and neither spouse's residence is within reasonable commuting distance of the other spouse's tax home. If the spouses' tax homes, or one spouse's residence and the other spouse's tax home, are within reasonable commuting distance of each other, only one spouse may exclude or deduct his or her housing cost amount (Treas. Reg. Sec. 1.911-5(a)(3)(ii)).

Other Tax Considerations

There are many other tax matters that concern the U.S. taxpayer moving abroad. For example, the taxpayer may sell or rent his or her home,

incur moving expenses, open a foreign bank account, and so forth. Many transactions and events may require special reporting or have a different tax treatment under U.S. tax law as a result of foreign residence.

Moving Expenses

When the taxpayer moves to a foreign country or back to the United States from a foreign country, a determination of the proper treatment of both the moving expenses and the moving expense reimbursement must be made. Section 217 permits an employee or self-employed individual to deduct from gross income the reasonable expenses of moving from one location to another for commencing work at the new location. The term *moving expenses* means the reasonable expenses connected with the following:

1. Moving household goods and personal effects from the former residence to the new residence
2. Traveling (including lodging when en route, but not meals) from the former residence to the new place of residence

In the case of a move to a foreign country, the reasonable expense of moving household goods and personal effects from the former residence to the new residence includes storage. For example, *reasonable storage costs* include the expenses of putting household goods and personal effects in storage, later removing them, and storing these goods and personal effects for part or all of the period the individual's new place of work outside the United States continues to be his or her principal place of work (section 217(h)).

There is also a special allowance for moving expense deductions for qualified retiree moving expenses and qualified survivor moving expenses. Moving expenses are allowed that are incurred by an individual whose former principal place of work and former residence were outside the United States and are incurred for a move to a new residence in the United States in connection with the bona fide retirement of the individual (section 217(i)(2)). In general, *qualified survivor moving expenses* are moving expenses that are paid or incurred by the spouse or any dependent who lived with a decedent who had a principal place of work outside the United States at the time of death and which were incurred for a move which begins within six months after death (section 217(i)(3)).

No deduction is allowed for moving expenses to the extent that the deduction is properly allocable to excluded earned income (section 911 (d)(6) and Treas. Reg. Sec. 1.911-6(b)). If an individual's new principal place of work is in a foreign country, deductible moving expenses will be allocable to foreign earned income. If an individual treats an employer reimbursement for expenses of a move from a foreign country to the United States as attributable to services performed in a foreign country, then deductible moving expenses attributable to that move will be allocable to foreign earned income (Treas. Reg. Sec. 1.911-6(b)(1)).

If a moving expense deduction is properly allocable to foreign earned income, the deduction is considered as attributable to services performed in the year of the move as long as the individual is qualified for a period that includes 120 days in the year of the move. If the individual is not qualified for this period, the deduction must be attributable to services performed both in the year of the move and the succeeding taxable year if the move is to a foreign country, or the prior year of the move is back to the United States. Storage expenses, however, will be attributable to the year in which the expenses are incurred (Treas. Reg. Sec. 1.911-6 (b)(2)).

The portion of the moving expense deduction that is allowed is determined using the following formula:

$$\text{Disallowed moving expense} = \frac{\text{Exclusion under foreign earned income and housing cost amount provisions}}{\text{Foreign earned income}} \times \text{Moving expenses}$$

Moving expense reimbursements are considered earned income under section 82, except that section 132(a)(6) treats qualified moving expense reimbursement as an exclusion from gross income. *Qualified moving expense reimbursement* means any amount received by an individual from an employer as a payment for or a reimbursement of qualified section 217 moving expenses (section 132(g)). It appears that if the taxpayer receives a reimbursement for deductible moving expenses, then there should be neither gross income nor a moving expense deduction.

If the taxpayer receives a reimbursement in excess of deductible moving expenses, in the absence of evidence to the contrary, the reimbursement is attributable to future services to be performed at the principal place of work. A taxable reimbursement received by an employee for the expenses of a move to a foreign country will generally be attributable to services performed in the foreign country. A reimbursement received by

an employee for expenses of a move from a foreign country to the United States will generally be attributable to services performed in the United States. The rule regarding the move back to the United States may be modified if there is an agreement between the employer and employee, or a statement of company policy, in writing before the move to the foreign country entered into or established to induce employees to move to a foreign country. The agreement or policy must state that the employer will reimburse the employee for moving expenses incurred in returning to the United States regardless of whether the employee continues to work for the employer after the employee returns to the United States (Treas. Reg. Sec. 1.911-3(e)(5)(i)).

Rental of Principal Residence

Any taxpayer who acts as lessor of a personal residence that was occupied by the taxpayer or the taxpayer's family for part of a tax year is subject to the provisions of section 280A. This situation is likely for a person relocating abroad or moving back to the United States. Section 280A provides rules for treating income and expenses of taxpayers who make personal use of a home in a year in which it is also rented. If the home is used for personal purposes (that is, used by the taxpayer or anyone else if rented for less than fair rental value) for more than fourteen days or 10 percent of the number of days the home is rented during the year, then there may be a limit on the deduction for expenses.

Three situations may affect the taxpayer if personal use of the home exceeds the fourteen-day or 10-percent period. In the first situation, when the home is rented for less than fifteen days, the rental amounts are excluded from gross income and expenses such as depreciation and maintenance attributable to the rental period are not deductible. Expenses such as interest on the mortgage and real estate taxes are deductible, since these expenses are allowable without regard to a trade or business or an income-producing activity.

In the second situation, when the home is rented for fifteen days or more, expenses attributable to the rental activity may not exceed the amount of gross income from the rental activity less deductions such as interest and real estate taxes. Expenses attributable to the rental activity must be determined by allocating expenses based on the number of days during the year the unit is rented and the total number of days during the year that the unit is used.

In the third situation, when property is converted from personal use to rental property, the taxpayer's personal use of the property before or after a qualified rental period will not cause a limitation of deductions. Therefore, expenses such as maintenance and depreciation allocable to the rental period will not be disallowed because of the gross income limitation. The *qualified rental period* is a consecutive period of twelve months (shorter if the house is sold or exchanged) or more that begins or ends during the taxable year during which the house is rented or held for rental.

Foreign Conventions

An individual who attends a convention, seminar, or similar meeting outside the North American area must satisfy certain requirements before a deduction will be allowed (section 274(h)). First, the meeting must be directly related to a trade or business or an activity for the production of income described in section 212. Second, the IRS must be satisfied that it was as reasonable to hold the meeting outside the North American area as within it. Regulations, when issued, will consider the following factors:

1. The purpose of the meeting and the activities taking place at the meeting
2. The purposes and activities of the sponsoring organizations or groups
3. The residence of the active members of the organization and the places at which other meetings of the sponsoring organization or group have been held or will be held
4. Any other relevant factor that the taxpayer may present

Reporting Foreign Bank Accounts

All taxpayers with $400 or more of interest or $400 or more of dividends filing Form 1040 must indicate on Schedule B whether an interest in a foreign account is held. If the taxpayer owns or controls foreign financial accounts valued at $10,000 or more at any time during a calendar year, Treasury Form 90-22.1 must be filed.[23] Form 90-22.1 must be filed no later than June 30 following the year under consideration.

[23]U.S. Treasury Department, News Release No. B-1224 (Oct. 23, 1978).

State Income Taxes

States with personal income taxes generally tax their residents on all of their income, both within and without the state. Nonresidents are generally taxed only on income from sources within that state. A U.S. taxpayer qualifying for the section 911 exclusion may still be subject to taxes under state tax statutes if resident status is continued under state tax laws or income is derived from sources within that state. One must consult individual state tax laws to determine if the person working overseas will be subject to state taxes.

Withholding

An employer may reduce withholding of income taxes from the wages of a citizen or resident employed abroad for the portion of income that will qualify for an exclusion under section 911. The employee must submit a statement to his or her employer that the employee reasonably expects to qualify for the exclusion. Filing Form 673(FOD), Statement for Claiming Benefits Provided by Section 911 of the Internal Revenue Code, with his or her employer permits the employer to exclude from income tax withholding all or part of the wages paid to that employee for services performed outside the United States. If the taxpayer is doubtful about qualifying under section 911, the taxpayer may wish to have appropriate amounts withheld from his or her salary or make estimated tax payments to avoid interest and penalties in case the requirements of section 911 are not satisfied.

Social Security Taxes

A U.S. employer is required to withhold Social Security taxes on compensation for services performed by a U.S. citizen. For a U.S. citizen working overseas, a *U.S. employer* is a domestic entity, including a branch of a U.S. corporation operating in a foreign country. Withholding is required whether or not the section 911 exclusion is claimed. On the other hand, there are no similar requirements to withhold Social Security taxes on compensation paid to resident or nonresident aliens working outside the United States. A U.S. taxpayer working outside the United States for a foreign employer does not fall under the requirements for Social Security withholding tax. However, if the foreign employer is a for-

eign entity of a U.S. parent corporation, an agreement between the U.S. employer and the IRS can be arranged to provide for Social Security withholding tax for all U.S. citizens and resident aliens employed by the foreign entity. The election is made by filing Form 2032, Contract Coverage Under Title II of the Social Security Act as Amended. A *foreign entity* is defined as one in which a U.S. employer owns directly or indirectly at least 10 percent of the voting stock or profits interest.

Filing Requirements

A taxpayer who normally files his or her return on the calendar-year basis and has his or her tax home outside the United States and Puerto Rico on April 15 is automatically granted an extension of two months, to June 15, for filing. A qualifying taxpayer filing on a fiscal-year basis also receives an automatic two-month extension on the usual filing date of three and one-half months after the close of the tax year, resulting in a total of five and one-half months after the close of the tax year in which to file his or her tax return. A longer extension (filed on Form 2350) may be permitted to cover the first taxable year in which the taxpayer may be entitled to claim a section 911 exclusion. This additional extension of time for filing the tax return does not carry with it an automatic extension for payment of the tax liability. A U.S. taxpayer with a foreign address who claims benefits under section 911 files his or her tax return with the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, PA 19155. Chapter 22 contains a more complete description of filing requirements.

Any return filed before completion of the period necessary to qualify for any exclusion or deduction under section 911 must be filed without regard to any exclusion or deduction provided by that section. A claim for a credit or refund of any overpayment of tax may be filed if the taxpayer subsequently qualifies for any exclusion or deduction under section 911. (See section 6012(c) and Treas. Reg. Section 1.6012-1(a)(3), relating to returns to be filed and information to be furnished by individuals who qualify for any exclusion or deduction under section 911.)

An individual desiring an extension of time (in addition to the automatic extension of time granted by Treas. Reg. Section 1.6081-2) for filing a return until after the completion of the qualifying period for claiming any exclusion or deduction under section 911 may apply for an extension. An individual whose moving expense deduction is attributable to services performed in two years may apply for an extension of time

for filing a return until after the end of the second year. The individual makes this application on Form 2350. The application must be filed with the Director, Internal Revenue Service Center, Philadelphia, PA 19255. The application must set forth the facts relied on to justify the extension of time requested and must include a statement as to the earliest date the individual expects to become entitled to any exclusion or deduction by reason of completion of the qualifying period.

In estimating gross income for the purpose of determining whether a declaration of estimated tax must be made for any taxable year, an individual is not required to take into account income which the individual reasonably believes will be excluded from gross income under the provisions of section 911. In computing estimated tax, however, the individual must take into account, among other things, the denial of the foreign tax credit for foreign taxes allocable to the excluded income (see Treas. Reg. Section 1.911-6(c)).

Income From U.S. Possessions

U.S. citizens employed in possessions of the United States are subject to special rules covered in Chapter 14.

Income Earned in a Restricted Country

Under section 911(d)(8), foreign earned income does not include any income from sources within a restricted country attributable to services performed during that period. Currently, the *restricted countries* are Cuba, Libya, and Iraq.[24] Furthermore, housing expenses will not include expenses allocable to the period for housing in the restricted country or for housing of the taxpayer's spouse or a dependent while the taxpayer is present in the restricted country. The individual also will not be considered a bona fide foreign resident of, or present in, the restricted country for any period of time the taxpayer was present in the restricted country.

Applying for Passports or Immigration Status

Any individual who applies for a passport or a passport renewal or applies for permanent resident status in the United States must include with his or her application the following:

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[24]Rev. Rul. 92-63, 1992-2 C.B. 195.

1. Taxpayer identification number (TIN), if any
2. In the case of a passport applicant, any foreign country in which the applicant is residing
3. In the case of an individual seeking permanent residence, information with respect to the individual's U.S. income tax status for the three most recent tax years
4. Any other information the Secretary of the Treasury may prescribe (section 6039E(b))

Government Employees

Under section 911, the earned income exclusion is not available for amounts paid to employees by the U.S. government or a U.S. agency. However, civilian officers and employees of the U.S. government stationed outside the United States who receive certain allowances (section 912(1)) or cost-of-living allowances (section 912(2)) may exclude these amounts from gross income. A volunteer in the Peace Corps may exclude certain allowances (such as leave allowances and living allowances constituting basic compensation) from gross income (section 912(3)).

17

Section 482

Section 482 gives the Secretary of the Treasury or his or her delegate, the district director, the authority to distribute, apportion, or allocate gross income, deductions, credits or allowances, or any items affecting taxable income between or among controlled entities to clearly reflect the true taxable income of each entity. The purpose of section 482 is to place a controlled entity on a tax parity with an uncontrolled entity, that is, to ensure that the prices charged by entities under common control reflect the arm's-length charges of independent entities.

Without the threat of a section such as 482, an entity could engage in transactions with affiliates so that taxes could be minimized or eliminated. For example, a business could perform services for, or sell goods to, affiliates at prices that could artificially split income among the businesses. By judiciously splitting income among related entities in the United States and abroad, income taxes of the group could be greatly reduced or possibly eliminated. With respect to this possibility of splitting income, one court stated that a person may not "reduce his income tax by transferring his money from one pocket to another even though he uses a different pair of trousers. A man with a half-dozen pockets might also

escape liability altogether."[1] The following conditions are prerequisites for the application of section 482.

1. There must be two or more organizations, trades, or businesses.
2. The entities must be owned or controlled directly or indirectly by the same interests.
3. A condition must exist whereby an entity has filed a tax return that does not clearly reflect income, ostensibly because of a non-arm's-length transaction between the controlled entities.

To minimize disagreements between the IRS and taxpayers, regulations under section 482 were promulgated to provide guidelines for dealings among controlled entities. Section 482 issues have increased in significance because of substantial Internal Revenue Service (IRS) audit activity in this area and the threat of penalties under Section 6662 for section 482 adjustments (Section 6662(e)(3)).

Application of Section 482

Burden of Proof

In order for the district director to apply section 482, he or she must show a factual basis that supports the allocation, as well as a basis on which proper allocations could be made.[2] The district director will attempt to show that the controlled entities are not dealing at arm's length and what the hypothetical result would be if the parties were dealing as independent entities. If the entities are dealing at arm's length, the mere fact that the effect of the transaction is to deprive the U.S. Treasury of tax does not give the district director the authority to apply section 482.[3] Once the allocation has been made, the burden of proof shifts to the taxpayer.[4] To prevail in court, the taxpayer has the burden of showing that the determination is arbitrary and an abuse of the commissioner's authority.[5] The

[1] *Alpha Tank & Sheet Metal Mfg. Co. v. United States*, 116 F. Supp. 721 (Ct. Cl. 1953).

[2] *The Friedlander Corp.*, 25 T.C. 70 (1955). 1341 (1954).

[3] *Simon J. Murphy Co. v. Comm.*, 231 F.2d 639 (CA-6, 1956), *rev'g. and rem'g.* 22 T.C.

[4] *Oppenheim's Inc. v. Kavanagh*, 90 F. Supp. 107 (E.D. Mich. 1950).

[5] *Epsen Lithographers, Inc. v. O'Malley*, 67 F. Supp. 181 (D. Neb. 1946); *Woodward Governor Co.*, 55 T.C. 56 (1970), *acq.*; *Ballantine Motor Co. v. Comm.*, 321 F.2d 796 (CA-4, 1968). In *Wisconsin Big Boy Corp. v. Comm.*, 452 F.2d 137 (CA-7, 1971) the court held that the taxpayer must not only show that the section 482 allocation was arbitrary, but he must show what a reasonable allocation would be.

district director may allocate; he or she is not required to do so. As a result, this means if a controlled entity is dealing with an affiliate at less than arm's length with resulting unfavorable tax consequences, the taxpayer cannot apply the provisions of section 482 to improve the tax result, nor can the taxpayer compel the district director to apply such provisions (Treas. Reg. Sec. 1.482-1(a)(2) and (3)). In addition, no allocations will be made where results achieved are within an arm's-length range (Treas. Reg. Sec. 1.482-1(e)(1)).

Section 482 applies to all controlled taxpayers, whether the controlled taxpayer files a separate or consolidated U.S. income tax return. If a controlled taxpayer files a separate return, its true separate taxable income will be determined. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer must be determined consistently with the principles of a consolidated return (Treas. Reg. Sec. 1.482-1(f)(iv)).

Allocations have been applied in the following situations as well as others: sales of goods or services,[6] profits from rentals,[7] profits from financial operations,[8] tax-free exchanges,[9] non-recognition-of-gain-or-loss transactions,[10] constructive dividend,[11] corporate income to individual shareholder,[12] personal service income to employee-shareholder,[13] and shifting of expenses.[14]

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[6]*Wisconsin Big Boy Corp. v. Comm.*, 452 F.2d 137 (CA-7, 1971); *Your Host, Inc.*, 58 T.C. 10 (1972), *aff'd.* 489 F.2d 957 (CA-2, 1974); *cert. denied; Southern Bankcorporation*, 67 T.C. 1022 (1977).

[7]*Welworth Realty Co.*, 40 B.T.A. 97 (1939); *Leedy-Glover Realty & Insurance Co.*, 13 T.C. 95 (1949), *aff'd.* 184 F.2d 833 (CA-5, 1950).

[8]*Home Furniture Co. v. Comm.*, 168 F.2d 312 (CA-4, 1948) *aff'g.* 6 T.C.M. 915 (1947); *Abbott Mortgage Co.*, T.C. Memo 1958-106.

[9]*Treas. Reg. Sec.* 1.482-1(f)(iii); *Bank of America v. United States* (DC, Cal., 1978); Rev. Rul. 77-83, 1977-1 CB 139; *Rooney v. Comm.*, 305 F.2d 681 (CA-9, 1962), *aff'g.* 189 F. Supp. 733 (N.D. Cal. 1960); *National Sec. Corp. v. Comm.*, 137 F.2d 600 (CA-3, 1943), *cert. denied*, 320 U.S. 794 (1943).

[10]*Ruddick Corp. v. United States*, 643 F.2d 747 (Ct. Cls. 1981); *Ruddick Corp. v. United States* (Ct. Cls. 1983); *Foster*, 80 T.C. 34 (1983).

[11]Rev. Rul. 69-630, 1969-2 C.B. 112; *Sparks Nugget, Inc. v. Comm.*, 458 F.2d 631 (CA-9, 1972) *aff'g.* T.C. Memo. 1970-74.

[12]Ach, 42 T.C. 114 (1964) *aff'd.* 358 F.2d 342 (CA-6, 1966), *cert. denied*, 385 U.S. 899 (1966); *Fegan*, 71 T.C. 791 (1979) *aff'd.* (CA-10, 1981); *Cooper*, 64 T.C. 576 (1975).

[13]*Keller v. Comm.*, 77 T.C. 1014 (1981) *aff'd.* (CA-10, 1983); *Fogelsong*, 691 F.2d 848 (CA-7, 1982) *rev'g. and rem'g.* 77 T.C. 1103 (1981).

[14]*Peck*, T.C. Memo. 1982-17; *Northwestern National Bank of Minneapolis v. United States*, 556 F.2d 899 (CA-8, 1977).

The Concept of Owned or Controlled

The Internal Revenue Code requires that the organizations in question must be owned or controlled directly or indirectly by the same interests. The organization can be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation, that is organized, operated, or doing business anywhere in the world (Treas. Reg. Sec. 1.482-1(i)(1)).

The regulations further expand the term *control* to include any kind of control—direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. (Treas. Reg. Sec. 1.482-1(i)(4)). For purposes of this meaning of control, one must differentiate between statutory control and de facto control. Statutory control as it relates to corporations in general[15] means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of all classes of stock (sections 269(a) and 304(c)). For partnerships, control means owning directly or indirectly more than 50 percent of the capital interest or the profits interest (section 707(b)).

In B. Forman Co., Inc.[16] the second circuit reversed the Tax Court decision that 50-percent ownership in a corporation, called Midtown, by each of two unrelated partners was not control. The decision stated, "Whether McCurdy and Forman was regarded as a partnership or joint venture, de facto, in forming Midtown, the conclusion is inescapable that they acted in concert in making loans without interest to a corporation, all of whose stock they owned and all of whose directors and officers were their alter egos." In effect, the concept of de facto control took precedence over statutory control.

In *Grenada Industries, Inc.*,[17] two corporations and two partnerships were owned by four families in identical 35-percent/35-percent/20-percent/10-percent proportions. In upholding an allocation of income

[15]Under subchapter C, subject to the exception of section 304, *control* means ownership of stock possessing at least 80 percent of total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

[16]453 F.2d 1144 (2d Cir. 1972), *cert. denied*, 407 U.S. 934, *reh'g. denied*, 409 U.S. 899 (1972), *rev'g*. 54 T.C. 912 (1970). In *Cayuga Serv., Inc.*, 34 T.C.M. 18 (1975), the Tax Court reiterated its view that 50-percent ownership does not constitute control.

[17]17202 F.2d 873 (CA-5, 1953), *cert. denied*, 346 U.S. 819, *aff'g*. 17 T.C. 231 (1951).

among the four organizations, the court noted that it was immaterial that the ownership of the stock and the partnership interests may not have been in identical persons at the same time. Control was inferred from the actions of the parties.

The regulations state that a presumption of control arises if income or deductions have been arbitrarily shifted. The taxpayer is thus placed in the position of proving that if the mechanical standards of statutory control are not satisfied, the de facto control also does not exist (Treas. Reg. Sec. 1.482-1(i)(4)).

Collateral Adjustments

Section 482 can be invoked by the district director to compute true taxable income whether or not the shifting of income, deductions or credits, or allowances between controlled taxpayers was due to an inadvertent act, an improper knowledgeable act, improper accounting, or a fraudulent or sham transaction (Treas. Reg. Sec. 1.482-1(f)(1)(i)). To show true taxable income, a distribution, apportionment, or allocation adjustment may take the form of a decrease or increase in gross income, deductions including depreciation, the basis of assets including inventory, or any other adjustment that may be appropriate. The district director will take into account appropriate collateral adjustments that affect the amount or the effect of a section 482 allocation. Appropriate collateral adjustments may include correlative adjustments, conforming adjustments, and setoffs (Treas. Reg. Sec. 1.482-1(g)(2)).

Correlative Allocations. When the district director makes an allocation under section 482 (called a *primary allocation*), appropriate correlative allocations will also be made with respect to any other member of the group affected by the allocation. For example, if an allocation of income is made to one member of a group, a corresponding decrease in the income of the other member is made. The district director will furnish the taxpayer with the information regarding the primary and correlative adjustment. A primary allocation will not be considered to have been made until the date of the final determination of the tax liability that reflects the allocation. This final determination with respect to the allocation includes the following:

- Assessment of tax following execution of a Form 870 with respect to the allocation
- Acceptance of a Form 870-AD

- Payment of the deficiency
- Stipulation in the Tax Court
- Final determination of tax liability by offer-in compromise, closing agreement, or final resolution of a judicial proceeding

Example 17.1. In 1998, Y, a U.S. corporation rents a building owned by X, also a U.S. corporation. In 2000, the district director determines that the rental charge paid by Y to X was not at arm's length and proposes to adjust X's income to reflect an arm's-length rental charge. X consents to the assessment reflecting such adjustment by executing Form 870, a Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment. The assessment of the tax with respect to such adjustment is made in 2000. Thus, the primary allocation is considered to have been made in 2000.

The adjustment made to X's income under section 482 requires a correlative allocation with respect to Y's income. The district director notifies X in writing of the amount and nature of the adjustment made with respect to Y. Y had net operating losses in 1995, 1996, 1997, 1998, and 1999. Although a correlative adjustment will not have an effect on Y's U.S. income tax liability for 1998, an adjustment increasing Y's net operating loss for 1999 will be made for purposes of determining Y's U.S. income tax liability for 2000 or a later taxable year to which the increased net operating loss may be carried (Treas. Reg. Sec. 1.482-1(e)(iv), example (1)).

Conforming Adjustments. Appropriate adjustments must be made to conform the taxpayer's accounts to reflect the section 482 allocation, such as dividends, capital contributions, or repayment of the allocated amount pursuant to applicable revenue procedures (Treas. Reg. Sec. 1.482-1(g)(3)).

Example 17.2. USD, a United States corporation, buys Product from its foreign parent, FP. In reviewing USD's income tax return, the district director determines that the arm's-length price would have increased USD's taxable income by $5 million. The district director accordingly adjusts USD's income to reflect its true taxable income. To conform its cash accounts to reflect the section 482 allocation made by the district director, USD applies for relief under Rev. Proc. 65-17, 1965-1 C.B. 833 to treat the $5 million adjustment as an account receivable from FP, due as of the last day of the year of the transaction, with interest accruing thereon (Treas. Reg. Sec. 1.482-1(g)(3)(ii), example).

Setoffs. When an allocation is made under section 482, any other controlled transaction in the same taxable year that is not at arm's length and

that would result in a setoff against the allocation that would otherwise be made with regard to the first transaction will be taken into account. Such setoff will be taken into account only if the taxpayer establishes that the other transaction was not at arm's length, determines the amount of the appropriate arm's-length charge, and documents the correlative adjustment resulting from the setoff (Treas. Reg. Sec. 1.482-1(g)(4)).

> *Example 17.3.* P renders services to S in connection with the construction of S's factory. An arm's-length charge for such services would be $100,000. During the same taxable year, P makes available to S a machine to be used in such construction. P bills S $125,000 for the services, but does not bill for the use of the machines. No allocation will be made with respect to the undercharge for the machine if the following occurs. P notifies the district director of the basis of any claimed setoff within 30 days after the date of a letter by which the district director transmits an examination report notifying P of proposed adjustments, and can establish that the excessive charge for services was equal to an arm's-length charge for the use of the machine and that the taxable income and income tax liabilities of P are not distorted, and documents the correlative adjustment resulting from the setoff (Treas. Reg. Sec. 1.482-1(g)(4)(iii), example (1)).

Creation of Income

The district director may "create" income under the authority of section 482. The Code allows the district director to distribute, apportion, or allocate. Regulatory authority for the creation of income is contained in Treas. Reg. Sec. 1.482-1(f)(1)(ii), which states that the district director may allocate income notwithstanding the fact that the ultimate income anticipated from a series of transactions *may not be realized* or is realized during a later period (emphasis added). This regulatory authority has been upheld by the courts.[18]

[18]Until the decision in *B. Forman, Inc.*, 453 F.2d 1144 (2d Cir. 1972), *cert. denied*, 407 U.S. 934, *reh'g. denied*, 409 U.S. 899 (1972), *rev'g.* 54 T.C. 912 (1970), the courts had taken the position that section 482 did not authorize the district director to first create and then to allocate income. As was expressed in *Simon J. Murphy Co.*, 231 F.2d 639 (CA-6, 1956) *rev'g. and rem'g.* 22 T.C. 1341 (1954), the commissioner was not authorized to transfer income or deductions from one controlled organization to another, unless, by reason of the relationship, the original distribution between the two entities, as reflected by the books, is in substance a fictitious one, improperly reflecting form instead of substance. In *Tennessee-Arkansas Gravel Co.*, 112 F.2d 508 (CA-6, 1940), *rev'g. and rem'g.* B.T.A. Memo. (June 30, 1938), the taxpayer rented equipment to an affiliate. The

(continued)

Arm's-Length Standards

In general, for purposes of determining the true taxable income of a taxpayer under section 482, the arm's-length result of a controlled transaction is the amount of consideration that would have been charged or paid (or the profits that would have been earned) in comparable transactions

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affiliate was unable to pay the rent since it operated at a loss. By an oral agreement the next year, no charge was made for the use of the equipment. The commissioner attempted to allocate rental income to Tennessee-Arkansas Gravel. The court rejected the allocation on the grounds that the commissioner was not authorized to set up income where none existed. In *Smith-Bridgman & Co.*, 16 T.C. 287 (1951), the commissioner attempted to add $5,800 to the taxable income of the taxpayer, constituting interest that supposedly should have been charged on non-interest-bearing loans to the parent company. The court stated that the commissioner had not allocated gross income but had created income where none, in fact, existed. The issue of creating interest income arose again in PPG Industries, Inc., 55 T.C. 928 (1970), when the commissioner attempted to allocate interest income to the taxpayer in 1960 for an interest-free loan made to the taxpayer's subsidiary in 1940. The court refused to authorize the creation of income and could not understand how loans made in 1940 could be considered as the transaction basis for the 1960 allocation. As late as 1971 in *Huber Home, Inc.*, 55 T.C. 598 (1971), the Tax Court stated that the courts will not authorize the creation of income out of a transaction in which no income was realized. The *Huber Homes, Inc.* case involved a builder who was unable to sell a number of homes in an area he had developed. He therefore sold these houses at cost to a wholly owned subsidiary actively engaged in the business of renting homes to the public. The Commissioner's allocation of profit equal to the difference between the fair market value and the cost to *Huber Homes, Inc.*, was rejected by the Tax Court, since no income from the transfer was actually realized by either *Huber Homes, Inc.*, or the subsidiary. This series of defeats came to a halt in B. *Forman Co.* when the second circuit court held the Commissioner's allocation of interest on non-interest-bearing notes was proper. The court, in rejecting *Huber Homes, Inc.*, *Smith-Bridgman & Co.*, *Tennessee-Arkansas Gravel Co.*, and *PPG Industries, Inc.*, stated that these cases were not in accord with either economic reality, or with the declared purpose of Section 482. They seriously impair the usefulness of Section 482. These cases may be correct from a pure accounting standpoint. Nevertheless, interest income may be added to taxpayers' incomes, as long as a correlative adjustment is made. . . for then the true taxable income of all involved will be properly reflected. (*B. Forman Co. Inc.*, 453 F.2d 1144) Within a short period of time, the eighth circuit in *Kahler Corp. v. Comm.*, 486 F.2d 1 (CA-8, 1973), *aff'g.* 58 T.C. 496 (1972), the ninth circuit in *Kerry Investment Co. v. Comm.*, 500 F.2d 108 (CA-9, 1974), *aff'g.* 58 T.C. 479 (1972), and the fifth circuit in *Fitzgerald Motor Co. v. Comm.*, 508 F.2d 1096 (CA-5, 1975), *aff'g.* 60 T.C. 957 (1973), joined the second circuit in allowing the commissioner to "create" interest income from non-interest-bearing notes. In *Latham Park Manor, Inc.*, 69 T.C. 199 (1977), the Tax Court held that the commissioner may allocate interest income if there is a non-interest-bearing loan between controlled corporations even though the borrowed funds do not generate income for the borrower.

between uncontrolled taxpayers. The comparability of controlled and uncontrolled transactions must be determined under the provisions specified in the regulations. The regulations specify arm's-length methods to be applied for loans and advances, services, and property.

Best Method Rule. The arm's-length result of a controlled transaction must be determined under the method that provides the most accurate measure of an arm's-length result under the facts and circumstances of the transaction. This is called the *best method rule*. The factors to be considered in selecting a method include the completeness and accuracy of the data used to apply each method and the degree of comparability between controlled and uncontrolled transactions. In addition, it may also be relevant to consider whether the results of the analysis are consistent with the results of an analysis under another method (Treas. Reg. Sec. 1.482-1(c)(2)). If two or more methods produce inconsistent results, the best method rule will be applied to select the method that provides the most reliable determination of an arm's-length result. If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account in selecting a method is whether any of the competing methods provide results that are consistent with the results obtained from the appropriate application of another method (Treas. Reg. Sec. 1.482-1(c)(2)(iii)).

Comparability

The basic factors to be evaluated for determining comparability of a controlled transaction and an uncontrolled transaction include the following:

- Functions
- Contractual terms
- Risks
- Economic conditions
- Property or services

In general, for two transactions to be considered comparable, an uncontrolled transaction must be sufficiently similar but need not be identical or exactly comparable to the controlled transaction. Adjustments may be made to the results of an uncontrolled transaction, if necessary, to account for material differences between the controlled and uncontrolled transactions, if the effect of these differences on prices

or profits can be ascertained with sufficient accuracy to improve the reliability of the results. These adjustments should be based on commercial practices, economic principles, or statistical analyses, as applied to the available data (Treas. Reg. Sec. 1.482-1(d)(2)).

> *Example 17.4*. FS manufactures product XX and sells that product to its parent corporation, P. FS also sells product XX to uncontrolled taxpayers at a price of $100 per unit. Except for the volume of each transaction, the sales to P and to uncontrolled taxpayers take place under substantially the same economic conditions and contractual terms. In uncontrolled transactions, FS offers a 2-percent discount for quantities of 20 per order, and a 5-percent discount for quantities of 100 per order. If P purchases product XX in quantities of 60 per order, it may be assumed that the arm's-length price to P would be $100, less a discount of 3.5 percent. If P purchases product XX in quantities of 1,000 per order, in the absence of further information about uncontrolled transactions at similar order quantities, a volume discount greater than 5 percent can be assumed only on the basis of proper economic and statistical analysis, not necessarily a linear extrapolation from the 2-percent and 5-percent catalog discounts applicable to sales of 20 and 100 units, respectively (Treas. Reg. Sec. 1.482-1(d)(3)(ii)(C), example (2)).

Functions. The comparison of the similarity of functions performed by controlled and uncontrolled taxpayers is based upon a functional analysis. Functional analysis identifies and compares the economically significant activities actually undertaken or to be undertaken by the taxpayers in both controlled and uncontrolled transactions. Although a functional analysis is not a pricing method and does not itself determine the arm's-length result for the controlled transaction under review, functional analysis identifies functions that may need to be accounted for in determining the comparability of two transactions. These functions might include research and development; product design and engineering; manufacturing or process engineering; product fabrication, extraction, and assembly; purchasing and materials management; marketing and distribution functions including inventory management, warranty administration, and advertising and marketing activities; transportation and warehousing; and managerial, legal, accounting and finance, credit and collection, training, and personnel management services (Treas. Reg. Sec. 1.482-1(d)(3)(i)).

Contractual Terms. The determination of whether the controlled and uncontrolled transactions are comparable requires a comparison of the significant contractual terms that could affect the prices that would be

charged or paid, or the profit that would be earned in the two transactions. These terms include the form of consideration charged or paid; payment terms or related financing arrangements; the volume of products purchased or sold; warranty obligations; rights to updates, revisions, or modifications; the duration of relevant contracts and related termination or renegotiation rights; collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and extension of credit and payment terms (Treas. Reg. Sec. 1.482-1(d)(3)(ii)).

Risk. The determination of whether controlled and uncontrolled transactions are comparable requires a comparison of the significant risks borne in each transaction. This comparison ordinarily consists of analyzing the contractual terms between the parties and the economic substance of that transaction. In considering the economic substance of the transaction, the following are relevant:

- Whether the pattern of the controlled taxpayer's conduct over time is consistent with the purported allocation of risk between the controlled taxpayers
- Whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk
- The extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized

Risks that ordinarily must be considered include market risks such as fluctuations in cost, demand, pricing, and inventory levels; risks associated with the success or failure of research and development activities; financial risks including fluctuations in foreign currency rates of exchange and interest rates; credit and collection risks; product liability risks; and general business risks related to the ownership of property, plant, and equipment (Treas. Reg. Sec. 1.482-1(d)(3)(iii)).

Example 17.5. FD, the wholly owned foreign distributor of USM, a U.S. manufacturer, buys widgets from its parent under a written five-year contract that was entered into before any transaction between the two parties. FD has adequate financial capacity to fund losses that may be expected to occur as a result of the transaction. Widgets are a new product in the market in which FD operates. Under the terms of the contract, FD must buy 20,000 units of widgets at $5 per unit for each of the five years of the contract, and

FD must finance any marketing strategies to introduce widgets to the foreign market. In Years 1, 2, and 3, a total of only 10,000 widgets were sold by FD to unrelated parties at $11 per widget. However, FD, as required by the contract, bought 20,000 units each year. In Year 4, the demand for widgets rose dramatically. FD was able to sell its entire inventory of widgets at $25 per widget. Because the allocation of the market risks borne by FD was documented in a written agreement entered into before the result of the risk was known or reasonably knowable, and the conduct of FD was consistent with the economic substance of the contract, FD will be deemed to bear the market risk (Treas. Reg. Sec. 1.482-1(d)(3)(iii)(C), example (1)).

Economic Conditions. The determination of whether the controlled and uncontrolled transactions are comparable requires a comparison of the significant economic factors that could affect the prices that would be charged or paid, or the profit that would be earned in the two transactions. These factors include the following:

- The similarity of geographic markets
- The relative size of each market, the extent of the overall economic development in each market
- The level of the market
- The relevant market shares for the products, properties, or services transferred or provided
- The location-specific costs of the factors of production and distribution
- The extent of competition in each market with regard to the property or services under review
- The economic condition of the particular industry (Treas. Reg. Sec. 1.482-1(d)(3)(iv))

Property or Services. The determination of whether controlled and uncontrolled transactions are comparable requires a comparison of the property or services transferred in the transactions. With respect to transfers of tangible or intangible property, the degree of similarity required will vary depending upon the method applied (Treas. Reg. Sec. 1.482-1(d)(3)(v)).

Special Circumstances. There are certain circumstances in which the price for a controlled transfer of property may be other than the amount charged in an otherwise comparable uncontrolled transaction, because of

market share strategy pricing policies, because of price differences in different geographic markets, or because of isolated transactions. In the situations of pricing because of a pricing strategy that is undertaken to enter new markets, to increase a product's share of an existing market, or to meet competition in an existing market, a controlled transaction may be priced in such a manner only if it can be shown that such price would have been charged in an uncontrolled transaction under comparable circumstances for a comparable period of time. The following additional conditions must also be documented:

- The costs incurred to implement the market share strategy are borne by the controlled taxpayer that would obtain the future profits that result from that strategy and it is reasonably likely to result in future profits that reflect an appropriate return on the costs incurred to implement it.
- The market share strategy is pursued for a period of time that is reasonable, taking into consideration the industry and product in question.
- The market share strategy, the related costs and expected returns, and any agreement between the controlled taxpayers to share the related costs, were established before the strategy was implemented (Treas. Reg. Sec. 1.482-1(d)(4)(i)).

Example 17.6. FORSUB, an X Country corporation, is a wholly owned subsidiary of USP, a U.S. manufacturer. USP establishes a transfer price to FORSUB which is intended to accomplish an objective of increasing its product's share of the market in Country X. This transfer price reflects increased market development expenses that are incurred by FORSUB. USP can document that a competitor engaged in a comparable strategy under comparable circumstances for a comparable period of time. In this situation, USP is not required to locate a comparable uncontrolled transaction that would satisfy the comparable uncontrolled price (CUP) method. USP must provide documentation, if requested, that substantiates the following:

1. The costs incurred to implement the market share strategy are borne by FORSUB, and there is reasonable likelihood that the strategy will result in future profits that reflect an appropriate return in relation to the costs incurred to implement it.
2. The market share strategy is pursued only for a period of time that is reasonable, taking into consideration FORSUB's industry and the product in question.

3. The market share strategy, and related costs and expected returns, and any agreement between USP and FORSUB to share related costs, were established before the market share strategy was implemented.

Usually uncontrolled comparables should be derived from the geographic market in which the controlled taxpayer operates. If information from the same market is not available, an uncontrolled comparable derived from a different geographic market may be considered if appropriate adjustments are made to account for differences between the two markets (Treas. Reg. Sec. 1.482-1(d)(4)(ii)).

Example 17.7. Manuco, a wholly owned foreign subsidiary of P, a U.S. corporation, manufactures products in Country Z for sale to P. No uncontrolled transactions are located that would provide a reliable measure of the arm's-length result under the comparable uncontrolled price method. The district director considers applying the cost plus method or the comparable profits method. Information on uncontrolled taxpayers performing comparable functions under comparable circumstances in the same geographic market is not available. Therefore, adjusted data from uncontrolled manufacturers in other markets may be considered in order to apply the cost plus method. In this case, comparable uncontrolled manufacturers are found in the United States. Accordingly, data from the comparable U.S. controlled manufacturers, as adjusted to account for differences between the United States and Country Z's geographic market, is used to test the arm's-length price paid by P to Manuco. However, the use of such data may affect the reliability of the results for purposes of the best method rule (Treas. Reg. Sec. 1.482-1(d)(4)(ii)(B), example).

If an uncontrolled taxpayer operates in a different geographic market than the controlled taxpayer, adjustments may be necessary to account for significant differences in costs attributable to the geographic locations (location savings). These adjustments are based on the effect these differences might have on the consideration charged or paid in the controlled transfer, given the relative competitive positions of buyers and sellers in each location (Treas. Reg. Sec. 1.482-1(d)(4)(ii)).

Example 17.8. Couture, a U.S. apparel design corporation, contracts with Sewco, its wholly owned Country Y subsidiary, to manufacture its clothes. Costs of production in Country Y are significantly lower than the costs of manufacturing in the United States. Although clothes with the Couture label sell for a premium price, the actual production of the clothes does not require significant specialized knowledge, and could be performed by several apparel-production firms comparable to Sewco in similar geographic markets. Thus, the fact that production is less costly in Country Y will not,

in and of itself, justify additional profits derived from lower costs of manufacturing in Country Y inuring to Sewco, because of the competitive effects attributable to the other producers in similar geographic markets capable of performing the same functions at the same low costs (Treas. Reg. Sec. 1.482-1(d)(4)(ii)(D), example).

Isolated transactions between uncontrolled taxpayers, and transactions arranged primarily for the purpose of establishing an arm's-length result with respect to a controlled transaction, ordinarily will not constitute comparable transactions for purposes of this section. In the case of tangible property, uncontrolled transactions should ordinarily be significant in number and amount, and should occur in the ordinary course of business in order to be considered comparable uncontrolled transactions for purposes of section 482 (Treas. Reg. Sec. 1.482-1(d)(4)(iii)).

Arm's-Length Range

In some situations, application of a single pricing method selected under the best method rule may produce a number of results from which a range of reliable results may be derived, rather than a single price. An arm's-length range is ordinarily determined by applying the best method rule to two or more comparable and reliable uncontrolled transactions. If there are material differences between the controlled and uncontrolled transactions, adjustments must be made to the uncontrolled transaction if the effect of the difference on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results.

The uncontrolled comparables that meet the following conditions will be included in the arm's-length range:

- The information on the controlled transaction and uncontrolled comparables is sufficiently complete that it is likely that all material differences have been identified.
- Each material difference has a definite and reasonable ascertainable effect on price or profit.
- An adjustment is made to eliminate the effect of each of the material differences (Treas. Reg. Sec. 1.482-1(e)(2)(iii)).

If there are no uncontrolled comparables that satisfy the above conditions, the arm's-length range is derived from the results of all uncontrolled comparables that achieve a similar level of comparability and reliability. If the reliability must be increased and it is possible to do so, the range is adjusted by applying valid statistical techniques to the

uncontrolled transactions selected. The reliability of the analysis is increased when the statistical methods used to establish the range produce a 75-percent probability of a result falling above the lower end of the range and a 75-percent probability of a result falling below the upper end of the range. If exactly 25 percent of the results are at or below the 25th percentile, then the 25th percentile is equal to the average of that result and the next higher result. The 75th percentile is determined analogously. The interquartile range ordinarily provides an acceptable measure of this range. It is the range from the 25th to the 75th percentile. The district director may propose an allocation on the basis of a single comparable uncontrolled price. However, if the taxpayer subsequently demonstrates the results claimed on its income tax return are within the range established by additional equally reliable comparable uncontrolled prices, no allocation will be made. On the other hand, if the taxpayer's results fall outside of this range, the district director may make allocations that adjust the result to any point within the range, ordinarily the median of the results. A different statistical method may be applied if it provides a more reliable measure.

Example 17.9. To evaluate the arm's-length result of a controlled transaction between USSub, the U.S. taxpayer under review, and FP, its foreign parent, the district director considers applying the resale price method. The district director identifies ten potential uncontrolled transactions. The distributors in all ten uncontrolled transactions purchase and resell similar products and perform similar functions to those of USSub. Data with respect to three of the uncontrolled transactions are very limited, and although some material differences can be identified and adjusted for, the level of comparability of these three uncontrolled comparables is significantly lower than that of the other seven. Further, of those seven, adjustments for the identified material differences can be reliably made for only four of the uncontrolled transactions. Of these four, there are some product and functional differences between the four uncontrolled comparables and USSub. However, the data are sufficiently complete to determine the effect of the differences. Applying the resale price method to the four uncontrolled transactions and making the required adjustments for these differences, the following results are derived by the district director:

Uncontrolled Comparable	*Result (Price)*
1	$42.00
2	44.00
3	45.00
4	47.50

It cannot be established in this case that all material differences are likely to have been identified and reliable adjustments made for those differences. Accordingly, if the resale price method is determined to be the best method, the arm's-length range must be established. In this case, the interquartile range is from $43 [($42 + 44)/2] to $46.25 [($45 + 47.50)/2]. If USSub's price falls outside this range, the district director may make an allocation. In this case, the allocation would be to the median of the results ($44.50) (Treas. Reg. Sec. 1.482-1(e)(5), example (3)).

Specific Pricing Rules

The regulations provide standards for arm's-length transactions and guidelines for establishing a deemed arm's-length price in five common areas of transactions between controlled entities. These deemed arm's-length prices offer safe haven from a section 482 challenge if the guidelines are satisfied. The following are the five common areas:

1. Loans or advances
2. Performance of services
3. Use of tangible property
4. Transfer of intangible property
5. Transfer of tangible property

Loans or Advances

If one member of a group of controlled entities makes a loan or advance or becomes a creditor of another member of the group on bona fide indebtedness and either charges no interest or charges interest at a rate which is not equal to an arm's-length rate of interest, then a section 482 allocation may be made.

The allocation of interest applies to interest on bona fide indebtedness, such as loans or advances of money or other consideration (whether or not evidenced by a written instrument), and indebtedness arising in the ordinary course of business from sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit (Treas. Reg. Sec. 1.482-2(a)(1)(ii)(A)). The allocation of interest rules do not apply to indebtedness that is not in fact a bona fide indebtedness (so-called alleged indebtedness). Examples of alleged indebtedness are contributions to the capital of a corporation or a distribution by a corporation with respect to its shares, and payments on a debt

instrument with respect to a transaction between controlled entities which in substance is a lease rather than a sale (Treas. Reg. Sec. 1.482-2(a)(1)(ii)(B)).

In general, the period for which interest shall be charged with respect to a bona fide indebtedness between controlled entities begins on the day after the day the indebtedness arises and ends on the day the indebtedness is satisfied (whether by payment, offset, cancellation, or otherwise). There are provisions that contain certain alternative periods during which interest is not required to be charged on certain indebtedness. These exceptions apply only to indebtedness incurred in the ordinary course of business from sales, services, etc.; between members of the group; and not evidenced by a written instrument requiring the payment of interest, referred to as *intercompany trade receivables*. The period for which interest is not required to be charged on intercompany trade receivables is called the *interest-free period* (Treas. Reg. Sec. 1.482-2(a)(1)(iii)(A)).

Interest is not required to be charged on intercompany trade receivables for the following:

- On an intercompany trade receivable until the first day of the third calendar month following the month in which the intercompany trade receivable arises, there is no interest.
- In the case of an intercompany trade receivable arising from a transaction in the ordinary course of a trade or business that is actively conducted outside the United States by the debtor, there is no interest until the first day of the fourth calendar month following the month in which the intercompany trade receivable arises.
- In the industry of the creditor and unrelated persons, it is a regular trade practice to allow unrelated parties a longer period without charging interest on similar transactions giving rise to intercompany trade receivables, and a longer interest-free period is allowed with respect to a comparable amount of intercompany trade receivables.
- If, in the ordinary course of business, one member of the group purchases property from another member of the group for resale to unrelated persons located in a particular foreign country, the related purchaser and the related seller may use as the interest-free period for the intercompany trade receivables arising during the related seller's taxable year from the purchase of such property within the same product group, an interest-free period equal to the sum of the number

of days in the related purchaser's average collection period (see Treas. Reg. Sec. 1.482-2(a)(2)) for sales of property within the same product group [three-digit Standard Industrial Classification (SIC) Code] sold in the ordinary course of business to unrelated persons located in the same foreign country, plus ten calendar days (up to 183 days) (Treas. Reg. Sec. 1.482-2(a)(1)(iii)(B)–(E)).

Arm's-Length Interest Rate. For purposes of section 482, an *arm's-length rate of interest* is a rate of interest that was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. Relevant factors to be considered include the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties (Treas. Reg. Sec. 1.482-2(a)(2)(i)).

If the loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower, the arm's-length rate for any taxable year must be equal to the rate actually paid by the lender, increased by an amount that reflects the costs or deductions incurred by the lender in borrowing such amounts and making such loans, unless the taxpayer establishes a more appropriate rate (Treas. Reg. Sec. 1.482-2(a)(2)(ii)).

For certain loans and advances made after May 8, 1986 (and term loans or advances made before August 7, 1986, pursuant to a written contract entered into before May 9, 1986), there are safe-haven interest rates. The safe-haven interest rate is based on the applicable federal rate. The rate of interest actually charged is that rate that is not less than 100 percent of the applicable federal rate (the lower limit), and not greater than 130 percent of the applicable federal rate (the upper limit).[19]

If either no interest is charged or if the rate of interest charged is less than the lower limit, then an arm's-length rate of interest shall be equal

[19]The safe haven rules for certain loans or advances existing before July 24, 1975, provided for an interest rate of at least 4 percent but not one in excess of 6 percent; otherwise a 5-percent rate would be imputed unless the taxpayer established a more appropriate rate. For loans made between July 24, 1975, and June 30, 1981, the safe haven rules provided for an interest rate of at least 6 percent but not one in excess of 8 percent; otherwise a 7-percent rate would be imputed unless the taxpayer established a more appropriate rate. For loans between July 1, 1981, and May 8, 1986, the rate was between 11 and 13 percent and a 12-percent rate was imputed unless the taxpayer established a more appropriate rate.

to the lower limit, compounded semiannually. If the rate of interest charged is greater than the upper limit, then an arm's-length rate of interest shall be equal to the upper limit, compounded semiannually.

In the case of any sale-leaseback described in section 1274(e), the lower limit is 110 percent of the applicable federal rate, compounded semiannually (Treas. Reg. Sec. 1.482-2(a)(1)(iii)). If the lender in a loan or advance transaction is regularly engaged in the trade or business of making loans or advances to unrelated parties, the safe-haven rates do not apply, and the arm's-length interest rate to be used, determined by reference to the interest rates charged in such trade or business by the lender on loans or advances of a similar type made to unrelated parties at and about the time the loan or advance was made (Treas. Reg. Sec. 1.482-2(a)(2)(iii)(D)).

The safe haven interest rates do not apply to any loan or advance the principal or interest f which is expressed in a currency other than U.S. dollars (Treas. Reg. Sec. 1.482-2(a)(2)(iii)(E)). Section 7872 provides that loans between related parties with no stated interest rate or a below market interest rate, will be recharacterized to reflect the substance of the underlying transaction. The substance of the transaction reflects two underlying transactions: a loan to the borrower in exchange for a note that requires the payment of interest at the applicable federal rate (AFR) coupled with an additional payment to the borrower, characterized as a gift, compensation, dividend, or capital contribution depending on the kind of transaction. Section 7872 does not apply to a below market loan between a foreign parent corporation and its U.S. subsidiary unless the interest income imputed to the foreign parent is effectively connected with the conduct of a U.S. trade or business and not exempt from U.S. taxation under an applicable income tax treaty (Temp. Treas. Reg. Sec. 1.7872-5T(2)).

Performance of Services

When one member of a controlled group performs services such as marketing, technical, management, or administration services, allocation to approximate an arm's-length charge will be made under the so-called benefits test. Allocations made will be consistent with relative benefits that were intended from the service. If the probable benefits to the member receiving the service are so indirect or remote that an unrelated party would not have charged for the service, no allocation will be made. Treas.

Reg. Sec. 1.482-2(b)(2) provides several examples demonstrating this concept:

> *Example 17.10.* X and Y are members of the same group of controlled entities. X operates an international airline, and Y owns and operates hotels in several cities serviced by X. X, in conjunction with its advertising, shows pictures of Y's hotels and mentions the names of Y's hotels. The primary benefit of the advertising is to X, but Y will also receive substantial benefits. Since an unrelated party would have charged Y for such advertising, X must charge Y an arm's-length rate according to the benefits each receives (Treas. Reg. Sec. 1.482-2(b)(2)(i), example (1)).

> *Example 17.11.* Assume the same facts as example 17.10, except that X's advertising neither mentions nor pictures Y's hotels. Although it is reasonable to anticipate that increased air travel attributable to X's advertising will result in some benefit to Y due to increased patronage by air travelers, the district director will not make an allocation with respect to such advertising since the probable benefit to Y was so indirect and remote that an unrelated hotel operator would not have been charged for such advertising (Treas. Reg. Sec. 1.482-2(b)(2)(i), example (2)).

Allocations will also not be made if the service is a mere duplication of a service that the related party has independently performed or is performing for itself. For example, if a company has a qualified staff to perform financial analysis of borrowing needs and a plan is reviewed by a related party to determine feasibility, no allocation will be made (Treas. Reg. Sec. 1.482-2(b)(2)(ii), example (2)).

Although an arm's-length rate is the amount charged in an independent transaction between unrelated parties, it is also the amount charged if services are an integral part of the taxpayer's business. If services are not an integral part of business, a deemed arm's-length charge is equal to costs or deductions incurred, unless the taxpayer establishes that a different charge is more appropriate. Costs or deductions that must be included are (1) direct costs such as compensation, bonuses, travel expenses, materials, and supplies; and (2) indirect costs such as utilities, occupancy, supervising and clerical compensation, and an allocable portion of overhead. Interest expenses on indebtedness not incurred specifically for the benefit of another member of the group, expenses associated with issuing stock and maintaining shareholder relations, and expenses incurred because of compliance with governmental regulations not directly related to the service performed, are not considered in the computation of costs (Treas. Reg. Sec. 1.482-2(b)(4) and (5)).

Where an arm's-length charge for services rendered is determined with reference to costs or deductions, and a member has allocated and apportioned costs or deductions to reflect arm's-length charges by employing sound accounting practices that produce a reasonable and consistent method of allocation and apportionment, this method will be accepted. If the method of allocation and apportionment employed is not reasonable and in keeping with sound accounting practice, the method of allocating and apportioning costs or deductions for the purpose of determining the amount of arm's-length charges will be based on the particular circumstances involved. It may be appropriate to use one or more allocation bases. In establishing the method of allocation and apportionment, appropriate consideration should be given to all bases and factors, including, for example, total expenses, asset size, sales, manufacturing expenses, payroll, space utilized, and time spent. The costs incurred by supporting departments may be allocated to other departments on the basis of reasonable departmental overhead rates. Allocations and apportionments of costs or deductions must be made on the basis of the full cost as opposed to the incremental cost (Treas. Reg. Sec. 1.482-2(b)(6)).

Example 17.12. W Corporation performs marketing services for X, a related corporation. Services are not an integral part of W's business. During the year, W incurred costs related to marketing services for W and X as follows:

	Total	*W*	*X*
Direct costs			
Salaries of marketing personnel	$137,000	$ 85,000	$52,000
Travel expenses	25,000	15,000	10,000
Supplies	4,000	2,500	1,500
	$166,000	$102,500	$63,500
Indirect costs			
Clerical	$ 28,000		
Utilities, depreciation, etc.	18,000		
	$ 46,000	$ 28,540	$17,460

Indirect costs have been consistently allocated based on salaries of marketing personnel. The arm's-length charge from W to X must be $80,960, computed as follows:

Direct costs	$63,500
Indirect costs $52,000/$137,000 × $46,000	17,460
	$80,960

Services as an Integral Part of Business. When services are an integral part of a business, a true arm's-length rate must be charged. Services are deemed an integral part of a business in four situations:

1. The renderer of the services or the recipient is engaged in a trade or business of rendering similar services to unrelated parties.
2. The rendering of services to one or more related parties is one of the principal activities of the renderer.
3. The renderer is particularly capable of rendering services and such services are a principal element in the operations of the recipient.
4. The recipient has received the benefit of a substantial amount of services from one or more related parties during its taxable year.

As indicated above, services are an integral part of a business when the renderer of the services or the recipient is engaged in a trade or business of rendering similar services to one or more unrelated parties (Treas. Reg. Sec. 1.482-2(b)(7)(i)).

Services are also an integral part of a business if rendering services to one or more related parties is one of the principal activities of the renderer (Treas. Reg. Sec. 1.482-2(b)(7)(ii)). Except in the case of services that constitute a manufacturing, production, extraction, or construction activity, the services are not considered a principal activity if their cost to the renderer for the taxable year does not exceed 25 percent of total costs or deductions (excluding costs of goods sold). Although the 25-percent test does not apply to manufacturing activities, such activities are included in total costs for purposes of the 25-percent test for service activities.

Example 17.13. G Corporation, a manufacturer not in the business of rendering services, performs manufacturing and marketing services for H, an affiliated corporation. During the taxable year, the cost of manufacturing of G Corporation was $2.5 million. The cost of rendering marketing services for H was $820,000. Manufacturing activities performed for related parties are excluded from consideration under the 25-percent test; however, manufacturing costs are included for purposes of determining total costs. Services are not considered a principal activity of G Corporation, since the services' costs were 24.7 percent of total costs ($820,000 / [$2,500,000 + $820,000]). The arm's-length charge for marketing services rendered H is cost. If the percentage exceeded 25 percent, the arm's-length charge for marketing services rendered to H must be the amount charged in an independent transaction between unrelated parties.

Services are considered an integral part of a business if the renderer of services is particularly capable of rendering the services and the services are a principal element in the operations of the recipient (Treas. Reg. Sec. 1.482-2(b)(7)(iii)). The related party rendering the services is considered particularly capable when advantageous circumstances exist, such as the utilization of special skills and reputation, utilization of an influential relationship with customers, or utilization of its intangible property. If the cost of the services is substantially greater than the value, the party rendering the services is not considered particularly capable of rendering its services.

Example 17.14. A and B are members of the same group of controlled entities. A is a savings and loan association engaged in the business of making mortgage loans. In connection with mortgage loans, adequate fire insurance is required on any structures mortgaged. A's borrowers are not required to take out fire insurance from any particular insurance company. At the same time the loan agreement is being finalized, A's employees suggest that the borrower take out insurance from B, an insurance agency. Most of A's borrowers take out insurance through B. Because of this utilization of its influential relationship with its borrowers, A is particularly capable of rendering selling services to B; and since a substantial amount of B's business is derived from A's borrowers, selling these services is a principal element in the operation of B's insurance business. Thus, the services rendered by A to B are an integral part of the business activity of A.

Services are also considered an integral part of a business if the recipient received benefits of a substantial amount from one or more related parties (Treas. Reg. Sec. 1.482-2(b)(7)(iv)). Services rendered by one or more related parties will be considered substantial if their total costs or deductions to the renderers exceed 25 percent of the total costs or deductions of the recipient during the taxable year. The total costs of the recipient include the renderers' costs directly or indirectly related to the services rendered but exclude amounts paid or accrued to the renderers and amounts paid or accrued for materials reflected in the recipient's cost of goods sold.

Example 17.15. D, E, and F corporations are members of the same group of controlled entities. D and E provide a variety of services to F. Neither D nor E is in the business of rendering services. During the taxable year, F's total costs, exclusive of amounts paid to D and E for services rendered and amounts paid for goods purchased for resale, were $210,000. If the total direct and indirect costs of D and E for services rendered to F during F's taxable year exceed $52,500 (25 percent of $210,000), the services rendered by D and E to F are considered substantial and an integral part of the business activity of

F. In such a case, the arm's-length charge for services rendered to F must be the amount that would be charged in an independent transaction between unrelated parties. If the total direct and indirect costs of D and E for services rendered to F are $52,500 or less, the charge is the total of such costs.

Services Rendered in Connection With the Transfer of Property. The transfer of tangible or intangible property by sale, assignment, loan, lease, or otherwise from one member of a group to another, that is accompanied by the rendering of services, may trigger an allocation. The amount of any allocation that may be appropriate is determined under the property transfer rules. A separate allocation with respect to the services is not made.

Services are rendered in connection with the transfer of property where these services are merely ancillary and subsidiary to the transfer of the property or to the commencement of effective use of the property by the transferee. This is a factual question. Examples of ancillary and subsidiary services are promoting a transaction by demonstrating and explaining the use of the property, or by assisting in the effective "starting-up" of the property transferred, or by performing under a guarantee relating to such effective starting-up (Treas. Reg. Sec. 1.482-2(b)(8)).

Use of Tangible Property

When a member of a controlled group transfers tangible property by lease or other arrangement to another member without charge or at a charge not equal to an arm's-length market rental, a section 482 allocation may be made to reflect an arm's-length charge. An *arm's-length rental charge* is the amount of rent that would be charged for the use of similar property, during the time it was in use, in independent transactions between unrelated parties under similar circumstances, considering the period and location of use, the owner's investment in the property or rent paid for the property, expenses of maintaining the property, the type of property involved, its condition, and all other relevant facts[20] (Treas. Reg. Sec. 1.482-2(c)(1)).

[20]The safe haven rental charges in the case of certain leases entered into before May 9, 1986, and for leases entered into before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986, is equal to the sum of the following amounts:

1. The depreciable basis divided by the total useful life (one-year's straight-line depreciation)
2. Three percent of the depreciable basis
3. The amount of expenses directly and indirectly connected with the property and paid by the owner of the property
4. The amount of expenses directly and indirectly connected with possession and use of property by the lessee that is paid by the owner

If the leased property is subleased to another related party, the deemed arm's-length charge must reflect the rent paid by the lessee to the owner plus deductions directly and indirectly connected with the property, such as maintenance, repairs, and utilities paid by the lessee during the period of the sublease (Treas. Reg. Sec. 1.482-2(c)(2)(iii)).

Transfer of Intangible Property

If tangible property or an interest in intangible property is transferred from one member of a group of controlled entities to another member for other than an arm's-length price, the district director may allocate income to reflect arm's-length consideration. The permissible methods are the following:

- The comparable uncontrolled transaction method
- The comparable profits method
- The profit split method
- Other unspecified methods

The selection of a method for a particular transaction under review is subject to the best method rule, the comparability analysis, and the arm's-length range. The arm's-length consideration for the transfer of an intangible determined under this section must be commensurate with the income attributable to the intangible (Treas. Reg. Sec. 1.482-4(a)). This means that if an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible (Treas. Reg. Sec. 1.482-4(f)(2)). Arm's-length consideration for an intangible is not limited by the prevailing rates of consideration paid for use or transfer of intangibles within the same or similar industry, nor is it limited because the transaction cannot be compared with a comparable uncontrolled transaction. The arm's-length consideration is usually in the form of a royalty if a transferee of an intangible pays nominal or no consideration to the controlled transferor (Treas. Reg. Sec. 1.482-4(f)). If an intangible is transferred in a controlled transaction for a lump sum, that amount must be commensurate with the income attributable to the intangible. In effect, the lump-sum amount must equal the present value of the projected royalty stream (Treas. Reg. Sec. 1.482-4(f)(5)).

Intangible property includes the following commercially transferable interests that have substantial value independent of the services of any individual:

- Patents, inventions, formulas, processes, designs, or patterns
- Copyrights and literary, musical, or artistic compositions
- Trademarks, trade names, or brand names
- Franchises, licenses, or contracts
- Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data
- Other similar items (Treas. Reg. Sec. 1.482-4(b))

Comparable Uncontrolled Transaction Method. The comparable uncontrolled transaction method evaluates whether the amount charged in a controlled transfer of intangible property was similar to an arm's-length amount in a comparable uncontrolled transaction. The comparable uncontrolled transaction method, when it can reasonably be applied on the basis of information involving the same intangible under the same or substantially the same circumstances, will generally be the most direct and reliable measure for determining an arm's-length charge for the transfer of intangible property. Factors to be considered in the application of this method include access to relevant pricing and other financial information and the existence of an active market, including contemporaneous transactions involving comparable property between uncontrolled taxpayers (Treas. Reg. Sec. 1.482-4(c)).

An uncontrolled transaction is comparable to a controlled transaction if it involves comparable intangible property and takes place under comparable circumstances. The intangible property involved in an uncontrolled transfer will be considered comparable to the intangible property involved in the controlled transfer if both intangibles are used in connection with similar products or processes within the same general industry or market; and have substantially the same profit potential. The profit potential of an intangible is measured by the net present value of the benefits to be realized (based on prospective profits to be realized or costs to be saved) through the use or subsequent transfer of the intangible, taking into consideration the capital investment and startup expenses required, the risks to be assumed, and other relevant considerations (Treas. Reg. Sec. 1.482-4(c)(2)(iii)(B)).

In evaluating the comparability of the circumstances of the controlled and uncontrolled transactions, specific factors that may be particularly relevant to this method include the following:

- The terms of the transfer, including the exploitation rights granted in the intangible, the exclusive or nonexclusive character of any rights granted, any restrictions on use, or any limitations on the geographic area where the rights may be exploited.
- The stage of development of the intangible (including, where appropriate, necessary governmental approvals, authorizations, or licenses) in the market in which the intangible is to be used.
- Rights to receive updates, revisions, or modifications of the intangible.
- The uniqueness of the property and the period for which it remains unique, including the degree and duration of protection afforded to the property under the laws of the relevant countries.
- The duration of the license, contract, or other agreement, and any termination or renegotiation rights.
- Any economic and product liability risks to be assumed by the transferee.
- The existence and extent of any collateral transactions or ongoing business relationships between the transferee and transferor.
- The functions to be performed by the transferor and transferee, including any ancillary or subsidiary services (Treas. Reg. Sec. 1.482-4(c)(2)(iii)(B)).

If two or more comparable uncontrolled transactions independently meet the standard of comparability, these transactions will establish an arm's-length range.

Example 17.16. USpharm, a U.S. pharmaceutical company, develops a new drug Z that is a safe and effective treatment of the disease zeezee. USpharm has obtained patents covering drug Z in the United States and in various foreign countries. USpharm has also obtained the regulatory authorizations necessary to market drug Z in the United States and in foreign countries. USpharm licenses its subsidiary in Country X, Xpharm, to produce and sell drug Z in Country X. At the same time, it licenses an unrelated company, Ydrug, to produce and sell drug Z in Country Y, a neighboring country. Prior to licensing the drug, USpharm had obtained patent protection and regulatory approval in both countries and both countries provide similar protection for intellectual property rights. Country X and Country Y are similar countries in terms of population, per capita income, and the incidence of the

disease zeezee. Consequently, drug Z is expected to sell in similar quantities and at similar prices in both countries. In addition, the costs of producing and marketing drug Z in each country are expected to be approximately the same. USpharm and Xpharm establish terms for licensing of drug Z that are identical in every material respect, including royalty rate, to the terms established between USpharm and Ydrug. In this case, the district director determines that the royalty rate established in the Ydrug license agreement is a reliable measure of the arm's-length royalty rate for the Xpharm license. If however, the incidence of the disease zeezee in Country Y is much higher than in Country X, the profit potential is likely to be higher in Country Y and the Ydrug license agreement is unlikely to provide a reliable measure of the arm's-length royalty rate for the Xpharm license (Treas. Reg. Sec. 1.482-4(c)(iv)(4), examples (1) and (2)).

The arm's-length consideration for the controlled transfer of an intangible is not limited by the consideration paid in any uncontrolled transactions that do not meet the requirements of the comparable uncontrolled transaction method. Similarly, the arm's-length consideration for an intangible is not limited by the prevailing rates of consideration paid for the use or transfer of intangibles within the same or similar industry (Treas. Reg. Sec. 1.482-4(f)(4)).

Comparable Profits Method. The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length, based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances (Treas. Reg. Sec. 1.482-5(a)). Ordinarily, the comparable profits method determines an arm's-length result based on the amount of operating profit a tested party would have earned if its profit level indicator was equal to an uncontrolled comparable, called comparable operating profit. Comparable operating profit is calculated by determining a profit level indicator for an uncontrolled comparable and applying the profit level indicator to the financial data related to relevant business activity of the tested party (the most narrowly identifiable business activity for which data incorporating the controlled transaction are available) (Treas. Reg. Sec. 1.482-5(b)(1)).

A *tested party* is a participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located. In most cases, the tested party will be the least complex and will not own valuable intangible property or unique assets.

Before this method is applied, the tested party's operating income must be adjusted to reflect all other allocations under section 482 (Treas. Reg. Sec. 1.482-5(b)(2)). For purposes of the comparable profits method, the arm's-length range will be established using comparable operating profits derived from a single profit indicator (Treas. Reg. Sec. 1.482-5(b)(3)).

Profit level indicators are financial ratios that measure the relationships among profits, costs incurred, and resources employed. In any given case, a variety of profit level indicators can be calculated. The selection of appropriate profit level indicators depends upon a number of factors, including the nature of the activities of the tested party, the reliability of the available data with respect to comparable uncontrolled taxpayers, and the extent to which a particular profit level indicator is likely to produce a reasonable determination of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length. Profit level indicators should be derived from at least a three-year period including the current taxable year. Profit level indicators that may provide a reliable basis for comparing operating profits of similar controlled and uncontrolled taxpayers include the following:

- Rate of return on capital employed (ratio of operating profit to operating assets)
- Financial ratios (ratios showing the relationships between profit and costs or sales revenue), such as the ratio of operating profit to sales; and the ratio of gross profit to operating expenses
- Other profit level indicators, only when they provide reasonable indications of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length (Treas. Reg. Sec. 1.482-5(b)(4))

The comparable profits method compares the profitability of a tested party to that of uncontrolled taxpayers in similar circumstances. The comparability of taxpayers is based upon the facts and circumstances and includes such factors as relevant lines of business, product or service markets involved, asset composition employed, size and scope of operations, and the stage in a business or product cycle (Treas. Reg. Sec. 1.482-5(c)(2)). Comparability is also dependent on resources employed and risks assumed. Other factors to consider are cost structures, differences in business experience, or differences in management efficiency (Treas. Reg. Sec. 1.482-5(c)(2)(iii)). If there are differences between the controlled and uncontrolled comparable that would materially affect the profits

determined under the relevant profit level indicator, then adjustments should be made.

Example 17.17. DevCo is a U.S. developer, producer and marketer of widgets. DevCo develops a new "high-tech widget" (htw) which it manufactures at its foreign subsidiary ManuCo located in Country H. ManuCo sells the htw to MarkCo (a U.S. subsidiary of DevCo) for distribution and marketing in the United States. The taxable year 1998 is under audit, and the district director examines whether the royalty rate of 5 percent paid by ManuCo to DevCo is an arm's-length consideration for the htw technology. It is determined during the examination that the comparable profits method will provide the most reliable measure of an arm's-length result. ManuCo is selected as the tested party because it engages in relatively routine manufacturing activities, while DevCo engages in a variety of complex activities using unique and valuable intangibles. Finally, because ManuCo engages in manufacturing activities, it is determined that the ratio of operating profit to operating assets is an appropriate profit level indicator.

Uncontrolled taxpayers performing similar functions cannot be found in Country H. It is determined that data from Countries M and N provide the best match of companies in a similar market performing similar functions and bearing similar risks. Such data are sufficiently complete to identify many of the material differences between ManuCo and the uncontrolled comparables, and to make adjustments to account for such differences. However, data are not sufficiently complete so that it is likely that no material differences remain. In particular, the differences in geographic markets might have materially affected the results of the various companies.

In a separate analysis, it is determined that the price that ManuCo charged to MarkCo for the htw is an arm's-length price. Therefore, ManuCo's financial data derived from its sales to MarkCo are reliable. ManuCo's financial data from 1996 to 1998 are as follows:

	1996	*1997*	*1998*	*Average*
Assets	$24,000	$25,000	$26,000	$25,000
Sales to MarkCo	25,000	30,000	35,000	30,000
Cost of goods sold	6,250	7,500	8,750	7,500
Royalty to DevCo (5 percent)	1,250	1,500	1,750	1,500
Other	5,000	6,000	7,000	6,000
Operating expenses	1,000	1,000	1,000	1,000
Operating profit	17,750	21,500	25,250	21,500

Applying the ratios of average operating profits to operating assets for the 1996 through 1998 taxable years derived from a group of similar uncontrolled comparables located in Countries M and N to ManuCo's average operating assets for the same period provides a set of comparable operating profits. The interquartile range for these average comparable operating profits is $3,000–$4,500. ManuCo's average reported operating profit for the years 1996–1998 ($21,500) falls outside this range. Therefore, the district director determines that an allocation may be appropriate for the 1998 taxable year. To determine the amount, if any, of the allocation for the 1998 taxable year, the district director compares ManuCo's reported operating profit for 1998 to the median of the comparable operating profits derived from the uncontrolled distributors' results for 1998. The median result for the uncontrolled comparables for 1998 is $3,750. Based on this comparison, the district director increases royalties that ManuCo paid by $21,500 (the difference between $25,250 and the median of the comparable operating profits, $3,750) (Treas. Reg. Sec. 1.482-5(e), example (4)).

Profit Split Method. The profit split method evaluates whether the allocation of the combined operating profit or loss, for the relevant business activity, attributable to one or more controlled transactions, is arm's length, by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss (Treas. Reg. Sec. 1.482-6(a)). The relative value of each controlled taxpayer's contribution to the success of the relevant business activity must consider the functions performed, risks assumed, and resources employed by each participant in the relevant business activity consistent with the comparability requirements, as if the participants were uncontrolled parties. The allocation of profit or loss must be made under the comparable profit split method or the residual profit split method.

A *comparable profit split* is derived by using each uncontrolled taxpayers' percentage of the combined operating profit or loss to allocate the combined profit or loss of the relevant business activity. The activities compared must be similar and conducted under similar circumstances. If there are differences between controlled and uncontrolled taxpayers that would materially affect the division of operating profit, adjustments must be made.

The reliability of the results is affected by the quality of the data and assumptions used. Factors such as the reliability of the allocation of costs,

income, and assets, and the degree of consistency between controlled and uncontrolled taxpayers in accounting practices that materially affect the items that determine the amount and allocation of operating profit, must be considered (Treas. Reg. Sec. 1.482-6(c)(2)(ii)(C)).

Under the *residual profit split*, the combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers following a two-step process. The first step allocates operating income to each party to the controlled transactions to provide a market return for its routine contributions (for example, tangible property, services, and intangibles generally owned by uncontrolled taxpayers in similar activities) to the relevant business activity. The first step is determined from a functional analysis. The second step divides residual profit among the controlled taxpayers based upon the relative value of their contributions of intangible property (not owned by the uncontrolled taxpayers) to the relevant business activity that was not accounted for as a routine contribution.

Example 17.18. XYZ is a U.S. corporation that develops, manufactures, and markets a line of products for police use in the United States. XYZ's research unit developed a bulletproof material for use in protective clothing and headgear (Nulon). XYZ obtains patent protection for the chemical formula for Nulon. Since its introduction in the United States, Nulon has captured a substantial share of the U.S. market for bulletproof material. XYZ licensed its European subsidiary, XYZ-Europe, to manufacture and market Nulon in Europe. XYZ-Europe is a well-established company that manufactures and markets XYZ products for the defense market, as well as a well-developed marketing network that employs brand names that it developed. XYZ-Europe's research unit alters Nulon to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defense industry in several European countries. Beginning with the 1998 taxable year, XYZ-Europe manufactures and sells Nulon in Europe through its marketing network under one of its brand names.

For the 1998 taxable year, XYZ has no direct expenses associated with the license of Nulon to XYZ-Europe and incurs no expenses related to the marketing of Nulon in Europe. For the 1998 taxable year, XYZ-Europe's Nulon sales and preroyalty expenses are $500 million and $300 million, respectively, resulting in net preroyalty profit of $200 million related to the Nulon business. The operating assets employed in XYZ-Europe's Nulon business are $200 million. Given the facts and circumstances, the district director determines under the best method rule that a residual profit split will provide the most reliable measure of an arm's-length result. Based on an examination of

a sample of European companies performing functions similar to those of XYZ-Europe, the district director determines that an average market return on XYZ-Europe's operating assets in the Nulon business is 10 percent, resulting in a market return of $20 million (10 percent ($200 million) for XYZ-Europe's Nulon business, and a residual profit of $180 million.

Since the first stage of the residual profit split allocated profits to XYZ-Europe's contributions other than those attributable to highly valuable intangible property, it is assumed that the residual profit of $180 million is attributable to the valuable intangibles related to Nulon, meaning the European brand name for Nulon and the Nulon formula (including XYZ-Europe's modifications). To estimate the relative values of these intangibles, the district director compares the ratios of the capitalized value of expenditures as of 1998 on Nulon-related research and development and marketing over the 1998 sales related to such expenditures.

Because XYZ's productive product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. The district director determines that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, the district director capitalizes and amortizes XYZ's protective product research and development expenses. This analysis indicates that the capitalized research and development expenditures have a value of $0.20 per dollar of global protective product sales in 1998.

XYZ-Europe's expenditures on Nulon research and development and marketing support only its sales in Europe. Using information on the average useful life of XYZ-Europe's investments in marketing and research and development, the district director capitalizes and amortizes XYZ-Europe's expenditures and determines that they have a value in 1995 of $0.40 per dollar of XYZ-Europe's Nulon sales.

Thus, XYZ and XYZ-Europe together contribute $0.60 in capitalized intangible development expenses for each dollar of XYZ-Europe's protective product sales for 1998, of which XYZ contributed one-third (or $0.20 per dollar of sales). Accordingly, the district director determines that an arm's-length royalty for the Nulon license for the 1998 taxable year is $60 million, meaning one-third of XYZ-Europe's $180 million in residual Nulon profit (Treas. Reg. Sec. 1.482-6(c)(iii), example (1)).

Other Unspecified Methods. Other than the comparable uncontrolled price method, the comparable profits method, or the profit split method, the arm's-length method may be used to evaluate the amount charged in

a controlled transaction. In establishing whether a controlled transaction was at arm's length, an unspecified method should be used to provide information on prices or profits the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction.

An unspecified method takes into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realization alternatives to that transaction and only enter into a particular transaction if none of the alternatives is preferred to it. Use of an unspecified method puts additional compliance burdens on the taxpayer. For example, an unspecified method should provide information on the price and profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction.

Periodic Adjustments. If an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible. Adjustments made must be consistent with the arm's-length standard. In determining whether to make such adjustments in the taxable year under examination, the district director may consider all relevant facts and circumstances throughout the period the intangible is used. The determination in an earlier year that the amount charged for an intangible was arm's length will not preclude the district director in a subsequent taxable year from making an adjustment to the amount charged for the intangible in the subsequent year. The commensurate with income standard has been a contentious concept with U.S. treaty partners.

In the situation of comparable uncontrolled transactions of the same intangible in comparable circumstances, no adjustment for transfers of that intangible in a controlled transaction will be made if each of the following facts is established.

- The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, the consideration was an arm's-length amount for the first taxable year in which substantial periodic consideration was required to be paid under the agreement, and the agreement remained in effect for the taxable year under review.
- There is a written agreement setting forth the terms of the comparable uncontrolled transaction relied upon to establish the arm's-length

consideration (uncontrolled agreement) that contained no provisions that would have permitted any change to the amount of consideration, a renegotiation, or a termination of the agreement, in circumstances comparable to those of the controlled transaction in the taxable year under review (or that contained provisions permitting only specified, noncontingent, periodic changes to the amount of consideration).

- The controlled agreement was substantially similar to the uncontrolled agreement, with respect to the time period for which it is effective.
- The controlled agreement limited use of the intangible to a specified field or purpose in a manner that was consistent with industry practice and any such limitation in the uncontrolled agreement.
- There were no substantial changes in the functions performed by the controlled transferee since the controlled agreement was executed, except changes necessitated by events that were not foreseeable.
- The aggregate profits actually earned or the aggregate cost savings actually realized by the controlled taxpayer from the exploitation of the intangible in all open years are not less than 80 percent or more than 120 percent of the prospective profits or cost savings that were foreseeable when the comparability of the uncontrolled agreement was established (Treas. Reg. Sec. 1.482-4(f)(2)(ii)(B)).

If these requirements are met for each year of the five-year period beginning with the first year in which substantial periodic consideration was required to be paid, then no periodic adjustment will be made in any subsequent year.

If the arm's-length amount was determined under any method other than that of a comparable uncontrolled transaction, no allocation will be made if each of the following facts is established.

- The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to that agreement, and that agreement remained in effect for the taxable year under review.
- The consideration called for in the controlled agreement was an arm's-length amount for the first taxable year in which substantial periodic consideration was required to be paid, and relevant supporting documentation was prepared contemporaneously with the execution of the controlled agreement.

- There have been no substantial changes in the functions performed by the transferee since the controlled agreement was executed, except changes required by events that were not foreseeable.
- The total profits actually earned or the total cost savings realized by the controlled transferee from the exploitation of the intangible in the year of examination, and all past years, are not less than 80 percent nor more than 120 percent of the prospective profits or cost savings that were foreseeable when the controlled agreement was entered into (Treas. Reg. Sec. 1.482-4(f)(2)(ii)(C)).

If these requirements are met for each year of the five-year period beginning with the first year in which substantial periodic consideration was required to be paid, then no periodic adjustment will be made in any subsequent year. In addition, no allocation will be made for certain extraordinary events. An *extraordinary event* for these purposes is one that was beyond the control of the controlled taxpayer and could not reasonably have been anticipated at the time the controlled agreement was entered into, the aggregate profits or aggregate cost savings realized by the taxpayer are less than 80 percent or more than 120 percent of the prospective cost savings and all of the requirements listed above for transfers involving comparable intangibles and transfers determined using methods other than comparable uncontrolled transaction are met (Treas. Reg. Sec. 1.482-4(f)(2)(ii)(D)).

Development of Intangibles. The owner of the rights to exploit an intangible must receive an amount of consideration for any transfer of a right. If another controlled member assists in the development of the intangible, that member may be entitled to receive consideration for that assistance. Except in the situation of a bona fide cost-sharing arrangement, in the case of intangible property that is not legally protected, the developer will be considered the owner. Other participating members will be regarded as assisters. The developer is ordinarily the member that bore the largest portion of the direct and indirect costs of the development, including the provision, without adequate compensation, of property or services likely to contribute substantially to developing the intangible.

A controlled taxpayer will be presumed not to have borne the costs of development if, pursuant to an agreement entered into before the success of the project is known, another person is obligated to reimburse the controlled taxpayer for its costs. Allocations may be made to reflect an arm's-length consideration for assistance such as loans, services, or the use

of tangible or intangible property. Assistance does not include expenditures of a routine nature that would be expected to be incurred in similar uncontrolled transactions.

Often, two or more members of a group of controlled entities will form a joint venture to develop intangible property, called *cost sharing*. In such a situation, if one member develops the intangible property and transfers it to another member, the district director will not allocate an arm's-length price if the two members are participating in a cost-sharing arrangement for the development of the intangible property. An allocation may, however, be made to properly reflect the share of costs and risks of developing the property. A bona fide cost-sharing arrangement is an agreement, in writing, between two or more members of a group of controlled entities, providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced. In order for the arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of development on an arm's-length basis. In order for the sharing of costs and risks to be on an arm's-length basis, the terms and conditions must be comparable to those that would have been adopted by unrelated parties similarly situated had they entered into such an arrangement (Treas. Reg. Sec. 1.482-7T).

> *Example 17.19.* C and D are members of a group of controlled entities. They enter into a bona fide cost-sharing agreement whereby C will develop intangible property and C and D will jointly share the full costs and risks of development. C and D will be considered joint developers of the property, and each will have a right to use the property developed without payment of royalties or other considerations.

Transfer of Tangible Property

The arm's-length character of the amount charged in a controlled transfer of tangible property must be determined under one of six methods. The selection of a method for the particular transaction under review will be subject to the best method rule, the comparability analysis, and the arm's-length range. The methods are the following:

- The comparable uncontrolled price method
- The resale price method
- The cost-plus method
- The comparable profits method

- The profit split method
- Other unspecified methods (Treas. Reg. Sec. 1.482-3(a))

Comparable Uncontrolled Price Method. The comparable uncontrolled price method evaluates whether the amount charged in a controlled transaction is comparable to the arm's length amount charged in an uncontrolled transaction. It relies on comparability of transactions between controlled and uncontrolled taxpayers and reliability of data. Similarity of products generally will have the greatest effect on comparability under this method. The results derived from the comparable uncontrolled price method will provide a direct and reliable measure of an arm's-length price for the controlled transaction if an uncontrolled transaction has no differences affecting price. Minor differences between the transactions that have no effect on the amount charged, or have a reasonable and ascertainable effect on price of adjustments to the uncontrolled transaction will also provide a direct and reliable measure of the arm's-length price, and these adjustments are made. Material product differences between the controlled and uncontrolled transactions will necessitate the application of other methods, such as the resale price method, the cost-plus method, the comparable profits method, or the profit split method.

Where functions performed by the taxpayer in the controlled transaction are materially different from the functions performed in the uncontrolled transaction, the comparable uncontrolled price method cannot be applied. In addition to factors determined from functional analysis, analysis of risk, contractual terms, and economic conditions, specific factors that may be particularly relevant to the use of this method include the following:

- Quality of the product
- Contractual terms such as warranties, sales or purchase volume, credit terms, and transport
- The level of the market (for example, wholesale, retail, etc.)
- The geographic market in which the transaction takes place
- Date of the transaction
- Intangible property associated with the sale
- Foreign currency risks
- The alternative commercial arrangements realistically available to the buyer and seller (Treas. Reg. Sec. 1.482-3(b)(ii)(B))

The reliability of the results for this method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made. Where two or more uncontrolled transactions independently establish an arm's-length price, then these transactions will establish an arm's-length range (Treas. Reg. Sec. 1.482-3(b)(iii)).

> *Example 17.20.* USM, a U.S. manufacturer, sells the same product to both controlled and uncontrolled distributors. The circumstances surrounding the controlled and uncontrolled transactions are substantially the same, except that the controlled sales price is a delivered price and the uncontrolled sales are made FOB USM's factory. Differences in the contractual terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, and adjustments are made to the results of the uncontrolled transaction to account for such differences. No other material differences have been identified between the controlled and uncontrolled transactions. Because USM sells in both the controlled and uncontrolled transactions, it is likely that all material differences between the two transactions have been identified. In addition, because the comparable uncontrolled price method is applied to an uncontrolled comparable with no product differences, and there are only minor contractual differences that have a definite and reasonably ascertainable effect on price, the results of this application of the comparable uncontrolled price method will provide the most direct and reliable measure of the arm's length result (Treas. Reg. Sec. 1.482-3(b)(4), example (1)).

> *Example 17.21.* This example uses the same facts as example 17.20, except that USM affixes its valuable trademark to the property sold in the controlled transactions, but does not affix its trademark to the property sold in the uncontrolled transactions. Under the facts of this case, the effect on price of the trademark is material and cannot be reliably estimated. Because there are material product differences for which reliable adjustments cannot be made, the comparable uncontrolled price method is unlikely to provide a reliable measure of the arm's-length result (Treas. Reg. Sec. 1.482-3(b)(4), example (2)).

Resale Price Method. The resale price method evaluates the arm's-length character of a controlled transaction by reference to the gross profit margin realized in comparable uncontrolled transactions. The resale price method measures the value of functions performed, ordinarily in cases involving the purchase and resale of tangible property where the reseller has not added substantial value to the tangible goods by physically altering the goods before resale or by the use of intangible property. Packaging,

repackaging, labeling, or minor assembly do not ordinarily constitute physical alteration. An arm's-length price is determined by subtracting the appropriate gross profit from the applicable resale price for the property involved in the controlled transaction under review. The applicable resale price is equal to either the resale price of the particular item of property involved or the price at which contemporaneous resales of the same property are made (Treas. Reg. Sec. 1.482-3(c)(2)(ii)).

Where the property purchased in the controlled sale is resold to one or more related parties in a series of controlled sales before being resold in an uncontrolled sale, the applicable resale price is the price at which the property is resold to an uncontrolled party, or the price at which contemporaneous resales of the same property are made. In such case, the determination of the appropriate gross profit will take into account the functions of all members of the group participating in the series of controlled sales and final uncontrolled resale, as well as any other relevant factors. The appropriate gross profit is computed by multiplying the applicable resale price by the appropriate gross profit margin (expressed as a percentage of total revenue derived from sales) earned in comparable uncontrolled transactions (Treas. Reg. Sec. 1.482-3(c)(2)(iii)).

In order to achieve comparability, the appropriate gross profit margin should be derived from comparable contemporaneous purchases and resales of the reseller involved in controlled sales, because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers. In the absence of these transactions, the appropriate gross profit margin may be derived from comparable uncontrolled transactions of other resellers (Treas. Reg. Sec. 1.482-3(c)(3)(ii)).

Comparability under this method is particularly dependent on similarity of functions, risks, and contract terms. For purposes of the resale price method, close physical similarity of the property involved in the controlled and uncontrolled transactions is not ordinarily necessary to establish the comparability of the distributor's gross profit margin, although substantial differences in the product may indicate significant functional differences between the controlled and uncontrolled taxpayers. For example, distributors of a wide variety of consumer durables might perform comparable distribution functions without regard to the specific durable goods distributed.

Appropriate adjustments for material differences that would affect the gross profit margin must be made to the gross profit margins earned

with respect to uncontrolled transactions. It may be necessary to consider operating expenses associated with functions performed and risks assumed. If there are differences in functions performed, the effect on price of such differences is not necessarily equal to the differences in the amount of related operating expenses. Specific factors that may be particularly relevant to this method include the following:

- The inventory levels and turnover rates, and corresponding risks, including any price protection programs offered by the manufacturer
- Contractual terms such as the scope and terms of warranties provided, sales or purchase volume, credit terms, and transport terms
- Sales, marketing, advertising programs and services (including promotional programs, rebates, and co-op advertising)
- The level of the market
- Foreign currency risks (Treas. Reg. Sec. 1.482-3(c)(ii)(C))

Where the controlled taxpayer is comparable to a *commission agent* (a sales agent that does not take title to goods), the commission earned by such sales agent, expressed as a percentage of the uncontrolled sales price of the goods involved, may constitute the appropriate gross profit margin (Treas. Reg. Sec. 1.482-3(c)(ii)(D)).

The reliability of the results of resale price method computations is affected by the completeness and accuracy of the data and the reliability of the assumptions made. In addition, the degree of consistency in accounting methods used (for example, inventory, cost-accounting methods) by controlled and uncontrolled taxpayers may affect the reliability of the result (Treas. Reg. Sec. 1.482-3(c)(iii)).

Example 17.22. S, a U.S. corporation, is the exclusive distributor for FP, its foreign parent. There are no changes in the beginning and ending inventory for the year under review. S's total reported cost of goods sold is $800, consisting of $600 for property purchased from FP and $200 of other costs of goods sold incurred to unrelated parties. S's applicable resale price and reported gross profit are as follows:

Applicable resale price	$1,000
Cost of goods sold	
Cost of purchases from P	600
Costs incurred to unrelated parties	200
Reported gross profit	$ 200

The district director determines that the appropriate gross profit margin is 25 percent. Therefore, S's appropriate gross profit is $250 (meaning

25 percent of the applicable resale price of $1,000). Because S is incurring costs of sales to unrelated parties, the arm's-length price for property purchased from P must be determined under a two-step process. First, the appropriate gross profit ($250) is subtracted from the applicable resale price ($1,000). The resulting amount ($750) is then reduced by the costs of sales incurred to unrelated parties ($200). Therefore, the arm's-length price in this case equals $550 (meaning $750 minus $200) (Treas. Reg. Sec. 1.482-3(c)(4), example (2)).

Cost-Plus Method. The *cost-plus method* evaluates the arm's-length character of a controlled transaction by referring to the gross profit markup realized in comparable uncontrolled transactions. This method is ordinarily used in cases involving the manufacture, assembly, or other production of goods that are sold to related parties. The cost-plus method measures an arm's-length price by adding the appropriate gross profit markup, expressed as a percentage of cost, earned in comparable uncontrolled transactions. The appropriate gross profit is computed by multiplying the controlled taxpayer's cost of producing the transferred property by the gross profit markup, expressed as a percentage of cost, in comparable uncontrolled transactions (Treas. Reg. Sec. 1.482-3(d)(1) and (2)). Where two or more uncontrolled transactions independently establish an arm's-length price, such transactions will establish an arm's-length range.

The determination of whether an uncontrolled transaction is comparable to the controlled transaction will be made by applying usual comparability standards. Comparability under this method is less dependent on product similarity and more dependent on similarity of functions, existence of trademarks, age of plant and equipment, business experience, management efficiency, etc. If possible, the appropriate gross profit markup should be derived from comparable uncontrolled transactions of the taxpayer involved in the sale. In the absence of such sales, the appropriate gross profit markup may be derived from comparable uncontrolled sales of other producers. If there are material differences between the controlled and uncontrolled transactions that would affect the gross profit markup, adjustments should be made to the gross profit markup earned in the comparable uncontrolled transactions. In addition to the usual criteria, specific factors that may be particularly relevant to this method include the following:

- The complexity of manufacturing or assembly
- Manufacturing, production, and process engineering

- Procurement, purchasing, and inventory control activities
- Testing functions
- Selling, general, and administrative expenses
- Foreign currency risks
- Contractual terms such as scope and terms of warranties provided, sales or purchase volume, credit terms, and transport terms (Treas. Reg. Sec. 1.482-3(d)(3)(ii)(C))

A controlled taxpayer that is comparable to a purchasing agent that earns a commission, but does not take title to property, may compute the appropriate gross profit markup based on the commission earned by such purchasing agent, expressed as a percentage of the purchase price of the goods (Treas. Reg. Sec. 1.482-3(c)(D)).

> *Example 17.23.* USP, a domestic manufacturer of computer components, sells its product to FS, its foreign distributor. UT1, UT2, and UT3 are domestic computer component manufacturers that sell to uncontrolled foreign purchasers. X is a domestic manufacturer of computer chips that sells computer chips to its foreign subsidiary Y. X and Y are members of the same group of controlled taxpayers. X earns an 8-percent gross profit markup with respect to its manufacturing operations. Relatively complete data is available regarding the functions performed and the risks borne by UT1, UT2, and UT3, and the contractual terms in the uncontrolled transactions. In addition, data are available to ensure accounting consistency between all of the uncontrolled manufacturers and USP. Because the available data are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, the effect of the differences are definite and reasonably ascertainable, and reliable adjustments are made to account for the differences, an arm's-length range can be established (Treas. Reg. Sec. 1.482-3(d)(4), example (1)).

Comparable Profits Method. The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length, based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities with other uncontrolled taxpayers under similar circumstances. This method was discussed in the section Transfers of Intangible Property, above.

> *Example 17.24.* Foreign Parent (FP) is a publicly traded foreign corporation with a U.S. subsidiary (USSub) that is under audit for its 1998 taxable year.

FP manufactures a consumer product for worldwide distribution. USSub imports the assembled product and distributes it within the United States at the wholesale level under the FP name. FP does not allow uncontrolled taxpayers to distribute the product. Other companies produce similar products but none of them are sold to uncontrolled taxpayers or to uncontrolled distributors. The district director determines that the comparable profits method will provide the most reliable measure of an arm's-length result. USSub is selected as the tested party because it engages in activities that are less complex than those undertaken by FP. There is data from a number of independent operators of wholesale distribution businesses. These potential comparables are further narrowed to select companies in the same industry segment that perform similar functions and bear similar risks to USSub. An analysis of the information available on these taxpayers shows that the ratio of operating profit is the most appropriate profit level indicator, and this ratio is relatively stable where at least three years are included in the average. For the taxable years 1996 through 1998, USSub shows the following results:

	1996	*1997*	*1998*	*Average*
Sales	$500,000	$560,000	$500,000	$520,000
Cost of goods sold	393,000	412,400	400,000	401,800
Operating expenses	80,000	110,000	104,600	98,200
Operating profit	27,000	1,500	(4,600)	20,000

After adjustments have been made to account for identified material differences between USSub and the uncontrolled distributors, the average ratio of operating profit to sales is calculated for each of the uncontrolled distributors. Applying each ratio to USSub would lead to the following comparable operating profit.

Unrelated Distributor	OP/S	*USSub* COP
A	1.7%	$ 8,840
B	3.1%	16,120
C	3.8%	19,760
D	4.5%	23,400
E	4.7%	24,440
F	4.8%	24,960
G	4.9%	25,480
H	6.7%	34,840
I	9.9%	51,480
J	10.5%	54,600

The data are not sufficiently complete to conclude that it is likely that all material differences between USSub and the uncontrolled distributors have been identified. Therefore, an arm's-length range can be established. The district director measures the arm's-length range by the interquartile range of results, which consists of the results ranging from $19,760 to $34,840. Although USSub's operating income for 1998 shows a loss of $4,600, the district director determines that no allocation should be made, because USSub's average reported operating profit of $20,000 is within this range (Treas. Reg. Sec. 1.482-5(e), example (1)).

Profit Split Method. The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The profit split method was discussed in the section Transfers of Intangible Property, above.

Other Unspecified Methods. A method other than the comparable uncontrolled price method, the resale price method, the cost-plus method, the comparable profits method, or the profit split method may be used in situations where in a similar situation an uncontrolled taxpayer evaluates the terms of a transaction by considering the realistic alternatives to that transaction and that transaction is entered under those terms when none of the alternatives was preferable to it. Again, other unspecified methods place additional compliance burdens on the taxpayer.

Example 17.25. Amcan, a U.S. company, produces toxicans, which are unique vessels for storing and transporting toxic waste, at its U.S. production facility. Amcan agrees by contract to supply its Canadian subsidiary, Cancan, with 4,000 toxicans per year to serve the Canadian market for toxicans. Prior to entering into the contract with Cancan, Amcan had received a bona fide offer from an independent Canadian waste disposal company, Cando, to serve as the Canadian distributor for toxicans and to purchase a similar number of toxicans at a price of $5,000 each. If the circumstances and terms of the Cancan supply contract are sufficiently similar to those of the Cando offer, or sufficiently reliable adjustments can be made for the differences between them, then the Cando offer price of $5,000 may provide reliable information indicating that an arm's-length consideration under the Canadian contract will not be less than $5,000 per toxican (Treas. Reg. Sec. 1.482-3(e)(2), example).

OECD and Transfer Pricing

The Organization for Economic Cooperation and Development (OECD) does not completely agree with the Treasury approach to transfer pricing. The OECD guidelines outlined in its report[21] restate the broad acceptance by all U.S. trading partners that traditional arm's-length pricing methods should be determined on information reasonably available at the time of the determination using the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. The report reflects little support for profit methodologies. The OECD report also takes a position against the use of safe harbors. As to advance pricing agreements, the OECD report states that there are numerous advantages to their use, although the report does not unequivocally support them.

Advance Pricing Agreements

An *advance pricing agreement* (APA) is an agreement between the Internal Revenue Service and the taxpayer on the transfer pricing method to be applied to any apportionment or allocation of income for section 482 purposes.[22] An APA may relate to any transaction subject to section 482. Under the APA request procedure, the taxpayer proposes a transfer pricing method and provides data showing that it produces arm's-length results between the taxpayer and specified affiliates regarding certain specified transactions. The Internal Revenue Service (IRS) will evaluate the taxpayer's APA by analyzing the data submitted and any other relevant information. If the taxpayer's proposal is acceptable, the taxpayer and the IRS execute an APA covering the proposed transfer pricing method. The IRS may also enter into an agreement, regarding the APA, with a foreign competent authority under an income tax treaty.[23] In addition, the IRS has also instituted a Small Business Taxpayer APA that treats companies with gross income of $200 million or less as small business taxpayers (SBT). This procedure also clarified that small transac-

[21] OECD Committee on Fiscal Affairs, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, *Part I* (1994) and *Part II* (1995).

[22] Rev. Proc. 91-22, 1991-1 C.B. 526.

[23] Rev. Proc. 96-53, 1996-2 C.B. 375.

tions without regard to taxpayer size would qualify for these procedures, and permitt transactions that involve non-routine intangibles to qualify.[24]

Foreign Legal Restrictions

The district director will take foreign legal restrictions that affect the results of transactions at arm's length into account if the restrictions affected an uncontrolled taxpayer under comparable circumstances for a comparable period of time. Legal restrictions will be considered if the following conditions are met.

- The restrictions are publicly promulgated, generally applicable to all similarly situated persons and not imposed as part of a commercial transaction between the taxpayer and a foreign sovereign.
- The taxpayer (or other member of the controlled group) to which the restrictions apply has exhausted all remedies (other than those with negligible chance of success) prescribed by foreign law or practice for obtaining a waiver of these restrictions.
- The restrictions expressly prevented the payment or receipt, in any form, of part or all of the arm's-length amount that would otherwise be required under section 482.
- The related parties subject to the restriction did not engage in any arrangement with controlled or uncontrolled parties that had the effect of circumventing the restrictions, and have not otherwise violated the restriction in any material respect (Treas. Reg. Sec. 1.482-1(h)(ii)).

If a foreign legal restriction prevents payment as receipt of the arm's-length amount, then the deferred income method of accounting may be elected. The restricted amount may be treated as deferrable if the controlled taxpayer establishes to the satisfaction of the district director that the payment or receipt of the arm's-length amount was prevented because of a foreign legal restriction; and the controlled taxpayer whose U.S. tax liability may be affected by the foreign legal restriction elects the deferred method of accounting, on a written statement attached to a timely U.S. tax return, filed before the IRS first contacts any member of the controlled group concerning an examination of the return for the taxable year to which the foreign legal restriction applies (Treas. Reg. Sec. 1.482-

[24]Notice 98-65, 1998-52 I.R.B. 10.

1(h)(iii)(B)). Under the deferred method of accounting, the payment or receipt that is prevented because of the foreign legal restrictions is deferrable until restrictions for the payment or receipt are lifted. Any deductions or credits related to the deferred amounts are also deferred (Treas. Reg. Sec. 1.482-1(h)(iv)).

Side Effects of a Section 482 Allocation

The consequences normally expected from a section 482 allocation are adjustments to the taxable incomes of the members of the controlled group involved in non-arm's-length dealings. In actuality, these adjustments to taxable income are perhaps just one of many consequences or side effects. There are also possible side effects of foreign tax credit amounts and double taxation on the allocated amounts, the possibility of placing certain tax entities in jeopardy with respect to desired or undesired tax status, and severe penalties.

Penalties

A section 482 price adjustment may lead to the 20-percent substantial valuation misstatement (or the 40-percent gross valuation misstatement) penalty under section 6662. The 20-percent substantial valuation misstatement penalty applies if a transfer price adjustment for a tax year exceeds the lesser of $5 million or 10 percent of gross receipts, or if the transfer price reported on a return is 200 percent or more (or 50 percent or less) of the arm's-length price. A 40-percent penalty applies if the section 482 transfer price adjustment exceeds the lesser of $20 million or 20 percent of gross receipts, or if the transfer price reported on a return is 400 percent or more (25 percent or less) of the arm's-length price.

Temp. Treas. Reg. 1.6662-6T details how taxpayers may qualify for exemptions from section 6662 transfer pricing adjustments. In addition to documentation requirements, the regulation permits the IRS to consider a number of factors in determining whether a taxpayer will be subject to a penalty. These factors include the taxpayer's transfer pricing knowledge and experience, the thoroughness of the data searches, compliance with the section 482 regulations, reliance on tax professionals, and whether the taxpayer, in attempting to determine an arm's-length result by using more than one uncontrolled comparable, arbitrarily selected a result that corresponds to an extreme range of results derived from the uncontrolled comparables (Temp. Reg. Sec. 1.6662-6T(d)(2(ii)).

If a taxpayer uses a specified method (comparable uncontrolled price, resale price, cost plus, comparable profits, or residual profit split method), and in circumstances in which no specified method is applicable, penalties can be avoided if, given the available data and the applicable pricing methods, the taxpayer reasonably concluded that the method and the application of that method provided the most reliable measure of the arm's-length result under the best method rule (Temp. Treas. Reg. Sec. 1.6662-6T(d)(3)(ii)(B) and (C)).

The taxpayer must satisfy documentation requirements in order to establish that it was reasonable to conclude that, given the available data and the applicable pricing methods, the method provided the most accurate measure of an arm's-length result under the best method rule. This documentation must be in existence when the tax return is filed and must be provided to the IRS within 30 days of a request for it. There are three categories of required documentation: principal documents (basic transfer pricing analysis conducted by the taxpayer), background documents (those pieces of data that typically support principal documents), and tax return documents (disclosure on a timely filed tax return of the use of the profit split method, disclosure of lump-sum payments as consideration for the transfer of an intangible, and disclosure of the use of an unspecified method of pricing) (Temp. Treas. Reg. Sec. 1.6662-6T(d)(iii)).

Foreign Tax Credit

A section 482 allocation of income or expense between a domestic parent and a foreign subsidiary will affect the amount of credit for foreign income taxes deemed paid. For example, an allocation under section 482 that increases the income of a domestic parent requires a correlative adjustment increasing the expenses of the foreign subsidiary. The decrease in income of the foreign subsidiary changes earnings and profits, which in turn affect the formula for calculating deemed-paid tax credits if the foreign country does not adjust taxes paid on account of the section 482 allocation.[25]

Double Taxation

When a section 482 allocation is made between two domestic corporations doing business in the United States, the primary and correlative

[25]Rev. Rul. 74-566, 1974-2 C.B. 158.

adjustments are symmetrical and the tax effects involve differences in only the marginal rates of the two entities.

Example 17.26. C and D are members of a controlled group of corporations. C performs services for D at less than an arm's-length price. The district director allocates $5,000 income to C and increases deductions to D for the same amount. During the year in question, C was in a marginal tax bracket of 35 percent whereas D was in a marginal tax bracket of 15 percent. The allocation increases C's tax by $1,750 (35% × 5,000) while correspondingly decreasing D's tax by $750 (15% × 5,000).

In the situation of a U.S. entity dealing at non-arm's-length rates with a foreign entity in the same controlled group, the results of a section 482 allocation may be quite different. A particular foreign country may not permit a correlative adjustment for computing taxable income (that is, taxable income under the tax laws of the particular foreign country of the foreign affiliate). The U.S. taxable income may therefore be increased or decreased without a corresponding increase or decrease in the taxable income of the foreign affiliate.

Many tax treaties provide for consultation between the competent authorities of the two countries in order to reach agreement on the allocation of amounts between related entities and thus prevent double taxation.[26] Rev. Proc. 91-23 explains the procedures a U.S. person should take to obtain such a consideration when the United States or a foreign country that is a party to a tax treaty proposes or makes an allocation of income or deductions. The mere fact that the United States may be a party to a tax treaty providing for consultation between competent authorities does not mean that if the district director proposes an allocation of income or deduction, the competent authorities of the treaty country will agree with the correlative adjustment or vice versa.

If the United States does not have a tax treaty with a particular country, and an adjustment is proposed or made between an affiliated entity doing business in such a country and an entity in the United States, the taxpayer receives no competent authority relief to consider the double taxation issues.

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[26]Rev. Rul. 74-158, 1974-1 C.B. 182; see also Rev. Rul. 76-508, 1976-2 C.B. 225 for treatment if parties to the allocation do not seek to exhaust their administrative remedies. 1991-1 C.B. 534, clarified by Rev. Proc. 91-26, 1991-1 C.B. 453, amplified by Rev. Proc. 91-22, 1991-1 C.B. 526.

Special Status

Section 936 Corporation. A section 482 allocation may affect the tax status of a section 936 corporation. A *section 936 corporation* must derive 80 percent or more of gross income from sources within a U.S. possession and a statutory percentage (see chapter 14) of gross income from the active conduct of a trade or business within a possession. A section 482 allocation may disturb an otherwise safe percentage so that the corporation might not qualify for its special status.

> *Example 17.27.* X and Y are members of a controlled group of corporations. Y is a section 936 corporation. Y lent X funds on a non-interest-bearing note not connected with Y's business. Interest income allocated to Y on account of the non-arm's-length loan will reduce Y's percentage of gross income from the active conduct of a trade or business. If the allocation reduces the percentage to less than the statutory percentage for the applicable period, Y's section 936 corporation status will be terminated for the year in question.

Foreign Personal Holding Company. A *foreign personal holding company* (FPHC) is a foreign corporation in which more than 50 percent of the stock is owned by five or fewer individuals who are U.S. citizens or residents, and is one in which its passive income (that is, dividends, interest, royalties, or annuities) constitutes at least 50 percent of its gross income (60 percent for the first taxable year). A section 482 allocation could alter FPHC status by affecting the gross income percentages for a corporation with the requisite ownership, thereby subjecting the U.S. individual owning the stock to tax on the undistributed personal holding company income.

Personal Holding Company. It is perhaps easier for a foreign corporation with U.S. shareholders to be a personal holding company than an FPHC. For purposes of imposing the personal holding company tax on a foreign corporation, resident, or nonresident that files a tax return, undistributed personal holding company income is computed only on taxable income from sources within the United States. If the corporation, resident, or nonresident does not file a return, the undistributed personal holding company income is computed on the basis of gross income from sources within the United States (Treas. Reg. Sec. 1.545-1(b)).

Under section 482, an allocation of interest from U.S. sources to a foreign corporation could precipitate personal holding company status if other conditions specified in section 542 are satisfied. In such a case, the

interest income would be taxed as undistributed personal holding company income. Such a corporation may not qualify as an FPHC, since the interest plus other FPHC income may not exceed the gross income ratio.

Subpart F: The De Minimis Rule

The *de minimis rule*, described in section 954(b)(3), provides that if the foreign base company income of a controlled foreign corporation (CFC) is less than the lesser of 5 percent of gross income or $1 million, the foreign base income will be ignored for subpart F purposes. On the other hand, if the foreign base company income of a CFC is more than 70 percent of gross income, all the CFC's gross income for the year will be treated as subpart F income. A section 482 allocation could dramatically affect the amount of income recognized under subpart F.

Constructive Dividend

An additional problem arises when the commissioner allocates income or expenses between two corporations, each owned by the same controlling stockholder. In such a case, the reallocation of income can be treated as a constructive dividend from one of the controlled corporations to the controlling stockholder, with a corresponding contribution of capital to the other corporation.[27] Rev. Rul. 69-630[28] states that when one of the principal purposes of such a transaction is to avoid taxes, a constructive dividend will result.

Relief Provisions for a Section 482 Allocation

If a section 482 allocation increases the taxable income of a U.S. taxpayer, permission may be obtained to receive payment from the entity whose income was decreased by the allocation, in an amount equal to a part or all of the allocation, without further tax consequences. Ann. 99-1 states that, in appropriate cases and pursuant to a closing agreement, taxpayers whose income has been increased or whose loss has been reduced under section 482 are permitted to make certain adjustments so that their

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[27]*George W. Knipe*, 24 T.C.M. 668 (1965); see also *Old Dominion Plywood Corp.*, 25 T.C.M. 678 (1966); *Christie Coal & Coke, Inc.*, 28 T.C.M. 498 (1969); *W.B. Rushing*, 52 T.C. 888 (1969), *aff'd.* 441 F.2d 593 (CA-5, 1971). Rev. Proc. 70-18, 1970-2 C.B. 493.

[28]1969-2 C.B. 112.

accounts reflect the section 482 allocation.[29] Repatriation is also available for adjustments initiated by the taxpayer pursuant to Treas. Reg. Sec. 1.482-1(a)(3) including downward as well as upward adjustments. Such treatment under the revenue procedure will be subject to review and adjustment and possible imposition of section 6662(e) or 6662(h) penalty by the IRS upon examination (Ann. 99-1).

A taxpayer will qualify for relief if the allocation arrangements or transactions did not result in a taxpayer penalty under section 6662(e)(1)(B) or section 6662(h) because of a pricing adjustment or because of fraud (Ann. 99-1). It should be noted that relief under Ann. 99-1 will not be available if competent authority consideration under Rev. Proc. 82-29[30] is requested.

Procedures

A qualifying taxpayer may be permitted to establish an interest-bearing account receivable from, or payable to, the related person from, or to, the section 482 allocation is made. The amount of the account is equal to the primary adjustment for each of the years in which an allocation is made. The account may be established and paid without the federal income tax consequences of the secondary adjustments that would otherwise be entailed as the result of the primary adjustment. The account must satisfy the following three conditions:

1. The account is deemed to have been created as of the last day of the taxpayer's taxable year for which the primary adjustment is made.
2. The account must bear interest at an arm's-length rate from the day after the date the account is deemed to have been created to the date of payment. This interest must be accrued and included in, or deducted from taxable income for each taxable year during which the account is deemed outstanding.
3. The account must be paid within the prescribed 90-day period. Payment must be in the form of money, a written debt obligation payable at a fixed date and bearing interest at an arm's length rate, or an accounting entry offsetting such account against an existing debt between the taxpayer and the related person.

[29]IRB 1999-2, effective for taxable years beginning after the publication of the underlying Rev. Proc. The IRS has not, as of the date of this publication, issued the underlying Rev. Proc.

[30]1982-1 C.B. 481.

A foreign tax credit is allowed for any foreign withholding tax with respect to the repayment of the principal or interest of the account to the extent and subject to the limitations provided under section 901.

Cases Pending With the Internal Revenue Service. If a U.S. taxpayer whose income has been adjusted by the IRS pursuant to section 482 who wants treatment under this revenue procedure must file a request in writing with the IRS before closing action is taken on the primary adjustment. The request shall be signed by a person having the authority to sign the taxpayer's federal income tax returns, and shall contain the following:

1. A statement that the taxpayer desires the treatment provided by this revenue procedure and the years for which the treatment is requested
2. A description of the arrangements or transactions, or the terms thereof, which gave rise to the primary adjustment
3. A statement that the applicable conditions are met, and that the taxpayer will cooperate fully with the IRS in providing evidence supporting such statement
4. An offer to enter into a closing agreement under section 7121

The IRS will determine whether the taxpayer qualifies for the requested treatment and inform the taxpayer of its decision. If the IRS concludes that the provisions of this revenue procedure properly apply, and if the amount of the primary adjustment has been agreed upon, the taxpayer will be requested to enter into a closing agreement under section 7121, establishing for each year involved—

1. The amount of the primary adjustment.
2. The amount of the account which the taxpayer elects to establish.
3. The amount of the interest on the account includible in income, or deductible.
4. The amount of any foreign tax credit that taxpayer will claim under section 901 with respect to payment of the principal or interest on the account established.
5. The manner of payment of the account, and the taxpayer's right to receive or make such payment free of the federal income tax consequences of the secondary adjustments that would otherwise be entailed as the result of the primary adjustment, provided such payment is made within 90 days after execution of the closing agreement on behalf of the commissioner.

If a U.S. taxpayer that has increased or decreased its taxable income pursuant to section 482 and Treas. Reg. Sec. 1.482-1(a)(3) wants the treatment provided in this revenue procedure, it must file a statement with its federal income tax return reporting the primary adjustment. The statement shall contain the following:

1. A statement that the taxpayer desires the treatment provided by the revenue procedure for the years indicated
2. A description of the arrangements or transactions, or the terms thereof, which gave rise to the primary adjustment
3. A statement that the applicable conditions are met, and that the taxpayer will cooperate fully with the IRS in providing evidence supporting such statement
4. The amount of the primary adjustment
5. The amount of the account that the taxpayer elects to establish
6. The amount of interest on the account includible in income, or deductible, and the years of such inclusion or deduction
7. The amount of any foreign tax credit that taxpayer will claim under section 901 with respect to payment of the principal or interest on the established account
8. The manner of payment of the account that is free of the federal income tax consequences of the secondary adjustments that would otherwise be entailed as the result of the primary adjustment, provided such payment is made within 90 days of the date on which the taxpayer files the return reporting the primary adjustment

Cases Pending Before the Tax Court. If a case reaches trial status in the Tax Court and it is determined that the taxpayer is entitled to the treatment under this revenue procedure, the parties may stipulate or otherwise arrange with the Court so that any adjustment in tax for the years before the Court will reflect its application, provided the taxpayer executes the required closing agreement.

Cases Within the Jurisdiction of the Department of Justice. If a taxpayer files with the IRS a request for treatment under the revenue procedure, with respect to a case within the jurisdiction of the Department of Justice, the IRS, through its Chief Counsel, will recommend to the Department of Justice the action to be taken with respect to the taxpayer's request.

Procedures for Requesting Competent Authority

The United States has in force with various countries income tax treaties that provide for consultation between a competent authority of the United States and a competent authority of the treaty country to resolve the question of interpretation or application of the treaty. A U.S. taxpayer that considers that the action of a treaty country may result in double taxation, particularly in the case of a section 482 adjustment, may request competent authority. In these situations, Rev. Proc. 91-23 should be consulted for the required procedures for requesting competent authority.[31]

[31]Rev. Proc. 91-23, 1991-1 C.B. 534.

18

Translation of Foreign Currency

The significant currency fluctuations in recent years have forced businesses with international transactions or operations to adapt to this environment of risk and uncertainty. The gains and losses arising from currency fluctuations have had a significant impact on accounting profits and taxes. The measure of this impact depends on the extent to which an entity uses foreign currencies as the medium of exchange for transactions or to account for transactions.

A U.S. entity arranging all international transactions so that payments and receipts are made entirely in U.S. currency will have no currency exchange gains or losses. When the taxpayer has operations conducted through a foreign branch or owns stock in a controlled foreign corporation (CFC), the results of those operations usually are denominated in a foreign currency, called *functional currency*. Economic gains and losses may be realized because of changes in the relative value of that functional currency and the U.S. dollar between the date income from such operations is recognized for U.S. tax purposes and the date remittances are converted into U.S. currency.

In addition to taxable income or loss from normal business receipts and payments, ordinary income or loss may be realized from certain transactions on amounts the taxpayer is entitled to receive (or is required to pay), denominated in terms of a nonfunctional currency, or determined by reference to the value of one or more nonfunctional currencies. The transactions to which this treatment applies are the acquisition of debt instrument or becoming an obligor under a debt instrument, accruing any item of expense or gross income or receipts that is to be paid or received after the date accrued, or entering into or acquiring any forward contract, futures contract, option, or similar financial instrument if such instrument is not marked to market at the close of the taxable year. Translation gains or losses may arise if foreign currency is held as an investment or if a foreign exchange contract is entered into (1) hedging foreign currency-denominated financial assets, anticipated income, liabilities, or expenses; (2) hedging the taxpayer's stock in a controlled foreign corporation (CFC); or (3) hedging an accounting exposure arising under generally accepted accounting practices on a consolidated financial statement.

Qualified Business Unit and Functional Currency

Section 985 states that, unless it is otherwise provided in the regulations, all determinations for income tax purposes must be made in the taxpayer's functional currency. A *functional currency* is the currency of the economic environment in which a significant part of a qualified business unit's (QBU) activities are conducted. If the QBU's activities are primarily conducted in U.S. dollars, the unit's functional currency is the U.S. dollar. To the extent provided by regulations, a taxpayer may also elect to use the dollar as the functional currency of a qualified business unit if that unit keeps its books in U.S. dollars or uses a method of accounting that approximates a separate transactions method.

Qualified Business Unit

A *qualified business unit* is any separate clearly identified unit of a trade or business of a taxpayer that maintains separate books and records. A corporation is a QBU (Treas. Reg. Sec. 1.989(a)-1(b)). An individual is not a QBU. The activities of an individual, however, will qualify as a QBU if these activities constitute a trade or business and a complete set of books and records is maintained with respect to the activities (Treas. Reg. Sec.

1.989(a)-1(b)(2)(ii)). A partnership, trust, or estate is a QBU of a partner or beneficiary.

Determining whether activities constitute a trade or business depends on all the facts and circumstances, but in general, a *trade* or *business* is a specific unified group of activities that constitute an independent enterprise carried on for profit (Treas. Reg. Sec. 1.989(a)-1(c)). For individuals, the same type of activities apply to determine whether a trade or business exists except that an activity that gives rise to section 212 deductions is not considered a trade or business, nor are activities of an individual as an employee considered to constitute a trade or business.

Functional Currency

Both Financial Accounting Standards Board (FASB) Statement No. 52, *Foreign Currency Translation*, and section 985 of the Internal Revenue Code define an entity's functional currency as the currency of the primary economic environment in which a significant part of such unit's activities are conducted (a QBU) and which is used by such unit in keeping its books and records (section 985(b)). Translation gains and losses result from exchange rate changes on transactions denominated in currencies other than the functional currency.

The functional currency of any qualified business unit must be the dollar if activities are primarily conducted in dollars (section 985(b)(2)). The taxpayer may elect to use the dollar as the functional currency of any qualified business unit if that unit keeps its books and records in dollars or the taxpayer uses a method of accounting that approximates a separate transactions method, that is, each transaction of the unit can be converted to dollars (section 985(b)(3)). In addition, Temp. Treas. Reg. Sec. 1.985-1T(a) provides that the dollar shall be the functional currency of the following: (1) any taxpayer that is not a QBU, (2) a QBU that conducts its activities primarily in dollars, (3) a QBU that has the United States, or any possession or territory of the United States where the dollar is the standard currency, as its residence, (4) a QBU that elects to use, or is otherwise required to use, the dollar as its functional currency, (5) a QBU that does not keep books and records in the currency of the economic environment in which a significant part of its activities are conducted, or (6) any activity (wherever conducted and regardless of its frequency) that produces income or loss that is or is treated as effectively connected with the conduct of a trade or business within the United States.

The functional currency of a QBU that is not required to use the dollar will be the currency of its economic environment in which a significant part if its activities are conducted, provided the QBU keeps its books and records in this currency. The economic environment in which a significant part of a QBU's activities are conducted is a facts-and-circumstances determination. These facts and circumstances may include, among others, the currency of the country in which the QBU is a resident, the principal currency of the QBU's cash flows, the principal currency in which the QBU generates revenues and incurs expenses, the principal currency in which the borrowing or lending of the QBU is conducted, the currency of the QBU's principal sales market, the duration of the QBU's business operations, and the significance or volume of the QBU's independent activities (Treas. Reg. Sec. 1.985-1(c)(2)). If, for purposes of generally accepted accounting principles (GAAP), a determination of functional currency is made based on these same facts and circumstances, that currency ordinarily will be accepted as the functional currency for income tax purposes (Treas. Reg. Sec. 1.985-1(c)(5)).

A QBU is presumed to keep books in the currency of the economic environment in which a significant part of its activities are conducted. This presumption may be overcome by demonstrating to the satisfaction of the district director that a substantial nontax purpose exists for not keeping any books and records in the currency of that environment (Treas. Reg. Sec. 1.985-1(c)(3)). A QBU that has more than one currency that satisfies the functional currency tests may choose any such currency as its functional currency (Treas. Reg. Sec. 1.985-1(c)(4)).

A foreign corporation that has more than one QBU, all of which do not have the same functional currency, will be treated as having a single functional currency as a whole that may be different from the functional currency of one or more of its QBUs. The determination of such a corporation's functional currency is done by applying the following two steps: (1) determine the functional currency of each QBU in accordance with Treas. Reg. Secs. 1.985-1(b) and (c) and Treas. Reg. Sec. 1.985-2, and (2) determine the functional currency of the foreign corporation by applying the principles of Treas. Reg. Secs. 1.985-1(b) and (c) to the activities of the corporation as a whole.

The income or loss of a foreign corporation with one or more of its QBUs having a different functional currency is determined by calculating the income or loss, or earnings and profits, or deficit in earnings and profits, of each QBU in its functional currency using the profit-and-loss method described in section 987. The amount of each QBU's income or

loss, or earnings and profits, or deficit in earnings and profits, is then translated into the foreign corporation's functional currency using the appropriate exchange rate for determining the corporation's income or earnings and profits (Treas. Reg. Sec. 1.985-1(d)(2)).

Example 18.1. Sharp, Ltd., a foreign corporation organized in country X, is wholly owned by Palico, Inc., a domestic corporation. Sharp, Ltd. conducts all of its operations through two branches. Branch A is located in country A and branch B is located in country B. Sharp, Ltd., branch A and branch B are QBUs. The currency of country A is the Q and the currency of country B is the R. The functional currencies of Sharp, Ltd, branch A, and branch B are determined using a two-step process:

1. The functional currency of branches A and B. Branch A and branch B both conduct all of their activities in their respective local currencies. The Q is the currency of branch A and the R is the currency of branch B under GAAP. After applying the principles in the regulations, it is determined that the functional currency of branch A is the Q and the functional currency of branch B is the R.
2. The functional currency of Sharp, Ltd. Sharp, Ltd.'s functional currency is determined by disregarding the fact that A and B are branches. When A's activities and B's activities are viewed as a whole, Sharp, Ltd. determines that it only conducts significant activities in the R. Therefore, Sharp, Ltd.'s functional currency is the R.

During the current year, branch A had income of Q3,000 and branch B had income of R50,000 as determined under section 987. The weighted average exchange rate for the year is Q1 = R20. Branch A's income is translated into R60,000 for purposes of computing Sharp, Ltd.'s income and earnings and profits for the year. Thus the total earnings and profits of Sharp, Ltd. from branch A and branch B is R110,000 (based on Treas. Reg. Sec. 1.985-1(f), examples (7) and (9)).

The use of a functional currency is treated as a method of accounting. Therefore, any change in the functional currency is treated as a change in the taxpayer's method of accounting for purposes of section 481 (section 985(b)(4)). Permission to change functional currencies generally will not be granted unless significant changes in the facts and circumstances of the QBU's economic environment occur. If the principles used to determine the functional currency for GAAP are substantially similar to those required for income tax purposes, permission to change functional currencies will ordinarily not be granted unless the taxpayer also changes to the new functional currency for GAAP (Treas. Reg. Sec. 1.985-4(b)).

Election to Use the Dollar as Functional Currency of a Qualified QBU

Section 985(b)(3) provides that a QBU with a functional currency other than the U.S. dollar may elect to use the dollar as its functional currency subject to regulatory guidelines. The regulations state that only eligible QBU's are permitted to make this election. An *eligible QBU* means a QBU whose functional currency is (without an election) a hyperinflationary currency (Treas. Reg. Sec. 1.985-2(b)(1)). A *hyperinflationary currency* is the currency of a country in which the cumulative inflation during a base period is at least 100 percent, as determined by reference to the consumer price index of the country in the monthly issues of *International Financial Statistics* or a successor publication of the International Monetary Fund. If a country is not listed in the *International Financial Statistics*, a QBU may use any other reasonable method consistently applied for determining the country's consumer price index. The base period for any taxable year is the thirty-six months immediately preceding the last day of the preceding taxable year (Treas. Reg. Sec. 1.985-2(b)(2)).

A U.S. person electing to use the dollar as the functional currency for a QBU that is a branch must file Form 8819 with that person's timely filed federal income tax return (including extensions) for the tax year the election is effective (Treas. Reg. Sec. 1.985-2(c)(1)(i)).

The election to use the dollar as the functional currency for other eligible QBUs (partnership, trust, or estate, CFC, branch of a CFC, or noncontrolled foreign corporation or branch of a noncontrolled foreign corporation) is made by filing Form 8819 within 180 days after the end of the tax year for which the dollar election is effective. Prior to filing Form 8819, the controlling U.S. shareholders (or the foreign corporation, if the dollar election is made by the corporation) must provide written notice that the dollar election will be made to all U.S. persons known to be shareholders of the foreign corporation.

Form 8819 requires that the following information be provided: the name, address, and identification number of the person making the election and the tax year for which the dollar election is effective, the entity for which the election is made, including name, address, identifying number and ownership interest, the names, addresses, and identifying numbers of all persons related to the electing QBU and who are eligible QBUs or who have a branch that is an eligible QBU; if the election is made by

or for a foreign corporation, the name of the foreign corporation, the country of organization or creation, and the principal place of business for each eligible QBU; in addition, the name, address, and identifying number of every U.S. person notified of the dollar election and the country where the principal place of business of the eligible QBU is located.

If an eligible QBU is a noncontrolled foreign corporation or a branch of a noncontrolled foreign corporation, the dollar election must be made on Form 8819 by the corporation or the majority domestic corporate shareholders on behalf of the corporation. The same rules apply for the QBUs that apply for CFCs or branches of CFCs, except that "majority domestic corporate shareholders" is used instead of "controlling U.S. shareholders." The term *majority domestic shareholders* means those domestic corporate shareholders who in the aggregate own greater than 50 percent of the total combined voting power of all classes of stock of the noncontrolled foreign corporation entitled to vote that is owned by all the domestic corporate shareholders (Treas. Reg. Sec. 1.985-2(c)(3)).

Conversion to the Euro

On January 1, 1999, eleven members of the European Union began the first phase of a plan to replace their national (legacy) currencies with the euro. On that date the rate of exchange for the conversion of the legacy currencies to the euro was established and transactions began to be conducted with the euro. From January 1, 1999 until June 30, 2002 (the transition period), the legacy currencies will remain in circulation as subunits of the euro. On July 1, 2002, the legacy currencies will no longer be accepted as legal tender. The eleven countries converting to the euro are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain. Other members of the European Union may convert their currencies to the euro at some future time.[1]

Conversion of legacy currencies to the euro does not result in a realization event. This rule applies when the rights and obligations of a taxpayer are altered solely by the conversion (Treas. Reg. Sec. 1.1001-5T). A QBU with a nonlegacy currency as its functional currency will not realize gains or losses on legacy currency-denominated instruments

[1]T.D. 8776, Preamble, 63 FR 40366, July 29, 1998.

merely due to the conversion. However, some aspects of the euro conversion may result in taxable events.

A QBU with a legacy currency as its functional currency is required to change its functional currency to the euro on the first day of the first taxable year that begins on or after the day that the euro is substituted for the legacy currency, and in which the QBU begins to maintain its books and records in euros. A QBU must change its functional currency to the euro no later than its last taxable year that begins on or before the first day the legacy currency is no longer valid legal tender.

Changing the functional currency of a QBU to the euro under these provisions is deemed to have the consent of the Commissioner for purposes of Treas. Reg. Sec. 1.985-4. The affected taxpayer shall attach to its return for the taxable year of change a statement that includes the following: "Taxpayer certifies that a QBU of the taxpayer has changed its currency to the euro pursuant to Treas. Reg. Sec. 1.985-8T" (Treas. Reg. Sec. 1.985-8T(a)). Rules are provided to account for exchange gains and losses in positions that had previously been accounted for in a nonfunctional currency but will, after the conversion, be accounted for in euros.

Generally, when a QBU changes from one functional currency to another, the QBU must immediately recognize exchange gains or losses attributable to section 988 transactions (Treas. Reg. Sec. 1.985-5). However, for purpose of the euro conversion, exchange gains and losses are generally deferred. Deferral is accomplished by continuing to treat section 988 transactions as nonfunctional currency transactions even though remaining payments will be made in the QBU's new functional currency, the euro.

Example 18.2. On February 1, 1999, X, a QBU that used the deutschmark as its functional currency, converted 12,000 deutschmarks into Dutch guilders (fl) at the spot rate of fl1.1 = DM1 and loaned the 10,000 guilders to an unrelated party for one year at a rate of 10 percent with principal and interest payable January 31, 2000. Assume the average exchange rate for the period February 1, 1999 through December 31, 1999 was fl1.07 = DM1. X accrues and recognizes eleven months of interest income of DM1028 (fl1100/1.07) in the 1999 taxable year. Assume that on January 1, 2000, X changed its functional currency to the euro, the euro/deutschmark conversion rate was set at euro1 = DM2, and the euro/guilder conversion rate was set at euro1 = fl2.25. In 2000, X accrues one month of interest equal to euro44.44 (fl1000/2.25). On January 31, 2000, X receives interest and principal denominated in euros. With respect to the interest accrued in

1999, X will realize an exchange loss of euro25.13 = [fl1100/2.25) − (DM1028.04/2)]. With respect to the one month of interest accrued in 2000, X will realize no exchange gain or loss since the exchange rate when the interest accrued and the spot rate on the payment date are the same. X will realize an exchange loss of euro666.67 on the repayment of principal [(12,000/2.25) − (12,000/2)] (adapted from Treas. Reg. Sec. 1.985-8T(c)(3), example 2).

Immediate Recognition. Deferral is not available for transactions in, or holdings of, nonfunctional currency cash. Unrealized exchange gain or loss attributable to nonfunctional legacy currency is realized as if the currency were disposed of on the last day of the taxable year immediately prior to the year of change (Treas. Reg. Sec. 1.985-8T(c)(3)(iii)).

Election. Taxpayers may determine that benefit of deferral is not worth the administrative costs associated with tracking exchange gains and losses on large quantities of trade accounts. A taxpayer may elect to recognize exchange gains and losses on all accounts receivable and payable immediately prior to the year of change. The affected taxpayer must attach a statement to its tax return for the taxable year of change which includes the following: "Taxpayer certifies that a QBU of the taxpayer has elected to realize currency gain or loss on legacy currency denominated accounts receivable and payable upon change of functional currency to the euro." A QBU making this election must do so for all its legacy currency denominated section 988 transactions (Treas. Reg. Sec. 1.985-8T(c)(3)(iv)).

Branches of QBUs

If a branch changes its functional currency from a legacy currency to the euro when the taxpayer's functional currency is not the euro, no adjustment to the basis pool is necessary. The branch's euro equity pool is simply the product of the legacy currency and the appropriate exchange rate. However, if a branch changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer's functional currency is the euro, the taxpayer realizes gain or loss attributable to the branch's unremitted earnings computed as if the branch terminated on the last day prior to the year of change. This amount is recognized ratably over four years beginning with the taxable year of change (Treas. Reg. Sec. 1.985-8T(c)(4)).

Section 988 Transactions

Some of the principal issues of foreign currency transactions relate to the timing of recognition, the character, and the geographic source of the gains or losses. Section 988 addresses those issues. Generally, the recognition of foreign currency exchange gain or loss generally must be separately accounted for; that is, the gain or loss must be accounted for separately from any gain or loss attributable to the underlying transaction. For example, a U.S. company may purchase inventory from a foreign manufacturer. If the purchase price is to be paid in U.S. dollars, the inventory will be recorded at the U.S dollar cost, and no foreign exchange gain or loss will be recognized regardless of changes in the exchange rate between U.S. currency and the foreign currency. If, on the other hand, the purchase price of the inventory items is to be paid in the currency of the foreign country and the exchange rate changes between the transaction date and the payment date (that is, when the payment in foreign currency is made), gain or loss is recognized on any change in the exchange rate between the date of purchase and the date the payment is made in foreign currency and is treated as ordinary income. The inventory is recorded at the dollar value as of the date of purchase. In addition, there must generally be a closed and completed transaction or realization event, such as the actual payment of a liability.

Example 18.3. R. Smith, a U.S. citizen, converted $20,000 into Swiss francs at a time when the exchange rate of Swiss francs to U.S. dollars was 0.33. The 60,000 francs were deposited in a Swiss bank. One year later, when the exchange rate of francs to dollars was 0.25, Smith had not converted the 60,000 francs into other property; therefore, no loss is recognized. If the funds had been converted to U.S. dollars or any property distinguishable from a bank deposit, the loss would be recognized.

Foreign currency gain means any gain from a section 988 transaction to the extent such gain does not exceed the gain realized because of changes in exchange rates on or after the booking date and before the payment date. A foreign currency loss means any loss from a section 988 transaction to the extent that such loss does not exceed the loss realized because of changes in the exchange rates on or after the booking date and before the payment date. The booking date is (1) the date of acquisition, (2) the date on which the taxpayer becomes obligor, (3) the date on which an item is accrued or otherwise taken into account, or (4) the date a position is entered into or acquired. The payment date is the date on

which payment is made or received or the date the taxpayer's rights with respect to the position are terminated.

Example 18.4. A taxpayer whose functional currency is the dollar acquires a debt instrument denominated in Qs for Q5,000. The debt is not part of a section 988 hedging transaction. The exchange rate at the time of the acquisition was Q1 = $.20. If the taxpayer sells the debt instrument for Q6,000 when the exchange rate is Q1 = $.24, of the $440 gain ([Q6,000 × $.24] – [Q5,000 × $.20]), $200 is a foreign currency gain ([$.24 – $.20] × Q5,000). If the taxpayer sells the debt instrument for Q6,000 when the exchange rate is Q1 = $.167, there would be no gain or loss on the section 988 transaction ([Q6,000 × $.167] – [Q5,000 × $.20]) and therefore no foreign currency gain or loss. If the exchange rate at the time of the sale was Q1 = $.19, there is a gain of $140 ([Q6,000 × $.19] – [Q5,000 × $.20]) but none of it is a foreign currency gain. If the exchange rate was Q1 = $.15, there is a loss of $100, all of which is a foreign currency loss.

A section 988 transaction includes a disposition of nonfunctional currency and certain transactions if the amount the taxpayer is entitled to receive or pay by reason of the transaction is denominated in terms of a nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies. These section 988 transactions include the following:

1. The taxpayer disposes of nonfunctional currency, which includes coin, currency, nonfunctional currency-denominated demand or time deposits, and similar instruments issued by a bank or other financial institution. These transactions are treated as section 988 transactions for the purpose of establishing the taxpayer's basis in the currency and determining exchange gains or losses (Treas. Reg. Sec. 1.988-1(a)(1)).
2. The taxpayer acquires a debt instrument or becomes an obligor under a debt instrument (Treas. Reg. Sec. 1.988-1(a)(2)(i)).
3. The taxpayer accrues or otherwise takes into account any item of expense or gross income or receipts that is to be paid or received after the date on which it is so accrued or taken into account (Treas. Reg. Sec. 1.988-1(a)(2)(ii)).
4. The taxpayer enters into or acquires any forward contract, futures contract, option, or similar financial instrument (which includes a notional principal contract). This provision covers a forward contract, futures contract, option, warrant, or similar property only if the

underlying property to which the instrument ultimately relates is a nonfunctional currency or is a payable or receivable. For example, a forward contract to purchase wheat denominated in a nonfunctional currency is not covered, whereas a forward contract to purchase a nonfunctional currency is covered (Treas. Reg. Sec. 1.988-1(a)(2)(iii)(A)). A *notional principal contract* means an interest rate swap, cap, floor, collar, or similar financial instrument that provides for the payment of amounts by one party to another at specific intervals measured by interest rates and notional principal amounts in exchange for specific consideration or a promise to pay similar amounts. It also includes a currency swap (Treas. Reg. Sec. 1.988-1(a)(2)(iii)(B)(2)).

The regulations exclude certain transactions from the definition of section 988 transactions, such as any regulated futures contract or non-equity option that would be marked to market under section 1256 if held on the last day of the taxable year (Treas. Reg. Sec. 1.988-1(a)(7)(i)). Although usually excluded, certain regulated futures contracts and non-equity options can be treated as section 988 transactions if the taxpayer makes an election. Treas. Reg. Sec. 1.988-1(a)(7)(iii) explains the procedure for making this election. The election may be made for any taxable year on or before the first day of that taxable year or, if later, on or before the first day during that year the taxpayer holds a regulated futures contract or nonequity option (section 988(c)(1)(D)(ii)). In the case of a partnership or S corporation, the election is made by each partner or shareholder separately. Certain partnerships making an election to be treated as a qualified fund, discussed subsequently, are not covered by the foregoing rule.

In the case of a qualified fund, section 988 transactions will not include entering into or acquiring any forward contract, futures contract, option, or similar financial instrument that would be marked to market under section 1256 if held on the last day of the taxable year. A *qualified fund* means any partnership if, at all times during the taxable year to which an election applies, the partnership has the following characteristics:

1. There are at least twenty partners, and no single partner owns more than 20 percent of the interests in the capital or profits. The interest of a general partner in the partnership will not be treated as failing to meet the 20-percent ownership requirements for any taxable year if

the partner had no ordinary income or loss that is foreign currency gain or loss. In addition, any income allocable to a general partner as incentive compensation based on profits rather than capital is not taken into account in determining the partner's interest in profits in the partnership. If a partner receives all tax-exempt income from a partnership, the interest of the partner will not be treated as failing the 20-percent test. For purposes of the 20-percent test, there is a look-through rule that requires that an interest in a partnership held by another partnership is treated as held proportionately by the partners in the other partnership.

2. The principal activity of the partnership consists of buying and selling options, futures, or forwards with respect to commodities.
3. At least 90 percent of the gross income for the taxable year consists of (a) income or gains from interest, dividends, commodities or futures, forwards, and options with respect to commodities or (b) gain from the sale or disposition of capital assets held for the production of interest or dividends.
4. No more than a de minimis amount of the gross income for the taxable year was derived from buying and selling commodities.
5. An election applies to the taxable year. This election must be made on or before the first day of the taxable year, or, if later, on or before the first day during the year in which the partnership holds an applicable instrument. Once made, the election is binding to all subsequent years unless revoked with the consent of the IRS (section 988(c)(1)(D)(iii)).

In the case of a qualified fund, any bank forward contract, any foreign currency futures contract, or any similar instrument traded on a foreign exchange that is not otherwise a section 1256 contract is treated as a section 1256 contract for purposes of section 1256 (section 988(c)(1)(D)(iv)(I)). Gains and losses on these section 1256 contracts will be treated as short-term (section 988(c)(1)(D)(iv)(II)).

Furthermore, a transaction entered into by an individual that otherwise qualifies as a section 988 transaction will be considered a section 988 transaction only to the extent expenses properly allocable to the transaction meet the requirements of section 162 or 212 (other than section 212 expenses addressing expenses incurred in connection with taxes). Thus, if a taxpayer converts a functional currency into a nonfunctional currency and disposes of the nonfunctional currency by paying purely per-

sonal expenses (such as a vacation), such disposition will not be a section 988 transaction (Treas. Reg. Sec. 1.988-1(a)(9)).

Transactions between or among the taxpayer and qualified business units of that taxpayer (intrataxpayer transactions) are not section 988 transactions, but instead are treated under section 987. Exchange gain or loss will be recognized on intrataxpayer transactions involving nonfunctional currency or debt; payables or receivables; forward, futures, or option contracts; or similar financial instruments entered into with another taxpayer when these items as a result of the transaction lose their character, or when the source of the exchange gain or loss could be altered. Such gains or losses are treated as dispositions of foreign currency and treated under section 988 (Treas. Reg. Sec. 1.988-1(a)(10)).

Taxpayers attempting to avoid section 988 treatment or to characterize a transaction under section 988 must be aware that the commissioner may recharacterize a transaction (or series of transactions) in whole or in part as a section 988 transaction, if the effect is to avoid section 988, or may exclude a transaction (which in form is a section 988 transaction) if it is not properly considered a section 988 transaction. For example, a taxpayer whose functional currency is the dollar, who transfers Swiss francs to a newly formed U.S. corporation whose functional currency is the dollar, and who immediately sells the stock of the newly formed U.S. corporation runs the risk that the commissioner may treat the sale of the stock as a substitute for disposition of an asset subject to section 988, even if the formation of the U.S. corporation qualifies as tax-free under section 351 (Treas. Reg. Sec. 1.988-1(a)(11)).

Dispositions of Nonfunctional Currency

Recognition and Computation of Exchange Gain or Loss

Generally, the recognition of gain or loss upon the sale or other disposition of nonfunctional currency is governed by the recognition provision in the Internal Revenue Code that applies to the sale or disposition of property. With respect to section 1031 transactions, nonfunctional currency is not considered "like kind" property with respect to a different nonfunctional currency. The following transactions are not considered recognition events:

1. An exchange of units of nonfunctional currency for different units of the same nonfunctional currency

2. The deposit of nonfunctional currency in a demand or time deposit, or similar instrument [such as a certificate of deposit (CD)] issued by a bank or other financial institution if such instrument is denominated in such currency
3. The withdrawal of nonfunctional currency from a demand or time deposit or similar instrument if such instrument is denominated in such currency
4. The receipt of nonfunctional currency from a bank or other financial institution from which the taxpayer purchased a certificate of deposit or similar instrument denominated in such nonfunctional currency, by reason of the maturing or other termination of such instrument
5. The transfer of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution to another demand or time deposit or similar instrument denominated in the same nonfunctional currency issued by a bank or other financial institution (Treas. Reg. Sec. 1.988-2(a)(1))

Example 18.5. X is a corporation on the accrual method of accounting, with the U.S. dollar as its functional currency. On January 1, 1999, X acquires 1,500 British pounds for $2,250 (£1 = $1.50). On January 3, 1999, when the spot rate is £1 = $1.49, X deposits the £1,500 with a British financial institution in a non-interest-bearing demand account. On February 1, 1999, when the spot rate is £1 = $1.45, X withdraws the £1,500. On February 5, 1999, when the spot rate is £1 = $1.42, X purchases inventory in the amount of £1,500. No exchange loss is realized until February 5, 1999, when X disposes of the £1,500 for inventory. At that time, X realizes exchange loss in the amount of $120. The loss is not an adjustment to the cost of the inventory (based on Treas. Reg. Sec. 1.988-2(a)(1)(iv), example).

Exchange gain or loss realized from the sale or other disposition of nonfunctional currency is the difference between the amount realized and the adjusted basis of such currency. The amount realized is determined under section 1001(b). The adjusted basis of nonfunctional currency is determined under the applicable provisions of the Internal Revenue Code (sections 1011–1023). If, however, the taxpayer uses a spot-rate conversion to determine exchange gain or loss with respect to a receivable, that taxpayer shall determine the adjusted basis for any nonfunctional currency received in satisfaction of the receivable in a consistent manner.

The exchange of nonfunctional currency for property is treated as (1) an exchange of nonfunctional currency for units of functional currency at

the spot rate on the date of the exchange and (2) the purchase or sale of the property for such units of functional currency (Treas. Reg. Sec. 1.988-2(a)(2)).

Example 18.6. G is a U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1998, G enters into a contract to purchase a paper manufacturing machine for 10,000,000 British pounds for delivery on January 1, 2000. On January 1, 2000, when G exchanges £10,000,000 (which G purchased for $12,000,000) for the machine, the fair market value of the machine is £17,000,000. On January 1, 2000, the spot exchange rate is £1 = $1.50. The transaction is treated as an exchange of £10,000,000 for $15,000,000 and the purchase of the machine for $15,000,000. Accordingly, in computing G's exchange gain of $3,000,000 on the disposition of the £10,000,000, the amount realized is $15,000,000. G's basis in the machine is $15,000,000. No gain is recognized on the bargain purchase of the machine (based on Treas. Reg. Sec. 1.988-2(a)(2)(ii)(C), example).

Translations With Respect to Debt Instruments

Interest Income. Interest income that is received with respect to a demand account with a bank or other financial institution and that is denominated in (or whose payments are determined by reference to) a nonfunctional currency is translated into functional currency at the spot rate on the date received or accrued or pursuant to any reasonable spot rate convention consistently applied by the taxpayer to all taxable years and to all accounts denominated in nonfunctional currency in the same financial institution. For example, the taxpayer may translate interest received with respect to a nonfunctional currency demand account on the last day of each month of the taxable year, on the last day of each quarter of the taxable year, on the last day of each half of the taxable year, or on the last day of the taxable year. No exchange gain or loss is recognized on the receipt or accrual of the interest income.

Translated interest income or expense on section 988 debt instruments when all payments are denominated in, or determined with reference to, a single nonfunctional currency is determined in units of nonfunctional currency and translated into functional currency at either the spot rate at the time of payment if accrual was not required or, if accrued, at the average rate (simple average of the spot rates) for the interest accrual period (Treas. Reg. Sec. 1.988-2(b)(2)). For taxable years beginning after March 17, 1992, a taxpayer may elect to translate interest

income and expense at the spot rate on the last day of the accrual period (Treas. Reg. Sec. 1.988-2(b)(ii)(B)).

The holder of a debt instrument will realize gain or loss with respect to the accrued interest income on the date the accrued interest is received or the instrument is disposed of. The amount of exchange gain or loss realized with respect to accrued interest income is determined for each accrual period by subtracting, from the translated units of nonfunctional currency interest income received with respect to the accrual period, the amount computed by translating the units of nonfunctional currency interest income accrued with respect to the income received at the average exchange rate for the accrual period (Treas. Reg. Sec. 1.988-2(b)(3)).

The obligor under a debt instrument will realize exchange gain or loss with respect to accrued interest expense on the date such accrued interest expense is paid or the obligation to make payments is transferred or extinguished (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). The amount of exchange gain or loss realized with respect to accrued interest expense is determined for each accrual period using the following procedure: (1) translating the units of nonfunctional currency interest expense accrued at the average rate (or other rate specified) (see Treas. Reg. Sec. 1.988-2(b)(2)(iii)(B)) for the accrual period and (2) subtracting from that amount the amount computed by translating the units of nonfunctional currency interest paid (or, if the obligation to make payments is extinguished or transferred, the units accrued) with respect to such accrual period into functional currency at the spot rate (a) on the date payment is made or (b) the obligation is transferred or extinguished (or deemed extinguished) (Treas. Reg. Sec. 1.988-2(b)(4)).

The holder of a debt instrument will realize exchange gain or loss with respect to the principal amount of such instrument on the date principal is received from the obligor or the instrument is disposed of (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). For purposes of computing exchange gain or loss, the principal amount of a debt instrument is the holder's purchase price in units of nonfunctional currency. If, however, the holder acquired the instrument in a transaction in which exchange gain or loss was realized but not recognized by the transferor, the nonfunctional currency principal amount of the instrument with respect to the holder shall be the same as that of the transferor. The amount of exchange gain or loss

so realized by the holder with respect to principal is determined by translating the units of nonfunctional currency principal at the spot rate on the date payment is received or the instrument is disposed of (or deemed disposed of) and subtracting from that amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date the holder (or a transferor from whom the nonfunctional principal amount is carried over) acquired the instrument (or is deemed to acquire the instrument) (Treas. Reg. Sec. 1.988-2(b)(5)).

An obligor under a debt instrument will realize an exchange gain or loss with respect to the principal amount on the date on which principal is paid or the obligation to make payments is extinguished or transferred. The principal amount of a debt instrument is the amount received by the obligor for the debt instrument in units of nonfunctional currency. If the obligation was acquired in a nontaxable exchange, the nonfunctional currency principal amount of the instrument for the obligor will be the same as that of the transferor. If exchange gain or loss realized is required to be recognized, the amount of gain or loss realized by the obligor is determined by subtracting, from the translated (at the spot rate) units of nonfunctional currency principal on the date the obligor became obligor, the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date payment is made or the obligation is extinguished or transferred (Treas. Reg. Sec. 1.988-2(b)(6)).

Example 18.7. X, an accrual method taxpayer with the dollar as its functional currency, converts $13,000 to Q10,000 on January 1, 1998, at a spot rate of Q1 = $1.30 and loans the Q10,000 to Y for three years. The terms of the loan provide that Y will make interest payments to Q1,000 on December 31 of the years 1998, 1999, and 2000, and will repay X's Q10,000 principal on December 31, 2000. Average and spot exchange rates for the dollar and Q are as follows:

Accrual Period	*Average Rate (Qs to Dollars)*	*Date*	*Spot Rate (Qs to Dollars)*
1998	Q1 = $1.32	1/1/98	Q1 = $1.30
1999	Q1 = $1.37	12/31/98	Q1 = $1.35
2000	Q1 = $1.42	12/31/99	Q1 = $1.40
		12/31/00	Q1 = $1.45

X will accrue the Q1,000 interest payments at the average exchange rate for the accrual period. Accordingly, X will have interest income of $1,320 for 1998, $1,370 for 1999, and $1,420 for 2000. Because X is an accrual basis taxpayer, X determines exchange gain or loss for each interest accrual

period by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the date received and subtracting the amount of interest income accrued for each period. Thus, X will realize exchange gain with respect to the interest received under the loan, computed as follows:

Year	*Spot Value Interest Received*	*Accrued Interest @ Average Rate*	*Exchange Gain*
1998	$1,350	$1,320	$30
1999	1,400	1,370	30
2000	1,450	1,420	30

X will realize exchange gain of $1,500 upon retirement of the Q10,000 loan principal amount on December 31, 2000, determined by translating the Q10,000 principal amount at the spot rate on the date it is received (Q10,000 × $1.45 = $14,500) and subtracting from it the amount determined by translating the Q10,000 at the spot rate on the date the loan was made (Q10,000 × $1.30 = $13,000) (based on Treas. Reg. Sec. 1.988-2(b)(9), example (2)).

Discount and Premium

Original Issue Discount (OID)

The original issue discount (OID) on an obligation denominated in a nonfunctional currency for any accrual period will be determined in that nonfunctional currency and translated into the taxpayer's functional currency based on the average exchange rate in effect during the accrual period. The functional currency amount of the OID deducted for any accrual period will be treated as the amount of functional currency added to the borrowing on account of the OID, for purposes of determining the amount of gain or loss realized when the borrowing is repaid.

Example 18.8. On December 31, 19X1, the taxpayer, whose functional currency is the U.S. dollar, issues for Q4,645 a bond that requires a semiannual payment of interest of Q150 and a final payment of Q5,000 at maturity (December 31, 19X3). The bond has a yield of 5 percent semiannually. The accrual period is six months, commencing on December 31, 19X1. At the end of the first accrual period, on June 30, 19X1, the first Q150 interest payment is made, all other interest payments are made on their accrual

dates, and the bond is retired on December 31, 19X3. Interest payments and accrued OID are translated at the exchange rate in effect at the end of the accrual period. The taxpayer deducts the dollar amount of the interest and accrued OID and increases the dollar basis in the bond by the same amount.

At the end of the first accrual period, June 30, 19X2, the first Q150 interest is paid. Interest payments are translated at the exchange rate in effect on the payment date. Accrued OID is Q82 (Q150 − [0.05 × Q4,645]). This amount is translated into U.S. dollars using the average exchange rate during the accrual period. The dollar equivalent OID is $26 (Q82 × 0.32). The taxpayer deducts the dollar amount of accrued OID and the interest paid and increases the dollar basis in the bond from 1,394 to 1,420. As a result of the appreciation of the Q, the taxpayer has an unrealized currency loss of $187, the difference between the dollar basis of the bond ($1,420) and the basis in Qs translated at the current exchange rate $1,607 (Q4,727 × .34). This currency loss is not recognized until the indebtedness is discharged. It is an ordinary loss and its source is the issuer's residence.

	Qs					*Dollars*			
Date Accrual Period Ends	*Basis*	*Cash*	*Accrued OID*	*End-of-Period Exchange Rate ($/Q)*	*Average Exchange Rate ($/Q)*	*Basis*	*Accrued Cash*	*OID*	*Accrued Currency Gain (Loss)*
12/31/X1	4,645			0.30		1,394			
6/30/X2	4,727	150	82	0.34	0.32	1,420	51	26	(187)
12/31/X2	4,813	150	86	0.34	0.34	1,449	51	29	(187)
6/30/X3	4,905	150	92	0.36	0.35	1,481	54	32	(285)
12/31/X3	5,000	150	95	0.34	0.36	1,515	54	34	(285)
12/31/X3	-0-	5,000				-0-	1,800		
Total		5,600					2,010	121	

Payment Ordering Rules

There is also an ordering rule specified in the regulations for amounts received or paid with respect to debt instruments subject to rules under section 163(e) or sections 1271-1288. Amounts received or paid are first treated as a receipt or payment of periodic interest, second as a receipt or payment of OID, and finally as a receipt or payment of principal. Payments on other debt instruments are treated as interest or principal under section 163 or other applicable sections of the Code (Treas. Reg. Sec. 1.988(b)(7)).

Example 18.9. C is a corporation that is a calendar year accrual method taxpayer whose functional currency is the dollar. On January 1, 1999, C lends

Q10,000 in exchange for a note under the terms of which C will receive two equal payments of Q5,762 on December 31, 1999, and December 31, 2000. There is no OID under section 1273. Each payment of Q5,762 represents an annual payment necessary to amortize the Q10,000 principal amount at a rate of 10 percent compounded annually over a two-year period. The following tables reflect the amount of principal and interest that constitutes each payment and the relevant exchange rates:

Date	*Principal*	*Interest*
12/31/99	Q4,762	Q1,000
12/31/00	Q5,238	Q 524

Date	*Spot Rate*	*Average Rate for Year-end*
1/1/99	Q1 = $1.30	—
12/31/99	Q1 = $1.40	$1.35
12/31/00	Q1 = $1.50	$1.45

Because C is an accrual basis taxpayer, C will translate the interest income at the average rate for the accrual period. C's interest income is $1,350 (Q1,000 × $1.35) in 1999 and $760 (Q524 × $1.45) in 2000. C will realize exchange gain or loss upon the receipt of the accrued interest in the amount of $50 ([Q1,000 × $1.40] – $1,350) in 1999 and $26 ([Q524 × $1.50] – $760) in 2000. In addition, C will realize exchange gain or loss upon the receipt of principal each year in the amount of $476 ([Q4,762 × $1.30] – [Q4,762 × $1.30]) in 1999 and $1,048 ([Q5,238 × $1.50] – [Q5,238 × $1.30]) in 2000 (based on Treas. Reg. Sec. 1.988-2(b)(9), example 6).

Limitation on Disposition

When a debt instrument is paid or disposed of, or when the obligation to make payments is satisfied by another person or extinguished or assumed by another person, exchange gain or loss is computed on interest and principal. The sum of any exchange gain or loss on the principal and interest is recognized only to the extent of the total gain or loss realized on the transaction (Treas. Reg. Sec. 1.988-2(b)(8)).

Bond Premiums

Amortizable bond premium is computed in units of the nonfunctional currency in which the bond is denominated. Amortizable bond premium reduces interest income or expense in units of nonfunctional currency. Exchange gain or loss is realized with respect to bond premium by treating the portion of premium amortized with respect to any period as a

return of principal. A holder of a bond that does not elect to amortize bond premium under section 171 will recognize a market loss when the bond matures (Treas. Reg. Sec. 1.988-2(b)(10)).

Example 18.10. X is an individual who is on the cash method of accounting and whose functional currency is the dollar. On January 1, 1996, X purchases Y corporation's note for Q10,799 from Z, an unrelated party. The note has an issue price of Q10,000, has a stated redemption price at maturity of Q10,000, pays interest in Qs at a rate of 10 percent compounded annually, and matures on December 31, 2000. X elects to amortize the bond premium of Q799 under the rules of section 171. Bond premium is determined and amortized in Q's. The amortization schedule is as follows:

Year Ending 12/31	*Bond Premium Amortized*	*Unamortized Premium Plus Principal*	*Interest*
—	—	Q10,799	—
1996	Q136	10,663	Q864
1997	147	10,516	853
1998	159	10,357	841
1999	171	10,186	829
2000	186	10,000	814

The bond premium reduces X's Q interest income under the note. Thus, for 1996 the Q1,000 interest payment made in 1996 is reduced by the Q136 of bond premium resulting in Q864 interest income translated at the spot rate on December 31, 1996. Exchange gain or loss is realized on the Q136 bond premium based on the difference between the spot rates on (1) January 1, 1996, (2) the date the premium is paid to acquire the bond, and (3) the date the bond premium is returned as part of the stated interest. The Q136 bond premium reduces the unamortized premium plus principal to Q10,663. On December 31, 2000, when the bond matures and the Q799 of bond premium has been fully amortized, X will realize exchange gain or loss with respect to the remaining purchase price of Q10,000 (based on Treas. Reg. Sec. 1.988-2(b)(10)(ii), example).

Market Discount

Market discount is determined in the units of nonfunctional currency in which the market discount is denominated. Accrued market discount (other than market discount currently included in income under section 1278(b)) is translated into functional currency at the spot rate on the date on which the market discount bond is disposed. No part of the accrued market discount is treated as exchange gain or loss.

When nonfunctional currency debt is exchanged for stock of an obligor (except for transactions treated under section 267, 1091, or 1092), the holder and the obligor must recognize exchange gain or loss on the principal and accrued instrument on the debt instrument. The amount of gain or loss is recognized only to the extent of the total gain or loss on the exchange. A debt instrument that is acquired by the obligor from a shareholder as a contribution to capital is treated as an exchange for stock whether or not additional stock is issued. Section 988 is applied before section 108; that is, to the extent section 988 applies, the amount of discharge of indebtedness income is reduced under section 108.

Example 18.11. X, a foreign corporation whose functional currency is the Q, lends Q10,000 at a market rate of interest to Y, its wholly owned U.S. subsidiary, on January 1, 1998, on which date the spot exchange rate is Q1 = $1. Y's functional currency is the U.S. dollar. On January 1, 2000, when the spot exchange rate is Q1 = $0.50, X cancels the debt as a contribution to capital. Y will realize and recognize exchange gain with respect to the Q10,000 issue price of the debt instrument on January 1, 2000. Y will compute a $5,000 exchange gain by translating the issue price at the spot rate on the date Y became the obligor (Q10,000 × $1) and by subtracting from that amount the issue price translated at the spot rate on the date of extinguishment (Q10,000 × $0.50). Under section 108(e)(6), on the acquisition of its indebtedness from X as a contribution to capital, Y is treated as having satisfied the debt with an amount of money equal to X's adjusted basis in the debt (Q10,000). For purposes of section 108(e)(6), X's adjusted basis is translated into U.S. dollars at the spot rate on the date Y acquires the debt (Q1 = $0.50). Therefore, Y is treated as having satisfied the debt for $5,000. The amount of indebtedness is considered to be reduced by the exchange gain from $10,000 to $5,000. Accordingly, Y recognized $5,000 of exchange gain and no discharge of indebtedness income on the extinguishment of its debt to X (based on Treas. Reg. Sec. 1.988-2(b)(13), example (2)).

Exchange Gain or Loss

Exchange gain or loss with respect to gross income or receipts that is to be received after the accrual date is realized on the date payment is made or received. Exchange gain or loss realized is determined by multiplying the units of nonfunctional currency received by the spot rate on the payment date, and subtracting from that the amount determined by multiplying the units of nonfunctional currency received by the spot rate on the booking date. Exchange gain or loss realized on an item of expense is

determined by multiplying the units of nonfunctional currency paid by the spot rate on the booking date and subtracting from such amount the amount determined by multiplying the units of nonfunctional currency paid by the spot rate on the payment date.

> *Example 18.12.* X is a calendar-year corporation with the dollar as its functional currency. X is on the accrual method of accounting. On January 15, 2000, X sells inventory for 10,000 Canadian dollars. The spot rate on January 15, 2000, is C$1 = U.S.$0.55. On February 23, 2000, when X receives payment of the C$10,000, the spot rate is C$1 = U.S.$0.50. On February 23, 2000, X will realize exchange loss. X's loss is computed by multiplying the C$10,000 by the spot rate on the date the C$10,000 are received (C$10,000 × .50 = U.S. $5,000) and subtracting from that the amount computed by multiplying the C$10,000 by the spot rate on the booking date (C$10,000 × .55 = U.S. $5,500). Thus, X's exchange loss on the transaction is U.S. $500 (U.S. $5,000 − U.S. $5,500).

Exchange gain or loss on a forward, futures, and option contract (but not a spot contract to buy or sell nonfunctional currency unless the spot contract is disposed of prior to making or taking delivery of the currency) is realized and recognized under the principles laid out in Treas. Reg. Sec. 1.988-2(d).

Gain or loss on these contracts is realized under the normal rules in the Internal Revenue Code (for example, Code sections 1001, 1092, and 1256). In general, exchange gain or loss is not realized solely because another transaction or transactions offset the transaction. If, however, the economic benefit is derived in any offset transaction, any gain inherent in the offset positions is recognized.

Exchange gain or loss on these contracts is determined by subtracting the amount paid (or deemed paid), if any, for the contract from the amount received or deemed received from the contract. This rule also applies if the taxpayer makes or takes delivery in connection with these contracts. Gain or loss is recognized as if the contract was sold for its fair market value on the delivery date.

> *Example 18.13.* X, a calendar-year corporation whose functional currency is the dollar, entered into a forward contract on October 1, 1999, to purchase Q100,000 for delivery on March 1, 2000. The six-month forward rate was $.4907. On March 1, 2000, X takes delivery of the Q100,000 when the spot rate is $.48. X is treated as if it sold the contract for its fair market value when it takes delivery of nonfunctional currency under the forward contract. Therefore, X has an exchange loss of $1,070 ([$.48 × Q100,000] −

[$.4907 × Q100,000]) and a basis of $48,000 in the Q100,000 (based on Treas. Reg. Sec. 1.988-2(d)(4)(iii), example (1)).

Currency Swaps and Other Notional Principal Contracts

Exchange gain or loss with respect to a notional principal contract must be realized according to the Taxpayer's method of accounting, as long as that method clearly reflects income.

In general, any exchange gain or loss realized with respect to a currency swap contract must be characterized as an exchange gain or loss and not as interest income or expense. Any realized exchange gain or loss is recognized unless otherwise provided by the Internal Revenue Code. A *currency swap* is a contract involving different currencies between two or more parties to (1) exchange periodic interim payments on principal to maturity of this contract and to (2) exchange the swap principal amount upon maturity of the contract. The timing and computation of the periodic interim payments provided in a currency swap agreement are determined by treating (1) payments made under the swap as payments made pursuant to a hypothetical borrowing that is denominated in the currency in which payments are required to be made under the swap and (2) payments received under the swap as payments received pursuant to a hypothetical loan that is denominated in the currency in which payments are received under the swap.

Exchange gain or loss with respect to the principal amount is realized on the day the units of swap principal in each currency are exchanged. The gain or loss is determined on the date of the exchange by subtracting the value (on that date) of the units of swap principal paid from the value of the units of swap principal received.

Example 18.14. C is an accrual method calendar-year corporation whose functional currency is the dollar. On January 1, 1997, when the spot rate was Q1 = $1.50, C enters into a currency swap contract with J under which C agrees to make and receive the following payments:

Date	*C Pays*	*J Pays*
12/31/97	$ 1,500	Q 1,200
12/31/98	4,104	1,200
12/31/99	0	1,200
12/31/00	15,000	11,200

C must treat the dollar periodic interim payments under the swap as made pursuant to a hypothetical dollar borrowing. The hypothetical issue price is

$15,000, and the stated redemption price at maturity is $20,604 ($15,000 + $5,604). The amount of the hypothetical interest expense must be amortized in accordance with economic accrual. J must therefore include, and C must deduct, periodic interim payment amounts as follows:

Date	*Amount Taken Into Account*	*Adjusted Issue Price*
12/31/97	$1,500	$15,000
12/31/98	1,500	12,396
12/31/99	1,240	13,636
12/31/00	1,364	—

Gain or loss on the periodic payments of the currency swap is determined with respect to the dollar cash flow, as in the foregoing amortization schedule, and the corresponding Q cash flow, as stated in the currency swap agreement (based on Treas. Reg. Sec. 1.988-2(e)(5), example (2)).

Character of Gains or Losses

In general, foreign currency gain or loss attributable to a section 988 transaction is computed separately and treated as ordinary income or loss (section 988(a)(1)(A)). Capital gain or loss treatment may be elected for forward contracts, futures contracts, and options that constitute capital assets in the hands of the taxpayer that are not marked to market under section 1256, are not parts of a tax straddle, and meet the identification requirements (section 988(a)(1)(B)). In some section 988 transactions, foreign currency gain or loss will be treated as interest income or expense (section 988(a)(2)). Exchange gain or loss realized on a section 988 transaction will be treated as interest income or expense on tax-exempt bonds, in allocations and apportionment of interest expense under Temp. Treas. Reg. Sec. 1.861-9T, and in administrative pronouncements.

Source of Gains or Losses

In general, foreign currency gain or loss attributable to a section 988 transaction that is treated as ordinary income will have its source determined by reference to the residence of the taxpayer or the QBU of the taxpayer on whose books the asset, liability, or item of income or expense is properly reflected. An individual's residence is the country in which the person's tax home (under the principles of section 911(d)(3)) is located. The residence of a U.S. corporation, partnership, estate, or trust is the United States. The residence of a foreign corporation, partnership,

estate, or trust is considered not to be in the United States. In the case of a QBU, the residence of each unit is the country in which it is located. The residency of a partner in a partnership not engaged in a U.S. trade or business is determined at the partner level (Treas. Reg. Sec. 1.988-4(d)).

There is a special sourcing rule for loans made by a U.S. person or a related person (as defined by section 954(d)(3)), to a 10-percent-owned foreign corporation, when the loan is denominated in a currency other than the dollar and bears an interest rate at least 10 percentage points higher than the federal midterm rate at the time the loan is made. In this case, for purposes of section 904 only, the affected loans are marked to market on an annual basis and interest income earned on the loan during the year is treated as domestic source income to the extent of any loss on the loan (Treas. Reg. Sec. 1.988-4(e)).

Any gain or loss realized on a section 988 transaction that is treated as interest income or expense must be sourced or allocated and apportioned pursuant to section 861(a)(1), 862(a)(1), or 864(e). The allocation and apportionment of exchange gain or loss under 1.861-9T does not affect the source of exchange gain or loss for purposes of sections 871(a), 881, 1441, 1442 and 6049 (Treas. Reg. Sec. 1.988-4(f) and (g)).

Hedging Transactions

Hedges are typically used by U.S. taxpayers to protect the value of a foreign currency-denominated item in terms of U.S. dollars. Such items include foreign currency-denominated financial assets, anticipated income, liabilities, and expenses. In addition, hedges are sometimes used to protect the dollar value of stock in a controlled foreign corporation (CFC) or to reduce or eliminate an accounting exposure arising under generally accepted accounting practices in a consolidated financial statement. Hedges are primarily entered into to reduce the risk from two classes of transactions. The first class includes transactions entered into to reduce the risk of foreign currency rate fluctuations with respect to property held or to be held by the taxpayer. The second class includes transactions entered into to reduce the risk of foreign currency fluctuations with respect to borrowings or incurred obligations of the taxpayer.

A hedging transaction may, for example, involve a forward sale of the currency of a foreign country that has an impact on the value of inventory, usually a commodity. A forward exchange contract obligates one party to deliver a stipulated amount of foreign currency (or dollars) on a

future specified date and the other party to deliver another currency (or dollars) at a specified rate, called the "forward rate." A bank is usually one of the parties. Forward exchange contracts are typically available for periods of 30, 60, 90, or 180 days. The seller (the party who agrees to deliver currency against dollars) typically covers the contract by purchasing currency sometime between the contract date and the delivery date, or instructs the bank to effect the liquidating purchase on its behalf at the maturity date. A gain will be realized if the currency has declined in value, and a loss will be realized if the currency has increased in value. It is hoped that the gain realized from a forward exchange contract will partially or fully offset any losses realized because of declines in inventory values.

> *Example 18.15.* Summerland Corporation purchased $500,000 of commodity Q, of which 60 percent of the world's supply is furnished by country D. At the time of the purchase, the exchange rate for D's currency against U.S. dollars was .025. The management of Summerland Corporation believes that the currency of D may devaluate by as much as 25 percent before commodity Q can be sold. In the past, any movements in the exchange rate of D's currency caused a comparable percentage change in the market price of Q. Summerland therefore enters into a forward exchange contract for 20 million units ($500,000/0.025) of D's currency. Within the period of the contract, D's currency is revalued to 0.02. The world market price for commodity Q drops by 18 percent. Summerland has a loss on inventory of $90,000 (18% × $500,000) and a gain of $100,000 on the forward exchange contract, since 20 million units of D's currency can be purchased for $400,000 and sold for $500,000.

In the case of any transaction giving rise to foreign currency gain or loss that is part of a section 988 hedging transaction, all positions in the hedge are integrated and treated as a single transaction or are otherwise treated consistently. No exchange gain or loss is recognized. A *section 988(d) hedging transaction* is an integrated economic transaction consisting of a qualifying debt and a hedge (section 988(d) hedge). A *section 988(d) hedge* is a spot contract, futures contract, forward contract, or similar financial instrument that permits the calculation of a yield to maturity.

A qualifying debt instrument and a hedge are an integrated economic transaction if six criteria are satisfied:

1. All payments to be made or received under the qualifying debt instrument (or amounts determined by reference to nonfunctional currency) are fully hedged on the date the taxpayer identifies the trans-

action as a qualifying hedging transaction, so that a yield to maturity in which the synthetic debt instrument is denominated can be calculated. Any contingent payment features of the qualifying debt instrument must be fully offset by the hedge so that the synthetic debt instrument is not classified as a contingent debt instrument.

2. The hedge is identified on or before the date on which acquisition of the financial instrument constituting the hedge is settled or closed.
3. None of the parties to the hedge are related under section 267(b) or 707(b).
4. In the case of a QBU with a residence outside of the United States, both the qualifying debt instrument and the hedge are properly reflected on the books of the QBU throughout the term of the qualified hedging transaction.
5. In general, both the qualifying debt instrument and the hedge are entered into by the same individual, partnership, trust, estate, or corporation (whether or not the corporation is a member of an affiliated group that files a consolidated return).
6. With respect to a foreign person engaged in a U.S. trade or business that enters into a qualifying debt instrument or hedge through this trade or business, all items of income and expense associated with the qualifying debt instrument and the hedge would have been effectively connected with that trade or business throughout the term of the qualified hedging transaction (Treas. Reg. Sec. 1.988-5(a)(5)).

If the hedge is entered into after the date the qualifying debt instrument is entered into or acquired (legging in), exchange gain or loss is realized for changes in exchange rates between the date the instrument was acquired, or the date the obligor assumed the obligation to make payments under the instrument and the leg-in date. Any gain or loss realized is recognized on the date that the qualifying debt instrument matures or is otherwise disposed of. The source and character of the gain is determined on the leg-in date as if the qualifying debt instrument was actually sold or terminated by the taxpayer.

If a qualifying debt instrument and hedge are properly identified as a qualified hedging transaction and the taxpayer disposes of or otherwise terminates the qualifying debt instrument or hedge prior to the maturity of the qualifying hedging transaction (legging out), five rules apply. First, the transaction will be treated as a qualified hedging transaction during the time it was an integrated economic transaction. Second, if the hedge is disposed of or otherwise terminated, the qualifying debt instrument is

treated as if sold for its fair market value on the date the hedge is disposed of (called the "leg-out date"), and any gain or loss occurring between the identification date and the leg-out date is realized and recognized on the leg-out date. The spot rate on the leg-out date is used to determine the exchange gain or loss.

The third rule is that if the qualifying debt instrument is disposed of or otherwise terminated, the hedge is treated as sold for its fair market value on the date the qualifying debt instrument is disposed of or otherwise terminated (the leg-out date), and any gain or loss occurring between the identification date and the leg-out date is realized and recognized on the leg-out date. The spot rate on the leg-out date is used to determine exchange gain or loss on the hedge. The fourth rule, in general, is that part of the qualifying hedging transaction that has not been terminated cannot be part of a qualifying hedging transaction for any period subsequent to the leg-out date. Fifth, if a taxpayer legs out of a qualified hedging transaction and realizes a gain with respect to the terminated instrument, the gain is not recognized if during the period beginning thirty days before the leg-out date and ending thirty days after the date, the taxpayer enters into another transaction that hedges at least 50 percent of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualifying hedging transaction (Treas. Reg. Sec. 1.988-5(a)(6)(ii)).

Identification Requirements

A taxpayer must establish a separate account for each qualifying hedging transaction containing the following information:

1. The date the qualifying debt instrument and hedge were entered into.
2. The date the qualifying debt instrument and hedge are identified as constituting a qualified hedging transaction.
3. The amount of any deferral because of a legging-in or legging-out transaction and the source and character of the deferred gain.
4. A description of the qualifying debt instrument and the hedge.
5. A summary of the cash flow resulting from treating the qualifying debt instrument and the hedge as a qualified hedging transaction.

A taxpayer who enters into a qualifying debt instrument and a hedge and who fails one or more of the tests of integration may nonetheless have the commissioner of internal revenue treat the qualifying debt

instrument and the hedge as a qualified transaction if it is determined that it is in substance a qualified hedging transaction (Treas. Reg. Sec. 1.988-5(a)(8)).

Taxation of Qualified Hedging Transactions

Transactions treated as qualified hedging transactions are integrated and treated as a single transaction during the period that the transaction qualifies as a qualified hedging transaction. The effect of integrating and treating a transaction as a single transaction is to create a synthetic debt instrument that is subject to the OID provisions of sections 1272–1278 and section 163(e). The terms of this synthetic debt instrument are determined as follows:

1. The denomination of the synthetic debt instrument is the same as the currency paid (or received) under the terms of the hedge to acquire the currency used to make payments (or the currency received) under the qualifying debt instrument.
2. The term of the synthetic debt instrument begins on the identification date and ends on the earlier of the date the qualifying debt instrument matures or is disposed of or otherwise terminated.
3. The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument translated into the currency in which the synthetic debt instrument is denominated at the spot rate on the identification date.
4. The stated redemption price at maturity is determined under section 1273(a)(2) on the identification date by reference to the amounts to be paid under the hedge to acquire the currency necessary to make interest and principal payments on the qualifying debt instrument. If the qualifying debt instrument is a lending, the stated redemption price at maturity is also determined under section 1273(a)(2) on the identification date by reference to the amounts to be received under the hedge in exchange for the interest and principal payments received pursuant to the terms of the qualifying debt instrument.

Interest income from a synthetic debt instrument is sourced under the normal interest sourcing rules in sections 861(a)(1) and 862(a)(1). For foreign tax credit basket purposes, the interest income is determined by reference to the character of the qualifying debt instrument. Interest expense on a synthetic debt instrument is allocated and apportioned

under Temp. Treas. Reg. Secs. 1.861-8T to 12T or under Treas. Reg. Sec. 1.882-5.

Example 18.16. K, a calendar year U.S. corporation, has the U.S. dollar as its functional currency. On December 24, 1992, when the spot rate for Q's is Q1 = $1, K enters into a forward contract to purchase Q10,000 in exchange for $10,004 for delivery on December 31, 1997. The Q10,000 are to be used to purchase an R-denominated debt instrument on December 31, 1997. The instrument will have a term of three years, have an issue price of Q10,000, and will bear interest at 6 percent, payable annually, with no repayment of principal until the final installment. On December 12, 1997, K also enters into a series of forward contracts to sell the R interest and principal payments that will be received under the terms of the R-denominated debt instrument for dollars according to the following schedule:

Date	*U.S. $*	*Q*
12/31/98	612	600
12/31/99	623	600
12/31/00	11,216	10,600

On December 31, 1997, K takes delivery of the Q10,000 and purchases the R-denominated debt instrument. If K satisfies all of the identification requirements, the purchase of the R debt instrument and the series of forward contracts are qualifying hedging transactions. The R debt instrument and all the forward contracts are integrated as one transaction with the following consequences.

1. The integration of the R debt instrument and the forward contracts results in a synthetic dollar debt instrument in an amount equal to the dollars exchanged under the forward contract to purchase the R's necessary to acquire the R debt instrument (that is, $10,004).
2. The total amount of interest and principal received by K with respect to the synthetic dollar debt instrument is equal to the dollars received under the forward sales contracts (that is, $612 in 1998, $623 in 1999, and $11,216 in 2000).
3. The synthetic dollar debt instrument is an installment obligation, and its stated redemption price at maturity is $10,615; that is, $612 of the payments in 1998, 1999, and 2000 are treated as periodic interest payments under the principles of section 1273. Because the stated redemption price at maturity exceeds the issue price, under section 1273(a)(1) the synthetic dollar debt instrument has an OID of $611.
4. The yield to maturity of the synthetic dollar debt instrument is 8 percent, compounded annually. K must include interest income of $800 in 1998 (of which $188 constitutes OID), $815 in 1994 (of which $203 consti-

tutes OID), and $832 in 1998 (of which $220 constitutes OID). The amount of the final payment received by K in excess of the interest income is includable in a return of principal and a payment of previously accrued OID.

5. The source of the interest income is determined by applying sections 861(a)(1) and 862(a)(1) with reference to the R interest income that would have been received had the transaction not been integrated (based on Treas. Reg. Sec. 1.988-5(a)(9), example (2)).

Hedged Executory Contracts

An executory contract and hedge may also be integrated. An executory contract and a hedge are identified as a hedged executory contract if the executory contract is the subject of a hedge. These two elements are integrated if the following are present:

1. The executory contract and the hedge are identified as a hedged executory contract.
2. The hedge is entered into on or after the date the executory contract is entered into and before the accrual date (that is, the date when payment is made or received with respect to the executory contract or the subsequent corresponding account payable or receivable).
3. The executory contract is hedged in whole or in part throughout the period beginning with the date the hedge is identified and ending on or after the accrual date, and the amount of the executory contract that is hedged is not decreased during this period.
4. None of the parties to the hedge are related, as defined in sections 267(b) and 707(b).
5. In the case of a QBU with a residence outside of the United States, both the executory contract and the hedge are properly reflected on the books of this QBU.
6. The same individual, partnership, trust, estate, or corporation, with the exception of QBUs in item 5 must enter into both the executory contract and the hedge.
7. With respect to a foreign person engaged in a U.S. trade or business that enters into an executory contract, the hedge would have been effectively connected with that U.S. trade or business throughout the term of the hedged executory contract had these transactions not been integrated (Treas. Reg. Sec. 1.988-5(b)(2)(i)).

An *executory contract* is an agreement entered into before the accrual date to pay nonfunctional currency (or an amount determined with reference thereto) in the future with respect to (1) the purchase of property used in the ordinary course of a taxpayer's trade or business or (2) the acquisition of services in the future or to receive nonfunctional currency with respect to (1) the sale in the ordinary course of business, or (2) the performance of services in the future. On the accrual date, the agreement is no longer considered an executory contract and is treated as an account receivable or payable. A contract to buy or sell stock is also an executory contract. Section 988 transactions are not considered executory contracts; for example, a forward contract to purchase nonfunctional currency is not an executory contract (Treas. Reg. Sec. 1.988-5(b)(2)(ii)).

In this context, a hedge is a deposit of nonfunctional currency in a separate account for each hedge with a bank or other financial institution, a forward or futures contract, or a combination of these, that reduces the risk of exchange rate fluctuations between the taxpayer's functional currency and the nonfunctional currency payments made or received under the executory contract (Treas. Reg. Sec. 1.988-5(b)(2)(iii)). A hedge also includes certain option contracts, provided the expiration date is on or before the accrual date.

Identification. Before the close of the date the hedge is entered into, a taxpayer must establish a record, must enter into the record a clear description of the executory contract and the hedge, and must indicate that the transaction is being identified as such. The commissioner may also identify a hedge and executory contract as an integrated transaction (Treas. Reg. Sec. 1.988-5(b)(3)).

Effect of Integration. The effect of integrating an executory contract and a hedge is to treat amounts paid or received under the hedge as paid or received under the executory contract. No exchange gain or loss is recognized on the hedge. If an executory contract becomes an account payable or receivable on the accrual date, no gain or loss is recognized on the payable or receivable for the period covered by the hedge.

If only part of an executory contract is hedged, the effect of integration of the executory contract and the hedge is to treat the amounts paid or received in functional currency under the hedge as paid or received under the portion of the executory contract being hedged. The amounts attributable to that portion of the executory contract that is not hedged are translated into functional currency on the accrual date, and exchange

gain or loss is realized when payment is made or received on any payable or receivable arising on the accrual date on the unhedged amount.

If a taxpayer identifies an executory contract as part of a hedged executory contract and disposes of the executory contract prior to the accrual date, the hedge is treated as if sold for its fair market value on that date, and any gain or loss is realized and recognized on that date. The spot rate on the date the hedge is treated as sold is used to determine subsequent exchange gain or loss on the hedge. If the hedge is disposed of prior to the accrual date, any gain or loss realized on the disposition is not recognized and is an adjustment to (1) the income from, or expense of, the services performed or received under the executory contract or (2) to the amount realized or basis of the property sold or purchased under the executory contract (Treas. Reg. Sec. 1.988-5(b)(4)).

Example 18.17. On January 1, 1999, K enters into a contract with a machine manufacturer to pay Q500,000 for delivery of a machine on June 1, 2000. On January 1, 1999, K also enters into a foreign currency forward agreement to purchase Q500,000 for $250,000 for delivery on June 1, 2000. K properly identifies the executory contract as a hedge. On June 1, 2000, K takes delivery of the Q500,000 (in exchange for $150,000) under the forward contract and makes a payment of Q500,000 in exchange for the machine. The hedge is integrated with the executory contract. Therefore, K is deemed to have paid $250,000 for the machine and there is no exchange gain or loss on the foreign currency forward contract. K's basis in the machine is $250,000 (based on Treas. Reg. Sec. 1.988-5(b)(4), example (1)).

Hedges of Publicly Traded Stock. If a taxpayer purchases or sells stocks or securities that are traded on an established securities market, hedges all or part of the purchase or sale for any period beginning on the trade date and ending on the settlement date, and identifies the hedge and the underlying stock or securities as an integrated transaction, then any gain or loss on the hedge will be an adjustment to the amount realized or adjusted basis of the stock or securities sold or purchased (Treas. Reg. Sec. 1.988-5(c)).

Section 1256 may apply to some hedging transactions, in addition to transactions covered under section 988. Section 1256 requires that each section 1256 contract held by the taxpayer at the close of the taxable year must be marked to market on the last day of the taxable year, and any gain or loss must be treated as short term to the extent of 40 percent and long term to the extent of 60 percent. A section 1256 contract includes any regulated futures contract and any foreign currency contract.

Transactions Effected by Foreign Entities

Gains and losses from foreign currency fluctuations may be realized for income earned by an entity that is part of or owned by a U.S. taxpayer and whose functional currency is not the dollar. These foreign entities include (1) branches, (2) foreign corporations from which dividends are received and a credit is claimed under section 902, (3) CFCs (a) from which subpart F income, income from investments in U.S. property, income from investments in excess passive assets, and associated credits under section 960 are claimed and (b) in situations in which earnings-and-profits determinations are required under section 1248, and (4) passive foreign investment companies.

Branches

A U.S. entity that establishes a branch in a foreign country typically accounts for branch operations in the functional currency of that foreign country. The profit or loss of the branch must be translated into U.S. dollars for purposes of U.S. taxable income measurement using the so-called profit-and-loss method. The net-worth method of computing branch profit or loss is not an acceptable method of accounting for taxable years beginning after December 31, 1986. Under the profit-and-loss method, the income of each foreign branch (QBU) is computed by translating the foreign currency net profit or loss of the taxable year into U.S. dollars, using the weighted average exchange rate for the taxable period. This amount is included in the taxpayer's income without reducing it by any remittances made during the taxable period. A taxpayer will recognize gains or losses on any remittances to the extent the exchange rate at the date of remittance is different from the exchange rate used to convert the profits for U.S. tax purposes. These exchange gains or losses will have a source where the branch income is earned and are treated as ordinary income or loss (section 987).

Example 18.18. P.Q. Company, a calendar-year domestic corporation using the accrual method of accounting, has a branch in Switzerland. The branch keeps its books in Swiss francs (Sfr), using the accrual method of accounting. The net profit of the P.Q. branch was Sfr143,000. Remittances of Sfr29,000 and Sfr37,000 were made on May 29, 2000, and October 31, 2000, respectively. The rates of exchange on May 29 and October 31, respectively, were .6522 and .6309. The weighted average exchange rate for the year was .6402. The calculation of P.Q. Company profit for branch operations is as follows:

Profit to be translated at weighted average exchange rates: Sfr143,000 × 0.6402 =	$91,549
Exchange gain (loss) on remitted profit of Sfr29,000 on May 29, 2000: Sfr29,000 × (0.6522 − 0.6402) =	348
Exchange gain (loss) on remitted profit of Sfr37,000 on October 31, 2000: Sfr37,000 × (0.6309 − 0.6402) =	(344)

A taxpayer claiming a foreign tax credit for taxes paid or accrued on foreign branch profits translates the pretax profit using the same method as for foreign tax credit calculations of an affiliated foreign corporation. Foreign taxes paid are translated using the exchange rate on the date of payment. Foreign income taxes accrued are translated using the average exchange rate for the tax year to which they relate. This rule does not apply to taxes paid more than two years after the close of the tax year to which these taxes relate, taxes paid in a tax year prior to the year to which they relate, or taxes denominated in an inflationary currency (section 986(a)(1)).

Foreign income taxes that do not fall under the above rule are translated into U.S. dollars using the exchange rate at the time the taxes are paid. Any adjustment to the amount of these taxes because of additional payments are translated into U.S. dollars when the adjustment is paid to the foreign country or possession. In the case of a refund or credit, the adjustment is made using the exchange rate as of the time of the original payment (section 986(a)(2)). Estimated taxes or withheld taxes are translated at the same exchange rate in effect on the payment date (Temp. Treas. Reg. 1.905-3T(b)(2)).

Foreign Corporations

A domestic corporation that meets the minimum stock ownership requirements in foreign corporations (10 percent of the voting power directly and 5 percent indirectly) and that receives actual or deemed distributions from a foreign corporation whose books are maintained in foreign currency will translate (1) earnings and profits from which the distribution was made, (2) the dividend includable in gross income, and (3) the foreign tax paid. This method is used if (1) an actual distribution is made or a distribution is deemed under subpart F, the foreign personal holding company rules, or passive foreign investment company rules or (2) gain is recharacterized as dividend under section 1248 on the disposition of CFC or former CFC stock (Sec. 989(b)).

On actual distributions of earnings and profits from a foreign corporation, the foreign corporation's current and accumulated earnings and

profits are translated from foreign currency into U.S. dollars at the spot exchange rate in effect on the day the dividend is included in income. Similarly, gain that is treated as a dividend under section 1248 is treated as an actual distribution, and earnings and profits are translated at the exchange rate in effect on the day the deemed dividend is included in income. No exchange gain or loss is separately recognized if exchange rate fluctuations occur between the time earnings and profits arise and the time of the distribution. This system is based on using the foreign currency as the unit of account, and it translates a single number into dollars. The amount of foreign taxes deemed paid is translated using the exchange rate as of the time of the payment. Any refund or credit of foreign tax is translated using the rate in effect as of the original payment date, and any increase is translated at the rate in effect on the date of adjustment.

In the case of deemed distributions under subpart F (section 951(a)), foreign personal holding company provisions (section 551(a)), or passive foreign investment provisions (section 1293(a)), earnings and profits are calculated in the functional currency of the QBU. The earnings and profits are then translated using the weighted average exchange rate for the corporation's taxable year (section 989(b)(3)). There will be exchange gain or loss if the exchange rate fluctuates between the date of the deemed distribution and an actual distribution of this income, which has been previously taxed. The source of this exchange gain or loss will be the same as the associated income. The character of the exchange gain or loss is ordinary. The amount of deemed paid foreign tax is translated using the exchange rate as of the time of the payment. Any refund or credit of foreign tax is translated using the rate in effect as of the original payment date, and any increase is translated at the rate in effect on the date of adjustment.

The following formula is used to compute the section 902 or section 960 foreign tax credit:

$$\text{Deemed-paid foreign income taxes} = \frac{\text{Actual or deemed dividend}}{\text{Earnings and profits}} \times \text{Foreign income taxes paid or accrued with respect to earnings and profits}$$

U.S. Dollar Approximate Separate Transactions Method (DASTM)

If a dollar election is made by a QBU whose functional currency is a hyperinflationary currency, the dollar will be the functional currency of

the QBU. This method of accounting must be used to compute profits and losses. The translated amount of income and earnings and profits is a combination of operating profits plus exchange gains or losses for each taxable period. The computation is accomplished in a four-step procedure:

1. Prepare financial statements from the books regularly maintained by the QBU as recorded in the QBU's hyperinflationary currency.
2. Adjust these statements to conform with U.S. generally accepted accounting and tax principles.
3. Translate the income statement accounts into U.S. dollars, and compute the profit in U.S. dollars.
4. Compute the foreign exchange gain or loss (Treas. Reg. Sec. 1.985-3(b)).

The accounts on the balance sheet must be translated under Treas. Reg. Sec. 1.985-3(d)(5), using exchange rates in effect at the time of the transaction receipt or payment. Table 18.1 lists the various accounts in the balance sheet and the required translation rate. The accounts on the income statement are translated using the procedures in Treas. Reg. Sec. 1.985-3(c)(3). Table 18.2 lists the various accounts in the income statement and the required translation rate.

Table 18.1

Translation Rates for Balance Sheet Accounts Under U.S. Dollar Approximate Separate Transactions Method

Account	*Translation Rate*
Inventory:	
Cost	Exchange rate for the transaction period in which the historical cost was incurred
Lower of cost or market	Exchange rate at the end of the year for market value or cost
Prepaid income or expense	Average exchange rate for the translation period during which they were paid or received
Hyperinflationary cash on hand or in a checking or savings account	Average exchange rate for the last translation period of the taxable year

(continued)

Table 18.1 *(continued)*

Account	*Translation Rate*
Certain assets	Average exchange rate for the translation period in which the cost of the asset was incurred
Long-term liabilities	Average exchange rate for the translation period in which incurred
Accounts payable	Average rate for the last translation period or the translation period to which they relate
Other assets and liabilities	Average exchange rate for the period the cost of the asset was incurred or the liability incurred

Table 18.2

Translation Rates for Income Statement Accounts Under U.S. Dollar Approximate Separate Transactions Method

Account	*Translation Rate*
Beginning inventory	Dollar amount of ending inventory from the previous year
Purchases	Average exchange rate for the transaction period in which the historical cost was incurred
Ending inventory:	
Cost method	Exchange rate for the transaction period in which the historical cost was incurred
Lower of cost or market	Exchange rate at the end of the year for market value or cost
Prepaid expenses or income	Average exchange rate at the time of payment or receipt
Depreciation, depletion, and amortization	Average exchange rate for the translation period during which the cost of the underlying asset was incurred

Example 18.19. A.M., Ltd., incorporated under the laws of T, is a wholly owned subsidiary of F.M., Inc., a U.S. corporation. F.M., Inc. is required to include in gross income all the income of A.M., Ltd. under subpart F. A.M., Ltd. is a QBU eligible to make a dollar election for the taxable year. The

financial accounts of A.M., Ltd. are kept in T's hyperinflationary currency, the *q* (its functional currency absent the dollar election). After adjustment of all the accounts of A.M., Ltd. according to generally accepted accounting principles and U.S. tax-accounting principles, the financial statements of A.M., Ltd. are as follows:

A.M., Ltd.
Income Statement
For the Year Ended 12/31/9X

Sales		*q*2,800,000
Cost of goods sold		
Beginning inventory	*q* 580,000	
Purchases	1,320,000	
Less: Ending inventory	450,000	1,450,000
Other expenses		700,000
Depreciation		150,000
		*q*2,300,000
Net income before tax		*q* 500,000
Income tax		*q* 250,000
Net income after tax		*q* 250,000

A.M., Ltd.
Balance Sheet
12/31/9X

Cash	*q* 830,000
Accounts receivable	360,000
Inventory [first-in, first-out (FIFO)]	450,000
Fixed assets	1,650,000
Less: Accumulated depreciation	600,000
Total assets	*q*2,690,000
Current liabilities	*q* 300,000
Long-term liabilities	850,000
Paid-in capital	450,000
Retained earnings	1,090,000
Total liabilities and net worth	*q*2,690,000

Other financial information and exchange rates are as follows:

1. Sales, purchases, other expenses, and the average monthly exchange rates for 199X follow. Income taxes were paid when the exchange rate was 0.3255.

(continued)

Month	*Sales*	*Average Monthly Exchange Rate*	*U.S. Dollars*
January	q 280,000	.5001	$ 140,028
February	290,000	.4805	139,345
March	285,000	.4753	135,461
April	295,000	.4575	134,963
May	293,000	.4125	120,863
June	287,000	.4018	115,317
July	280,000	.3944	110,432
August	275,000	.3899	107,223
September	285,000	.3687	105,080
October	300,000	.3502	105,060
November	260,000	.3422	88,972
December	270,000	.3355	90,585
	q3,400,000		$1,393,329

Month	*Purchases*	*Average Monthly Exchange Rate*	*U.S. Dollars*
January	q 108,000	.5001	$ 54,011
February	110,000	.4805	52,855
March	108,000	.4753	51,332
April	115,000	.4575	52,613
May	114,000	.4125	47,025
June	113,000	.4018	45,403
July	110,000	.3944	43,384
August	108,000	.3899	42,109
September	111,000	.3687	40,926
October	120,000	.3502	42,024
November	102,000	.3422	34,904
December	101,000	.3355	33,886
	q1,320,000		$ 540,472

Month	*Expenses*	*Average Monthly Exchange Rate*	*U.S. Dollars*
January	q 58,000	.5001	$ 29,006
February	59,000	.4805	28,350
March	57,000	.4753	27,092
April	65,000	.4575	29,738
May	58,000	.4125	23,925
June	56,000	.4018	22,501
July	55,000	.3944	21,692
August	52,000	.3899	20,275
September	54,000	.3687	19,910
October	65,000	.3502	22,763
November	61,000	.3422	20,874
December	60,000	.3355	20,130
	q 700,000		$ 286,256

2. Beginning inventory was purchased when the exchange rate was .5312. Ending inventory in U.S. dollars is calculated as follows:

*q*101,000 × .3355 =	$ 33,886
102,000 × .3422 =	34,904
120,000 × .3502 =	42,024
111,000 × .3687 =	40,926
16,000 × .3899 =	6,238
*q*450,000	$157,978

3. Fixed assets of *q*1,650,000 were purchased in 198X when the exchange rate was .5501. Depreciation expenses and accumulated depreciation related to these fixed assets are *q*150,000 and *q*600,000, respectively.
4. Net income after tax is computed in U.S. dollars as follows:

Sales		$1,393,329
Cost of goods sold		
Beginning inventory	$ 308,096	
Purchases	540,472	
Less: Ending inventory	(157,978)	690,590
Other expenses		287,256
Depreciation		82,515
Net income before tax		$ 333,968
Income tax		81,375
Net income after tax		$ 252,593

5. Long-term liabilities were incurred when the exchange rate was 0.5501.
6. Paid-in capital was furnished when the exchange rate was 0.7284.
7. Retained earnings at the end of the previous year expressed in U.S. dollars were $632,000.
8. A distribution of *q*1,100,000 was made in January 199X when the exchange rate was 0.5000.
9. To determine the foreign exchange gain or loss, the retained earning A.M., Ltd. in U.S. dollars must be calculated as follows:

	q's	*Exchange Rate*	*U.S. Dollars*
Cash	*q* 830,000	0.3355	$ 278,465
Accounts receivable	360,000	0.3355	120,780
Inventory (FIFO)	450,000	various	157,978
Fixed assets	1,650,000	0.5501	907,655
Less: Accumulated depreciation	600,000	0.5501	330,060
Total assets	*q*2,690,000		$1,134,818

(continued)

	q's	*Exchange Rate*	*U.S. Dollars*
Current liabilities	*q* 300,000	0.3355	$ 100,650
Long-term liabilities	850,000	0.5501	467,585
Paid-in capital	450,000	0.7284	356,916
Retained earnings	1,090,000		209,667*
Total liabilities and net worth	*q*2,690,000		$1,134,818

*Total assets less liabilities and paid-in capital ($1,134,818 – [$100,650 + $467,585 + $356,916] = $209,667).

The exchange gain or loss is calculated as follows:

Retained earnings at the end of the year	$209,667	
Plus: Distribution during the year	550,000	$ 759,667
Less: Retained earnings at the end of the previous year	$632,000	
Income for the year ended	252,593	884,593
Exchange gain (loss)		$(124,926)

If a QBU begins to use the dollar approximate separate transactions method of accounting, certain adjustments must be made for foreign corporations, U.S. shareholders of CFCs, and QBU branches (see Treas. Reg. Sec. 1.985-7).

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Taxation of Foreign Taxpayers

The current framework for U.S. taxation of foreign taxpayers was formulated with the Foreign Investors Tax Act of 1966 (FITA). Prior to FITA, nonresident aliens were classified in three categories for purposes of U.S. taxation. The first category included those nonresident aliens deriving U.S.-source fixed and determinable income (primarily passive income) of $21,200 or less. Such income was taxed at a flat rate of 30 percent (or a lower treaty rate) on the gross amount. No deductions were allowed. The second category included those nonresident aliens deriving U.S.-source fixed and determinable income in excess of $21,200. Such income was taxed at a flat rate of 30 percent on gross (or a lower treaty rate) on the first $21,200 and at the higher of 30 percent on gross (or a lower treaty rate) or regular individual rates applied to net income. The third category included those nonresident aliens engaged in a trade or business in the United States. Such taxpayers were subject to tax at regular rates on net income.

Foreign corporations not engaged in a U.S. business were taxed at a flat 30 percent (or a lower treaty rate) on U.S.-source fixed and deter-

minable income. A foreign corporation engaged in a trade or business in the United States was taxed at regular corporate rates.

The so-called force-of-attraction principle provided that all U.S.-source income was taxed at ordinary rates to a foreign taxpayer engaged in a trade or business in the United States (or deriving business income through a permanent establishment if the taxpayer was a resident of a treaty country). Under the force-of-attraction principle, the foreign taxpayer was taxed on all U.S.-source income regardless of its relationship to the business.

In the early 1960s the rules governing the taxation of foreigners, especially the force-of-attraction principle, were thought to be a deterrent to investment in the United States. It was further thought that liberalizing the tax laws would provide incentives for foreign investment and would thus help to alleviate the U.S. balance-of-payments deficits.

What Constitutes a Foreign Taxpayer Under Current Law

Under current U.S. tax law, there are two classes of foreign taxpayers: (1) those with U.S.-source fixed or determinable income not effectively connected with a trade or business in the United States and (2) those who have income effectively connected with a U.S. trade or business. U.S.-source income of a foreign taxpayer not effectively connected with a U.S. trade or business is taxed at a flat rate of 30 percent (or a lower treaty rate) on gross income (sections 871(a) and 881(a)). Income effectively connected with a U.S. trade or business is taxed at regular tax rates (sections 871(b) and 882).

In the case of a nonresident alien individual or foreign corporation that disposes of U.S. real property, the resulting gain or loss is treated as effectively connected with a U.S. trade or business, taxed at regular rates. A nonresident alien individual is subject to a minimum tax on such gain described in section 897(a)(2).

Capital gains not effectively connected with a U.S. trade or business are taxed only to nonresident aliens who are physically present in the United States for 183 days or more during the year in which the gain is realized (section 871(a)(2)). A foreign corporation is not taxed on capital gains unless effectively connected with a U.S. trade or business.

Tax conventions to which the United States is a party provide special rules for determining the source of income, exclusions, rates of tax,

and other provisions that may modify the rules in the U.S. Internal Revenue Code. For example, dividends paid by a U.S. corporation to certain Swiss shareholders are subject to a 15-percent rather than a 30-percent tax. In some cases the rates of tax on certain income may be reduced to zero (for example, on royalties paid to a British resident) or remain at 30 percent (for example, on natural resource royalties paid to a Danish resident).

Foreign Taxpayers With Fixed and Determinable Income

Sections 871(a) and 881 provide that nonresident aliens and foreign corporations are subject to a 30-percent U.S. tax rate on the gross amount of fixed or determinable income not effectively connected with a U.S. trade or business in the year the income is received.

U.S. Residency

A person is considered a resident of the United States with respect to any calendar year if any of three tests are satisfied: (1) The individual is a lawful permanent resident of the United States (a "green card" holder) at any time during the calendar year, (2) the individual meets the substantial presence test, or (3) the individual makes an election to be treated as a resident of the United States and satisfies certain requirements. The individual is considered a nonresident alien if none of the three tests is satisfied and if the individual is not a citizen of the United States (section 7701(b)(1)).

During the first year of residency, the individual is considered a resident for only that portion of the calendar year that begins on the residency starting date, which corresponds to the date an individual satisfies one of the three tests above: the day the individual becomes a lawful permanent resident, the day the individual meets the substantial presence test, or the day the election to be treated as a U.S. resident is effective (section 7701(b)(2)(A)).

During the last year of residency, an individual will not be treated as a resident for any portion of a calendar year after the individual departs the United States, and has a closer connection to a foreign country than to the United States, and is not a resident of the United States at any time during the next calendar year (section 7701(b)(2)(3)).

For purposes of establishing the date residency begins or ends, an individual is not treated as present in the United States during any period (but not more than ten days) for which the individual establishes that he or she has a closer connection to a foreign country than to the United States (section 7701(b)(2)(c)).

Substantial Presence Test. An individual meets the substantial presence test with respect to any calendar year if the individual was present in the United States on at least thirty-one days during the calendar year and is present in the United States for the equivalent of 183 days or more during the current year and the two preceding years.[1] The 183-day threshold is determined by (1) multiplying the number of days the individual is present in the United States during the current year by one, the number of days during the preceding year by one-third, and the number of days during the second preceding year by one-sixth, and (2) adding these three products together. If this sum equals or exceeds 183 days, the U.S. substantial presence test is satisfied (section 7701(b)(3)(A)).

If an individual is present in the United States fewer than 183 days during the current year and has a tax home in a foreign country, and a closer connection to that foreign country than to the United States is established, then the individual will not be treated as meeting the substantial presence test for the current year. This exception will not apply if at any time during the year the individual had an application for adjustment of status pending or the individual took other steps to apply for status as a lawful permanent resident of the United States (section 7701(b)(3)(B) and (C)).

Present in the United States. A person is treated as being present in the United States on any day he or she is physically present at any time during that day. However, if an individual regularly commutes to employment (or self-employment) in the United States, he or she will not be treated as present in the United States on such days. Also, if the individual is in transit between two foreign points, he or she will not be treated as present in the United States, if physically present in the United States for less than twenty-four hours (section 7701(b)(7)).

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[1] An individual is not considered present in the United States under the substantial presence test on any day that he or she is temporarily present as a member of the regular crew of a foreign-owned vessel engaged in transportation between the United States and a foreign country or a U.S. possession, unless on that day the individual otherwise engages in a trade or business in the United States (section 7701(b)(7)(D)).

Exempt Individuals. Certain exempt individuals, or an individual unable to leave the United States because of a medical condition that arose while the individual was in the United States, will not be treated as being present in the United States on those days. Those who meet the definition of an exempt individual include:

1. A *foreign government-related individual*. The definition is any individual temporarily present in the United States by reason of diplomatic status or a visa that the Secretary of the Treasury (after consultation with the Secretary of State) determines represents full-time diplomatic or consular status, a full-time employee of an international organization, or a member of the immediate family of this individual (section 7701(b)(5)(B)).
2. A *teacher or trainee*. The definition is any individual who is temporarily in the United States under section 101(15)(J) of the Immigration and Nationality Act and who substantially complies with the requirements for being so present. There is a two-year limitation on this exemption (section 7701(b)(5)(E)(i)).
3. A *student*. The definition of *student* is any individual who is temporarily present in the United States under section 101(15)(F) or (M), as a student under section 101(15)(J) of the Immigration and Nationality Act, and who substantially complies with the requirements for being so present. A student can be an exempt individual for up to five years only if he or she continues to be a student and for subsequent periods unless the IRS is satisfied that such individual does not intend to permanently reside in the United States.
4. A *professional athlete temporarily in the United States to compete in a charitable sports event*. This event is described in section 274(l)(1)(B) (section 7701(b)(5)).

First-Year Election. An alien individual who satisfies certain requirements may elect to be treated as a resident of the United States with respect to the election year. Such election may provide tax benefits not available with nonresident alien filing status. The requirements that must be satisfied for an alien individual to make this election are as follows:

1. The alien individual is not a resident of the United States under the lawfully-admitted-for-permanent-residence test or the substantial presence test.
2. The alien individual was not a resident of the United States during the preceding year.

3. The alien individual will be a resident of the United States for the year following the election year.
4. The alien individual is both present in the United States for a period of at least thirty-one consecutive days in the election year and present in the United States at least 75 percent of the number of days during a testing period beginning with the first day of the thirty-one-day period and ending the last day of the year. The individual may treat up to five days absent from the United States as U.S. presence days for the 75-percent test (section 7701(b)(4)(A)).

The alien who makes this election is treated as a resident of the United States for the portion of the election year that begins with the first day of the testing period (the consecutive thirty-one-day period) (section 7701(b)(4)(C)). The election is made on the individual's tax return for the election year and remains in effect for the election year, unless it is revoked with the consent of the secretary. The election cannot be made before the substantial presence test is met (section 7701(b)(4)).

In certain situations a nonresident alien will not be treated as a resident because of provisions in a tax treaty. Most treaties have "tie breaker" provisions that determine residency in situations where the individual could be treated as a resident of both countries. For example, article 3 of the United States-France tax treaty is as follows:

> An individual who is a resident in both Contracting States shall be deemed a resident of that Contracting State in which he maintains his permanent home. If he has a permanent home in both Contracting States or in neither of the Contracting States, he shall be deemed a resident of that Contracting State with which his personal and economic relations are closest (center of vital interests). If the Contracting State in which he has his center of vital interests cannot be determined, he shall be deemed a resident of that Contracting State in which he has an habitual abode. If he has an habitual abode in both Contracting States or in neither of the Contracting States, the competent authorities of the Contracting States shall settle the question by mutual agreement. For purposes of this Article, a permanent home is the place in which an individual dwells with his family. An individual who is deemed to be a resident of one Contracting State and not a resident of the other Contracting State, by reason of the provisions of this paragraph, shall be deemed a resident only of the former State, for all purposes of this Convention (including Article 22).

A person considered a resident under the treaty is a resident only for purposes of the income covered by the treaty.

Fixed or Determinable Income

Fixed or determinable income includes U.S.-source interest, dividends, rents, royalties, salaries, wages, premiums, annuities, compensation, remuneration, and emoluments (sections 871(a)(1)(A) and 881(a)(1)). Even though salaries and wages are included here, they are considered effectively connected U.S. trade or business income under section 864(b).

In addition, certain items of income that might otherwise escape tax when received by a foreign individual are taxed because they are not normally considered to be in a fixed or determinable annual or periodic income category. These items include:

1. Gains from total distributions of certain employees' trusts under section 402(a)(2) and certain annuity plans under section 403(a)(2) (Treas. Reg. Sec. 1.871-7(c)(1)(i)).
2. Gains on the disposal of timber, coal, or iron ore with a retained economic interest under section 631(b) or (c) (section 871(a)(1)(B)).
3. In the case of a sale or exchange of an original discount obligation, the amount of the original discount accruing while such obligation was held by the nonresident alien individual. Also, a payment on an original issue discount obligation in an amount equal to the original issue discount accruing while such obligation was held by the nonresident alien individual (section 871(a)(1)(C)). Original issue discount for these purposes does not include original issue discount (OID) obligations payable 183 days or less from the date of the original issue and tax-exempt obligations are not considered OID obligations (section 871(g)).
4. Gains on the transfer of patent rights under section 1235 (section 871(a)(1)(B)).
5. Gains from the sale or exchange of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, other like property, or any interest in this type of property to the extent the gains are from payments that are contingent upon the productivity, use, or disposition of the property or interest sold or exchanged or from payments treated as contingent, but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States (section 871(a)(1)(D)).
6. One-half of any Social Security benefits (section 871(a)(3)).

The provisions of section 1286 relating to treatment of stripped bonds and stripped coupons apply for purposes of section 871 (section 871(g)(4)).

Portfolio Interest. A nonresident alien individual is exempt from U.S. tax on U.S.-source interest received from portfolio debt investments. Portfolio interest is defined as any interest including original issue discount that would otherwise be taxed and that is paid on unregistered obligations described in section 163(f)(2)(B) or on registered obligations with respect to which the U.S. withholding agent receives a statement that the beneficial owner is not a U.S. person (section 871(h)(2)). Interest received by a 10-percent shareholder is not considered portfolio interest.

Portfolio interest does not include contingent interest, that is, interest determined by reference to receipts, sales, cash flows, income or profits, property value changes, dividends, partnership distributions, or any other type of contingent interest identified by regulations to prevent avoidance of the federal income tax (section 871(h)(4)). The statement concerning foreign ownership of registered obligations satisfies the requirements of section 871 if it is made by the beneficial owner of the obligation or by a securities-clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business (section 871(h)(5)).

Other Interest and Dividends. No tax is imposed on interest on bank or savings institution deposits if the interest is not effectively connected with the conduct of a trade or business within the United States. Furthermore, no tax is imposed on the portion of dividends paid by a domestic corporation that meets the 80-percent foreign business requirements related to the percentage of that corporation's income from foreign sources. In addition, income derived by a foreign central bank of issue from bankers' acceptances is exempted from tax (section 871(i)).

Certain Gambling Winnings. No tax is imposed on the proceeds from a wager placed in blackjack, baccarat, craps, roulette, or big-6 wheel games unless the secretary determines by regulation that the collection of tax is administratively feasible (section 871(j)).

Withholding Requirements

Any person who pays section 1441(a) fixed or determinable income, as defined in section 1441(b), from U.S. sources to a nonresident alien,

must withhold tax from the payment. Withholding is not required on payments to foreign taxpayers on income that is effectively connected with a U.S. trade or business, which is included in gross income. Withholding is also not required on amounts received as an annuity exempt from tax by reason of section 871(f) (section 1441(c)(7)) or for portfolio interest, unless the person required to deduct and withhold tax knows, or has reason to know, that such interest is not portfolio interest (section 1441(c)(9)). Withholding is also not required for compensation for personal services of a nonresident alien individual that is subject to the usual graduated withholding under section 3402 employment tax provisions (Temp. Treas. Reg. Sec. 1.1441-4T(b)).

Section 1442 provides similar rules for withholding for payments from foreign corporations. Exemption from withholding tax may apply to payments from a foreign corporation if such withholding would impose an undue administrative burden, and if the collection of the tax imposed by section 881 on that corporation would not be jeopardized by the exemption (section 1442(b)).

The withholding rate for section 1441 and 1442 is 30 percent unless a lower treaty rate applies. The treaty rates as of (need to cross-reference this), are reproduced in exhibit 6.2. Amounts received by a nonresident alien individual who is temporarily present in the United States as a nonimmigrant under subparagraph (F), (J), or (M) of section 101(a)(15) of the Immigration and Nationality Act or as a scholarship student qualifying under section 117(a) are subject to withholding at a 14-percent rate on the amounts included in gross income (section 1441(b)).

Section 1445 requires withholding of tax on the realized amount on dispositions of U.S. real property interests by a nonresident under section 897. Exemptions from this withholding include the following:

- The transferor furnishes an affidavit that includes the transferor's U.S. taxpayer identification number and states that the transferor is not a foreign person.
- A nonpublicly traded domestic corporation furnishes an affidavit that states that interests in the corporation are not U.S. real property interests.
- The transferee receives a qualifying statement described in section 1445(b)(4)(B)).
- A property transferred was used as a residence and the amount realized for the property was not more than $300,000.
- Stock was disposed of that was regularly traded on an established securities market (section 1445(b)).

The withholding rate for section 1445 is 10 percent of the amount realized on the disposition of a U.S. real property interest, but not to exceed the transferor's maximum tax liability.

Section 1446 requires withholding on any portion of income effectively connected with a U.S. trade or business allocable to a foreign partner under section 704 (section 1446(b)(1)). If the partner is not a corporation, the withholding rate is the highest marginal rate specified in section 1. In the case of a corporate partner, the withholding rate is the highest marginal rate specified in section 11(b)(1) (section 1446(b)(2)).

Each withholding agent is required to deposit income tax withheld with an authorized commercial bank depository of a Federal Reserve Bank. If a withholding agent fails to withhold at all or fails to withhold the proper amount of the tax, the agent is personally liable for these taxes (section 1461). The withholding agent is released from this liability if the foreign taxpayer pays the tax, however, not from the liability for interest or penalties for failure to withhold (section 1463).

Capital Gains

A nonresident alien is not subject to tax on capital gains unless the gains are from the sale or exchange of certain types of property (see section 897) or the nonresident alien is present in the United States for a continuous or aggregate period of 183 days or more during the taxable year (section 871(a)(2)).

Capital gains and losses are taken into account even though the nonresident alien is not present in the United States at the time the sales or exchanges are effected. A nonresident alien who has been present in the United States for fewer than 183 days during the taxable year will not be taxed on capital gains except for the gains described in section 871(a)(1) and section 897.[2]

A foreign corporation is taxed only on capital gains that are effectively connected with a U.S. trade or business, which include gains from

[2]One area of disagreement between taxpayers and the IRS involves treatment of gain of a foreign limited partner from the disposition of an interest in a partnership that conducts a trade or business through a fixed place of business or has a permanent establishment in the United States. The IRS takes the position that under the aggregate theory of partnership taxation, the gain is effectively connected with the U.S. trade or business or attributable to a permanent establishment. Taxpayers take the position that under the entity theory the gain is not be subject to tax (Rev. Rul. 91-32, 1991-24, I.R.B. 120).

the disposition of U.S. real property interests. The gains from U.S. sources are netted against losses from U.S. sources. Capital losses for this purpose are determined without any benefit of the capital loss carryforward.

Election to Treat Real Property Income as Effectively Connected With a U.S. Trade or Business

A nonresident alien or foreign corporation that has income from real property with operations insufficient in activity to be considered a U.S. trade or business (such as a "triple-net lease," which in effect provides a guaranteed return for minimal activity) will be subject to the 30-percent tax on gross income unless an election is made under sections 871(d) or 882(d). Such an election permits the nonresident alien or foreign corporation to treat the income from the property as though it is effectively connected with a U.S. trade or business. This election may be made whether or not the taxpayer is otherwise engaged in a trade or business in the United States.

The election applies to (1) all income from real property that is located in the United States and, in the case of a nonresident alien, held for the production of income, (2) all income derived from any interest in the property, (3) rents or royalties from natural resources, and (4) gains from the disposal of timber, coal, or iron ore treated under section 631(b) or (c).

Once the election is made, the income to which the election applies is aggregated with all the foreign taxpayer's other income that is effectively connected with the conduct of a trade or business in the United States. Deductions related to real property income are treated as associated with income effectively connected with the conduct of a trade or business in the United States.

This election does not treat the taxpayer that is not engaged in a trade or business in the United States during the taxable year as if he or she was engaged in such trade or business. For example, if a nonresident alien had gains from the casual sales of personal property in the United States that was not effectively connected with a U.S. trade or business, these gains would not be treated as effectively connected with a U.S. trade or business because the election is in effect (Treas. Reg. Sec. 1.871-10(c)(1)).

Once the election is made, it remains in effect for all subsequent taxable years unless revoked with the consent of the commissioner. This means the election affects all real property held at the time of the election as well as all property acquired in the future. Some U.S. tax treaties provide what is known as a *net-basis election*. This election permits deductions for expenses, and therefore tax computation, based on the net income.

Foreign Taxpayers Engaged in a Trade or Business Within the United States

The phrase "engaged in a trade or business within the United States" is not defined in the Internal Revenue Code or the regulations. The Code and regulations state that performance of personal services for a foreign employer not engaged in a trade or business within the United States, outside of certain specified limitations, is considered engaged in a trade or business within the United States; trading in securities or commodities under certain specified limitations is not so considered. If the nonresident is engaged in other activities, continuity of the activity and the active pursuit of profit are the determinative tests. For example, it is doubtful that one or two isolated noncontinuous transactions in which an insignificant amount of income was earned would be viewed as engaged in a trade or business within the United States. On the other hand, just one transaction, such as the construction of a large bridge, that generated a significant amount of income might cause the nonresident to be considered engaged in a trade or business within the United States. If the nonresident's activities in the United States are limited to purchasing, in general, there is not a U.S. trade or business.

It should be noted that the meaning of the phrase "engaged in a trade or business" may also play an important role in determining a nonresident's status under an income tax treaty. Many treaties use the phrase *engaged in a trade or business in the United States through a permanent establishment*. This is a two-pronged test: It must be determined if a permanent establishment exists, which in many cases is fairly easy to do, and it must be determined if the nonresident is engaged in a trade or business in the United States. For example, it is possible for a nonresident to engage in commercial activity in the United States without maintaining an office and hence not be deemed to have a permanent establishment, even though he or she might be deemed to be engaged in a trade or business within the United States in the absence of a treaty.

Real estate activities constitute a trade or business if the taxpayer's activities are extensive enough to require considerable attention (that is, activities over and above merely holding the property for investment). For example, the ownership and operation of multitenant buildings is considered a trade or business because duties such as collecting rents, paying expenses, and so forth must be performed by the owner or his or her agent. At the other extreme, a triple-net lease (that is, a lease in which the lessee pays all expenses and the lessor has in effect a guaranteed return) probably would not constitute a trade or business, although section 897 will treat the gain from the sale of such property as income effectively connected with a trade or business.

In addition to the nonresident's activities causing him or her to be engaged in a trade or business within the United States, section 875 provides that a nonresident alien or foreign corporation that owns an interest in a partnership or that is a beneficiary of an estate or trust engaged in a trade or business in the United States will be considered engaged in a trade or business within the United States.

Performance of Personal Services for a Foreign Employer

When a nonresident alien performs personal services in the United States, these services are not considered a trade or business in the United States if all of the following criteria are satisfied:

1. The services are performed (a) for a nonresident alien, foreign partnership, or foreign corporation not engaged in a trade or business in the United States or (b) for an office or place of business maintained in a foreign country or in a possession of the United States by an individual who is a citizen or resident of the United States or by a domestic partnership or domestic corporation.
2. The nonresident alien is temporarily present in the United States for a period or periods not exceeding a total of ninety days during the taxable year.
3. The compensation for the services does not exceed $3,000 (section 864(b)(1)).

These criteria may be modified by treaty. For example, the United States-Germany Income Tax Treaty provides a 183-day period without limitation on the compensation for labor or personal services performed in the United States for a German resident or German company.

Trading in Securities or Commodities

A foreign taxpayer who trades in stocks, securities, or commodities of a kind customarily dealt in on an organized commodity exchange, and who engages in transactions of a kind customarily consummated at such place in the United States, will not be deemed engaged in a trade or business in the United States, provided the securities or commodities are traded through a resident broker, commission agent, or other independent agent. A foreign taxpayer trading in stocks, securities, or commodities for his or her own account will not be considered engaged in business if the trading is done by the taxpayer, his or her employees, or through a resident broker commission agent, custodian, or other agent, regardless of whether the employee or agent is dependent or independent (section 864(b)(2)). A nonresident alien, foreign partnership, foreign estate, foreign trust, or foreign corporation will not be considered to be engaged in a trade or business within the United States solely because of membership in a partnership that trades in stocks, securities, or commodities for the partnership's own account. However, membership in a partnership that is a dealer in stocks or securities or a partnership that has a principal business of trading in stocks or securities for its own account will deem the foreign taxpayer partner to be engaged in a trade or business in the United States if the partnership's principal office is in the United States. A partnership that trades in stocks or securities for its own account and that has its principal office in the United States will not be considered engaged in a trade or business in the United States if during the last half of the taxable year five or fewer individuals owned more than 50 percent of either the capital or profits of the partnership (Treas. Reg. Sec. 1.864-2(c)(2)(ii)).

Income Effectively Connected With a U.S. Business

U.S.-Source Income

A foreign taxpayer engaging in a trade or business in the United States will be taxed on effectively connected income at regular income tax rates. If the income, gain, or loss from U.S. sources for the taxable year consists of (1) capital gains or losses or (2) fixed or determinable income, several factors must be weighed in determining whether the income, gain, or loss is effectively connected with the conduct of a trade or business in the United States. If it is effectively connected income, it is taxable at regu-

lar rates; if it is not, it is taxed at the 30-percent rate (or lower treaty rate) (Treas. Reg. Sec. 1.864-4(b)).

It is important to note that the force-of-attraction rules prior to FITA are still operational in this respect. That is, if a foreign individual or corporation is engaged in a business in the United States, all income except fixed or determinable annual or periodic income from U.S. sources is considered effectively connected and is taxed as such.

Two tests, the asset use test and the business activities test, are used to determine whether (1) capital gains or losses or (2) fixed or determinable income are effectively connected with the conduct of a trade or business in the United States. In applying the asset use test and the business activities test, consideration is given to whether the asset or the income is accounted for on the books of the U.S. trade or business (section 864(c)(2)).

The asset use test determines if the income is derived from assets used in the conduct of a trade or business in the United States. Ordinarily, an asset is treated as used in, or held for use in, the conduct of a trade or business in the United States if it is (1) held for the principal purpose of promoting the present conduct or needs (not anticipated future needs) of a trade or business in the United States, (2) acquired and held in the ordinary course of a trade or business conducted in the United States, or (3) otherwise held in a direct relationship to the business conducted in the United States (Treas. Reg. Sec. 1.864-4(c)(2)(ii)).

The regulations contain several examples illustrating these points. For one, if a company doing business in the United States temporarily invests idle working capital in U.S. Treasury bills, the income from these bills is considered effectively connected with the conduct of that business in the United States (Treas. Reg. Sec. 1.864-4(c)(2)(iv), example (1)). On the other hand, if the funds invested were not working capital but general surplus reserves, the income is not effectively connected with the conduct of the business in the United States (Treas. Reg. Sec. 1.864-4(c)(2)(iv), example (2)).

The business activities test determines if the activities of a trade or business conducted in the United States were a material factor in the realization of the income, gain, or loss. The business activities test is ordinarily applied to determine whether passive-type income arises directly from the conduct of the taxpayer's trade or business in the United States. For example, royalties derived in the active conduct of a business consisting of the licensing of patents or similar intangible property would be

considered arising directly from the conduct of a U.S. business (Treas. Reg. Sec. 1.864-4(c)(3)).

A foreign taxpayer who is not engaged in a trade or business in the United States at any time during the year will have income treated as effectively connected with a trade or business in the United States in several situations:

1. The taxpayer makes the net basis election to treat the real property income as effectively connected with a U.S. trade or business under section 871(d) or 882(d).
2. The taxpayer has income as a participant in certain exchange or training programs under section 871(c).
3. The taxpayer has income that is attributable to the sale or exchange of property or the performance of services or any other transaction in any taxable year.
4. The taxpayer has income from certain property transactions.

In the second situation, section 871(c) provides that income such as interest, dividends, and rents earned by a nonresident alien participating in certain exchange and training programs will be treated as effectively connected with the conduct of a trade or business in the United States.

In the third situation, if the taxpayer has income that is attributable to the sale or exchange of property, the performance of services, or any other transaction in any taxable year, the income, gain, or loss will be treated as effectively connected with the conduct of a trade or business in the United States even if it was recognized during a year that the taxpayer was not engaged in a trade or business in the United States. The income will be considered effectively connected if it would have been treated as such had it been taken into account in the year earned (section 864(c)(6)).

Example 19.1. During 1999 a nonresident alien was engaged in the business of providing services in the United States. The taxpayer reported income from services using the cash method of accounting. During 1999 the income from performing services was effectively connected with a U.S. business. If the nonresident alien abandoned these business efforts prior to the end of 1999 and received payments after 1999 related to services performed while the nonresident alien was engaged in a business in the United States, such income from the rendering of services would be effectively connected with a U.S. business.

In the fourth situation, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the

United States, any gain attributable to a sale or exchange of that property that occurs within ten years after cessation will be considered effectively connected income (section 864(c)(7)).

Banking

A nonresident alien or a foreign corporation will be deemed engaged in the active conduct of a banking or financing business in the United States if at some time during the taxable year the taxpayer's business consists of one or more of the following activities:

- Receiving deposits from the public
- Making loans to the public
- Purchasing, selling, discounting, or negotiating notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness
- Issuing letters of credit
- Providing trust services to the public
- Financing foreign exchange transactions for the public (Treas. Reg. Sec. 1.864-4(c)(5))

It is the character of the business actually carried on in the United States during the taxable year that determines whether the taxpayer is actively conducting a banking business in the United States. The fact that the nonresident alien or corporation is subject to the banking and credit laws of a foreign country will also be taken into account.

A foreign corporation that is a *foreign finance subsidiary* (that is, acts merely as a financing vehicle for borrowing funds for its parent company or any other related person) will not be considered to be engaged in the active conduct of a banking business in the United States (Treas. Reg. Sec. 1.864-4(c)(5)(i)).

If a nonresident alien or foreign corporation is determined to be engaged in a banking business in the United States, then dividends or interest from stocks or securities, or any capital gains from the sale of stocks or securities, are treated as effectively connected income in accordance with detailed rules of Treas. Reg. Sec. 1.864-4(c)(5)(ii).

Foreign-Source Income

A nonresident alien or foreign corporation with income, gain, or loss from sources without the United States is treated as having income effectively connected with the conduct of a trade or business in the United States if the taxpayer has an office or other fixed place of business

within the United States to which the income, gain, or loss is attributable. Such trade or business income is subject to U.S. taxation if it is characterized as:

1. Rents or royalties from, or gain or loss on the sale or exchange of, intangible property derived in the active conduct of a trade or business (section 864(c)(4)(B)(i)).
2. Dividends or interest from, or gain or loss on the sale or exchange of, stocks, notes, bonds, or other evidences of indebtedness that is either (a) derived in the active conduct of a banking, financing, or similar business within the United States or (b) received by a corporation whose principal business is trading in stocks or securities for its own account (section 864(c)(4)(B)(ii)).
3. Gains or losses from the sale or exchange of personal property held as inventory or for sale to customers in the ordinary course of business outside the United States. If the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer outside the United States participated materially in the sale, then the income is not effectively connected income (section 864(c)(4)(B)(iii)).

No income from sources without the United States is considered as effectively connected with the conduct of trade or business within the United States if it is either is dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns (under section 958(a) or (b)) more than 50 percent of the combined voting power of all classes of stock entitled to vote or is subpart F income under section 952(a) (section 864(c)(4)(D)).

Office or Other Fixed Place of Business. The definition of *office or other fixed place of business* in Treas. Reg. Sec. 1.864-7 (for example, a factory, store, or workshop) is similar to the permanent establishment concept in many U.S. tax treaties. A foreign taxpayer is not considered to have an office or other fixed place of business in the United States merely because another person's office is used to transact business.

Material Factor. For this purpose, the activities of the office or other fixed place of business are considered to be a material factor in the realization of the income, gain, or loss if they provide a significant contribution to the realization of the income, gain, or loss. Thus, for example, meetings

in the United States of the board of directors of a foreign corporation do not of themselves constitute a material factor in the realization of income, gain, or loss. It is not necessary that the activities of the office or other fixed place of business in the United States be a major factor in the realization of the income, gain, or loss. An office or other fixed place of business located in the United States at some time during a taxable year may be a material factor in the realization of an item of income, gain, or loss for that year, even though the office or other fixed place of business is not present in the United States when the income, gain, or loss is realized (Treas. Reg. Sec. 1.864-6(b)).

> *Example* 19.2. F, a foreign corporation, is engaged in the active conduct of the business of licensing patents, which it has either purchased or developed in the United States. F has a business office in the United States. Licenses for the use of such patents outside the United States are negotiated by offices of F located outside the United States, subject to approval by an officer located in the U.S. office. All services which are rendered to F's foreign licenses are performed by employees of F's offices located outside the United States. None of the income, gain, or loss resulting from the foreign licenses so negotiated by F is attributable to its business office in the United States (Treas. Reg. Sec. 1.864-6(b)(2)(i), example (1)).

A nonresident alien or foreign corporation might be considered to have an office or other fixed place of business through the presence of a dependent agent in the United States. The foreign taxpayer is considered to have an office or fixed place of business in the United States if the agent has (1) the authority to negotiate and conclude contracts in the name of the foreign taxpayer and regularly exercises that authority, and (2) a stock of merchandise from which the agent regularly fills orders on behalf of the foreign taxpayer (section 864(c)(5)(A)).

The term *independent agent* refers to an agent that is not dependent, and in general describes a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his or her business in that capacity (Treas. Reg. Sec. 1.864-7(d)(3)).

A foreign corporation is not considered to have an office or fixed place of business merely because a person controlling that corporation has a fixed place of business from which he generally supervises and controls the policies of that foreign corporation. Therefore, certain management activities affecting the foreign corporation can take place in the United States without the foreign corporation being treated as having an office

or other fixed place of business in the United States (Treas. Reg. Sec. 1.864-7(c)).

If the foreign taxpayer's U.S. office is not a material factor in the production of the income, if the income was not derived from its usual U.S. business activities, and if the income was not properly allocable to the U.S. business activities, then only U.S.-source income is considered attributable to the U.S. office (Treas. Reg. Sec. 1.864-5 through 1.864-7).

Determining Gross Income, Taxable Income, and Tax

Income effectively connected with a U.S. trade or business is taxed on a net-income basis at the tax rates appropriate for the corporation, individual, estate, or trust. The gross amount of a foreign taxpayer's fixed or determinable income is taxed at a 30-percent rate (or a lower treaty rate). A nonresident alien or corporation must segregate gross income for the taxable year into two categories: (1) income effectively connected with the conduct of a trade or business in the United States and (2) income that is not effectively connected with the conduct of a trade or business in the United States.

Income of any kind that is exempt from tax under treaty provisions is not included in gross income of a foreign taxpayer. Income on which the tax is limited by treaty and not otherwise excluded from gross income is included in gross income.

Corporations created or organized in Guam, American Samoa, the Northern Mariana Islands, or the Virgin Islands that satisfy all of the following three tests during any taxable year are not treated as foreign corporations for purposes of the foregoing tax scheme, nor for the branch tax on foreign corporations as well.

1. At all times during the taxable year less than 25 percent in value of the stock of the corporation is owned directly or indirectly by foreign persons.
2. At least 65 percent of the gross income of the corporation is effectively connected with the conduct of a trade or business in a possession or the United States for the three-year period ending with the close of the taxable year of the corporation.
3. No substantial part of the income of the corporation is used to satisfy obligations to persons who are not bona fide residents of a possession or the United States (section 881(b)).

Community Income in the Case of Nonresident Alien Individuals

The case of a married couple, one or both of whom are nonresident alien individuals, and who have community income for the taxable year, will be treated as follows:

1. Earned income, other than trade or business income and a partner's distributive share of partnership income, is treated as the income of the spouse who rendered the personal services.
2. Trade or business income and a partner's distributive share of partnership income are treated as under section 1402(a)(5). Section 1402 provides that any income and deductions derived from a trade or business (other than by a partnership) that is community income under applicable community property laws, will be attributable to the husband, unless the wife exercises substantially all of the management and control of the trade or business. If this is the case, all of the gross income and deductions will be treated as attributable to the wife. In the case of partnership income treated as community income, the amounts considered attributable to each spouse are the amounts used in computing the net earnings from self-employment.
3. Community income not described in items 1 or 2 above that is derived from the separate property of one spouse is treated as the income of that spouse.
4. All other community income is treated as provided under applicable community property law (section 879(a)).

The foregoing treatment will not apply if a section 6013(g) election is in effect (section 879(b)).

Exclusions From Gross Income

Nonresident alien individuals and foreign corporations are permitted to exclude the same categories of income (such as interest on state and local government obligations under section 103) as a citizen or resident. Section 872 (for nonresident individuals) and section 883 (for foreign corporations) also permit a foreign taxpayer to exclude:

1. Earnings from the operation of ships or aircraft if the person is a resident of a foreign country or a corporation is organized in a country that grants an equivalent exemption to citizens of the United States

and domestic corporations (sections 872(b)(1), 872(b)(2), 883(a)(1), and 883(a)(2)).

2. Compensation paid by a foreign employer to a nonresident alien individual for the period he or she is temporarily present in the United States as a nonimmigrant under section 101(a)(15), subsections (F) or (J) of the Immigration and Nationality Act. A *foreign employer* for these purposes is a nonresident alien, foreign partnership, foreign corporation, or office or place of business maintained in a foreign country or in a U.S. possession by a domestic corporation, domestic partnership, U.S. individual, or resident (section 872(b)(3)).
3. Income derived by a nonresident alien from series E or series H United States savings bonds if purchased while the person was a resident of the Ryukyu Islands or the trust territory of the Pacific Islands (section 872(b)(4)).
4. Earnings derived by a corporation from payments by a common carrier for the temporary use (not expected to exceed a total of ninety days in any taxable year) of railroad rolling stock owned by a corporation of a foreign country that grants an equivalent exemption to corporations organized in the United States (section 883(a)(3)).
5. Earnings derived from the ownership and operation of a communications satellite system by a foreign entity designated by a foreign government to participate in such ownership, if the United States, through its designated entity, participates in the system pursuant to the Communications Satellite Act of 1962 (section 883(b)).

Income received by a nonresident alien from a qualified annuity under section 403(a)(1) or from a qualified trust under section 401(a) is not included in gross income and is exempt from tax if either of the following conditions are satisfied: (1) the personal services that gave rise to the annuity were performed outside the United States at a time when the individual was a nonresident alien, and (2) the services were performed in the United States by a nonresident alien but were not personal services causing the individual to be engaged in a trade or business in the United States. Also required is that at the time the first amount was paid as an annuity, 90 percent or more of the employees or annuitants under the plan were U.S. citizens or residents (section 871(f); Treas. Reg. Sec. 1.872-2(e)).

Deductions Allowed Foreign Taxpayers

A foreign taxpayer is allowed deductions to the extent they are associated with income effectively connected with a U.S. business. No deductions are allowed on income subject to the flat 30-percent rate. This means that only expenses, losses, and other deductions that are connected with or allocable to those items of U.S. income and a ratable part of any expenses, losses, or deductions that cannot definitely be allocated to some item or class of gross income can be deducted.

Other than deductions related to effectively connected income, a nonresident alien individual is allowed (1) casualty losses sustained on property located in the United States, (2) U.S. charitable contributions, and (3) one personal exemption (section 873(b)). Other than deductions connected with the conduct of a trade or business, a foreign corporation is allowed only a deduction for charitable contributions, whether or not they are related to income effectively connected with a U.S. business (section 882(c)(1)(B)).

A nonresident alien receives the benefit of deductions and credits only if a true and accurate return is timely filed within one year, including all the information necessary for calculating the deductions and credits (sections 874(a) and 882(c)(2)). Regardless of whether a true and accurate return is filed, the credit for tax withheld at its source or the credit for certain uses of gasoline, special fuels, and lubricating oil will be allowed.

Interest Deduction Limitations by U.S. Affiliates of Foreign Investors

Section 163(j) provides that a foreign or domestic corporation may not deduct current payments of disqualified interest on its U.S. income tax return. This provision is the so-called earnings-stripping provision, which limits a corporation's current deduction for interest paid or accrued by the corporation during the taxable year. *Disqualified interest* means (1) any interest paid or accrued by the taxpayer (directly or indirectly) to a related person if no federal income tax is imposed on that interest, and (2) any interest paid or accrued by the taxpayer to an unrelated person if there is a disqualified guarantee of such indebtedness and no gross basis federal income tax is imposed on that interest (section 163(j)(3)). A *disqualified guarantee* means any guarantee by a related person that is a tax exempt organization or foreign person. A qualified guarantee includes a guarantee in circumstances identified by the Secretary of the Treasury

that by regulation would have been subject to a net basis tax if the interest had been paid to the guarantor or if the taxpayer owns a controlling interest in the guarantor (section 163(j)(6)(D)).

If section 163(j) applies to a corporation for any taxable year, no interest deduction is allowed for disqualified interest paid or accrued during the taxable year. The amount disallowed cannot exceed the corporation's *excess interest expense* for the year. This provision applies to any corporation that has excess interest expense and whose debt-to-equity ratio at the end of the year exceeds 1.5 to 1.

Excess interest expense is the excess of the corporation's net interest expense over the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward. *Net interest expense* is the excess of the interest paid or accrued over the amount of interest includable in gross income for the taxable year (section 164(j)(6)(B)). *Adjusted taxable income* is taxable income computed without taking into consideration net interest expense, net operating loss deductions, and depreciation or depletion (section 164(j)(6)(A)). Any excess limitation (the excess of 50 percent of adjusted taxable income over the corporation's net interest expense) is carried forward indefinitely and is used on a first-in, first-out basis. These rules are applied on a group basis rather than a separate-company basis (section 164(j)(6)(C)).

A related person in general is defined by sections 267(b) or 707(b)(1). A partnership is not treated as a related person if less than 10 percent of the profits and capital interests in the partnership is held by persons who are not subject to U.S. income tax, except in the case of interest allocable to any partner in the partnership who is a related person to the corporation (section 163(j)(4)).

In the case of any interest paid or accrued to a partnership, the determination of whether a tax is paid is made on the partner level. A similar rule applies in the case of any pass-through entity, tiered partnerships, and other entities.

In the case of a treaty between the United States and any foreign country that reduces the rate of tax on interest paid or accrued to a related party, that interest will be treated as exempt from tax to the following extent (section 163(j)(5)):

$$\text{Interest exempt from tax} = \frac{\text{Rate of tax without regard to treaty less rate of tax imposed under the treaty}}{\text{Rate of tax without regard to treaty}} \times \text{Interest paid or accrued}$$

Tax Rates

An unmarried resident alien is taxed at rates applicable to U.S. unmarried individuals either under the regular tax or the alternative minimum tax and under section 402(e)(1) on lump-sum distributions from a qualified plan on income effectively connected with a U.S. business (section 871(b)(1)). Other fixed or determinable income is taxed at the 30-percent rate or a lower treaty rate. A married nonresident alien is taxed according to these same rules except that the rates applicable to married individuals filing separate returns are used. A nonresident alien cannot use the rates applicable to a head of household or married taxpayers filing a joint return; however, a nonresident alien married to a U.S. citizen may elect to file a joint return as a resident alien (section 6013(g)). A foreign corporation is taxed at a 30-percent tax rate (or lower treaty rate) on fixed or determinable income and under regular rates or alternative minimum tax rates on regular or alternative minimum taxable income effectively connected with the conduct of a trade or business in the United States (section 882(a)(1)).

Tax on Transportation Income

A nonresident alien individual or foreign corporation that has U.S.-source transportation income is subject to a tax equal to 4 percent of this gross income (section 887(a)). *U.S.-source gross transportation income* means any gross income that is defined as transportation income and treated as U.S.-source transportation income under section 863(c). Transportation income of any taxpayer will not be treated as effectively connected with the conduct of a trade or business in the United States, unless the taxpayer has a fixed place of business in the United States involved in earning the transportation income, and substantially all of the U.S.-source gross transportation income is attributable to regularly scheduled transportation. If the income is from leasing of a vessel or aircraft, the income must be attributable to a fixed place of business in the United States to be effectively connected (section 887(b)).

Taxation of Foreign Governments, International Organizations, and Their Employees

A foreign government is exempt from tax on income received from an investment in the United States in stocks, bonds, or other domestic securities owned by the foreign government, financial instruments held in the

execution of government financial or monetary policy, or interest on deposits in banks in the United States of money belonging to the foreign government (section 892(a)(1)). An exclusion from U.S. tax is not available to a foreign government for any income derived from the conduct of a commercial activity within or without the United States or received from an entity the foreign government controls. A central bank of issue is treated as a controlled commercial entity only if it engages in commercial activities within the United States (section 892(a)(2)).

International organizations are exempt from income tax on all U.S.-source income (section 892(b)).

Wages, fees, or the salary of any employee of a foreign government or of an international organization, received as compensation for official services to that government, is not included in gross income for U.S. tax purposes and is exempt from tax if three tests are satisfied:

1. The employee is not a citizen of the United States, or is a citizen of the Philippines, whether a citizen of the United States or not.
2. In the case of an employee of a foreign government, the services are of a character similar to those performed by employees of the government of the United States in foreign countries.
3. In the case of an employee of a foreign government, the foreign government grants an equivalent exemption to employees of the government of the United States performing similar services in such foreign country (section 893).

Foreign Trusts

There are several different regimes relating to the taxation of foreign trusts. A foreign trust may be taxed as a nonresident alien individual who is not present in the United States at any time during the year. Thus, the foreign trust is taxed on certain U.S. source income and income effectively connected with a U.S. trade or business. Grantor trust rules that cause the grantor to be taxed on trust income apply to foreign trusts. A grantor may be treated as the owner of the trust. Also, a U.S. person who transfers property to a foreign trust may be treated as the owner and taxed currently on the income during each year the trust has a U.S. beneficiary. There is also an interest charge on foreign trust distributions to U.S. beneficiaries of accumulated income.

A *foreign trust* is defined as a trust that is not a U.S. trust. Section 7701(a)(31) contains a two-part test for classifying a trust as a U.S. trust. First the trust must be one in which a court within the United States is able to exercise primary supervision over the administration of the trust. It is expected that any trust instrument that specifies that it is to be governed by the laws of any state will satisfy this test. Second, one or more U.S. persons have the authority to control all substantial trust decisions. It is expected that in any case where fiduciaries that are U.S. persons hold a majority of the fiduciary power (by vote or otherwise) and which important decisions cannot be vetoed by a foreign fiduciary, such as a "trust protector" or other trust advisor will satisfy this test. In addition, in applying the second test, a trust will not be considered foreign until after a reasonable period of time to replace a U.S. fiduciary that resigns or dies.

Foreign Trusts With No U.S. Beneficiaries

A foreign trust with no U.S. beneficiaries is taxed as a nonresident alien individual who is not present in the United States at any time. It is subject to U.S. income tax on fixed or determinable annual or periodic income from sources within the United States and on income effectively connected with a U.S. trade or business. Fixed or determinable annual or periodic income includes income from—

- Investments such as interest (section 861(a)(1).
- Dividends (section 861(a)(2) and rents (section 861(a)(4)).
- Compensation such as salaries, wages, and annuities (section 861(a)(3)).
- Certain kinds of capital gains, such as those realized from the sale of timber, coal, iron ore rights, and intangibles (section 871(a)(1)).

These types of income are taxed at a flat 30-percent rate (or lower treaty rate), and no deductions are allowed. Capital gains, such as those derived from the sale of securities, are taxed only if a nonresident alien individual is present in the United States 183 days or more during the taxable year (section 871(a)(2)). Since a foreign trust is treated as if it were never present in the United States, capital gains not effectively connected with a U.S. trade or business are not taxable. Capital gain or loss from the disposition of a U.S. real property interest is taxed under section

897. Income effectively connected with a U.S. trade or business is taxed at regular rates.

Inbound Foreign Grantor Trusts

The grantor trust rules (that is, the grantor treated as owner of the trust) generally apply only to the extent that income or other amounts are currently taken into account, directly or indirectly, in computing the income of a U.S. citizen or resident or a domestic corporation. Thus the grantor trust rules generally do not apply to any portion of a trust that a foreign person is considered to own (section 672(f)(1)).

There are several exceptions to the above rule. First, the grantor trust rules apply to that portion of a trust that is revocable by the grantor either without approval of another person or with the consent of a related or subordinate party who is subservient to the grantor (see section 672(c)). Second, the grantor trust rules apply to the portion of the trust where the only amounts distributable from that portion during grantor's lifetime are to the grantor or the grantor's spouse. Third, the grantor trust rules generally apply where the grantor is a CFC. Fourth, The grantor trust rules apply in determining whether a foreign corporation is characterized as a passive foreign investment company (PFIC), with the result that a foreign corporation cannot avoid PFIC status by transferring its assets to a grantor trust. (Section 672(f))

Also not treated as grantor trusts are trusts established to pay compensation and certain trusts in existence as of September 19, 1995, provided that the trust is treated as owned under section 676 or 677 (other than section 677(a)(3)). This rule does not apply to the portion of the trust attributable to assets transferred after this date.

The transfer of property to a foreign grantor of an inbound grantor trust by a U.S. beneficiary, or a family member of such beneficiary, will cause the U.S. beneficiary to be treated as a grantor of a portion of the trust to the extent of the transfer. This rule does not apply if the transfer is a sale of the property for full and adequate consideration or if the transfer is a gift that qualifies for the section 2503(b) annual exclusion (section 672(f)(5)). In addition, the Treasury Department has the power to recharacterize a transfer, directly or indirectly, from a partnership or foreign corporation that the transferee treats as a gift or bequest, to prevent the avoidance of section 671(f)(3).

It is anticipated that foreign tax credit relief (subject to foreign tax credit limitations) will be available in the case of double-taxed income.

That is, in the situation where the foreign grantor pays foreign taxes and the U.S. beneficiary pays U.S. taxes on the same income, the U.S. beneficiaries will be treated as having paid the foreign taxes that are paid by the foreign grantor.

Any U.S. person (other than certain tax-exempt organizations) is required to report any purported gifts or bequests from foreign sources that total more than $10,000 (indexed for inflation) during the taxable year. Reportable gifts exclude amounts that are qualified tuition or medical payments made on behalf of a U.S. person and amounts that are distributions to a U.S. beneficiary of a foreign trust if such amounts are properly disclosed under the applicable reporting requirements.

Outbound Foreign Grantor Trusts

Any U.S. person directly or indirectly transferring property to a foreign trust that has a U.S. beneficiary is treated as owner of the portion of the trust attributable to the property transferred by the U.S. person (section 679(a)(1)). Section 7701(a)(3) defines *U.S. person* as a citizen or resident of the United States, a domestic partnership, a domestic corporation, any estate other than a foreign estate, and any trust that is not a foreign trust. This rule in section 679 applies to simple or complex trusts. It does not apply to employee trusts, described in section 404(a)(4), created or organized outside of the United States or to transfers to a charitable trust.

There are several exceptions to this grantor trust treatment. Grantor trust treatment does not result from any transfer by reason of death or the transferor (section 679(a)(2)(A)). Also, grantor trust treatment does not result from a transfer of property by an U.S. person to a foreign trust in the form of a sale or exchange where gain is recognized by the transferor (section 679(a)(2)(B)). Obligations issued by the trust, by any grantor or beneficiary of the trust, or by any person related to any grantor or beneficiary generally are not taken into account (section 679(a)(3)). It is anticipated that Treasury regulations will provide exceptions for loans with arm's-length terms and whether there is a reasonable expectation of repayment. For this purpose, a person is treated as related to the grantor or beneficiary if the relationship between the grantor and beneficiary would result in disallowance of losses under section 267(a) or 707(b), except that in applying section 267(c)(4) an individual's family includes the spouses of the members of the family. In determining the portion of the trust attributable to the property transferred, principal payments

made by the trust on obligations are taken into account on or after the date of the payment.

A nonresident alien individual who transfers property, directly or indirectly, to a foreign trust and then becomes a resident of the United States within five years after the transfer generally is treated as making a transfer to the foreign trust on the individual's U.S. residency starting date. The amount of the deemed transfer is the portion of the trust (including undistributed earnings) attributable to the property previously transferred. As a consequence, the individual generally is treated as owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries. A beneficiary will not be treated as a U.S. person with respect to any transfer of property to a foreign trust if the beneficiary first became a U.S. person more than five years after the date of the transfer.

Both direct and indirect transfers will cause the transferor to a foreign trust to be treated as owner of a portion of the trust attributable to the property transferred. The following are conditions of indirect transfers[3]:

1. A transfer of property to a foreign person or entity that subsequently transfers the property or its equivalent to a foreign trust that has U.S. beneficiaries
2. A transfer of property to a domestic trust or corporation that subsequently transfers that property or its equivalent to a foreign trust
3. A transfer to a domestic trust that subsequently becomes a foreign trust
4. A formal or informal guarantee by a U.S. person for repayment of a loan by a foreign trust that borrows money or other property

Any property that is derived, directly or indirectly, by a U.S. person from a foreign trust through another person (intermediary) is deemed to have been paid directly by the foreign trust to the U.S. person if any of the following conditions is satisfied:

1. The intermediary is related to either the U.S. person or the foreign trust and the intermediary transfers to the U.S. person either property that the intermediary received from the foreign trust or proceeds from the property that the intermediary received from the foreign trust.

[3]Senate Committee on Finance, *Tax Reform Act of 1976*, 94th Cong., 2d sess., 1976, 219.

2. The intermediary would not have transferred the property to the U.S. person but for the fact that the intermediary received property from the foreign trust.
3. The intermediary received the property from the foreign trust pursuant to a plan of which avoidance of U.S. tax was one of the principal purposes (Prop.Treas. Reg. 1.643(h)-1(a)).

If the intermediary is an agent of the foreign trust, the payment is treated as paid to the U.S. person in the year the amount is by the intermediary to the U.S. person. If the intermediary is an agent of the U.S. person, the payment is treated as paid to the U.S. person in the year the amount is paid by the foreign trust to the intermediary. An intermediary not considered an agent of the foreign trust or the U.S. person under generally applicable agency principles is treated the same as an agent of the foreign trust. A payment is treated as paid by the foreign trust to the U.S. person in the year the amount is paid by the intermediary to the U.S. person (Prop.Treas. Reg. 1.643(h)-1(c)).

Gain is recognized upon the transfer of appreciated property by a U.S. person to a foreign trust, except as regulation may provide. The transfer is treated as a sale or exchange equal to the fair market value of the property transferred and gain is recognized on this amount in excess of the adjusted basis (section 684(a)). Gain is not recognized if any person is treated as owner of the trust under the grantor trust rules (section 684(b)). This rule also applies to a domestic trust that becomes a foreign trust. Such trust is treated as having transferred, immediately before becoming a foreign trust, all of its assets to a foreign trust (section 684(c)).

Treatment of U.S. Beneficiaries of Foreign Nongrantor Trusts

If the income of a foreign trust is taxed to the grantor under section 679, the U.S. beneficiary will not be taxed when a distribution is received. In cases in which income of a foreign trust is not taxed to the grantor under the grantor trust rules (such as if the grantor recognizes the full gain on the transfer to the trust), the U.S. beneficiary is subject to an interest charge in addition to the normal income taxes on the distribution (section 668). The interest charge is based on the length of time during which tax was deferred because of the trust's accumulation of income. The period for which interest charged uses the section 6621(a)(2) interest rate and is determined as a weighted average.

The undistributed net income for each year it is accumulated is multiplied by the number of tax years between the undistributed net income year and the year of distribution. The time period includes the undistributed net income year but excludes the year of distribution. These products are summed and divided by the aggregate undistributed net income to determine the period to which the section 6621(a)(2) interest is applied. Interest was at a rate of six percent without compounding until January 1, 1996.

Example 19.3. A foreign nongrantor trust has $10,000 of undistributed net income in year 1, $7,000 in year 2, and $15,000 in year 3. It distributes $12,000 of accumulated income in year 4. The period for which the section 6621(a)(2) interest rate is charged is determined as follows:

$$\frac{(\$10{,}000 \times 3) + (\$7{,}000 \times 2) + (\$15{,}000 \times 1)}{\$32{,}000} = 1.84 \text{ years}$$

The amount of interest charged, when added to the total partial tax computed under section 667(b) cannot exceed the amount of the accumulated distribution with respect to which the partial tax was determined (section 668(b)). The interest charge is not deductible (section 668(c)).

Reporting Requirements

There are reporting requirements with respect to foreign trusts with a U.S. grantor or a distribution from a foreign trust to a U.S. person. There are also certain events with respect to foreign trusts, which require compliance with reporting requirements by a responsible party. In addition, a U.S. person who is treated as the owner of any position of a foreign trust is responsible for certain foreign trust reporting requirements. Beneficiaries of foreign trusts who receive a distribution from a foreign trust must report certain information to the IRS. These reporting requirements are covered in chapter 22.

Expatriation to Avoid Tax

Section 877 applies to certain former U.S. citizens and former long-term U.S. residents for 10 years following the date of loss of U.S. citizenship or U.S. residency status, unless the expatriation did not have a principal purposes of avoiding U.S. income, estate, gift or generation skipping

transfer taxes. Gain recognition is required on certain exchanges of property following loss of U.S. citizenship or U.S. residency status, unless the individual enters into a gain recognition agreement. In addition, the Treasury has regulatory authority to apply this rule to the 15-year period beginning 5 years before the loss of U.S. citizenship or U.S. residency status. In addition, in the case of an exchange occurring during the 5-year period before the loss of U.S. citizenship or U.S. residency status, any gain required to be recognized under regulations is to be recognized immediately after the date of such loss of U.S. citizenship. The running of the 10-year period with respect to gain on the sale or exchange of any property is suspended for any period during which the individual's risk of loss with respect to the property is substantially diminished. An individual's risk is substantially diminished by holding a put with respect to the property (or similar property), by holding by another person of a right to acquire the property, or a short sale or any other transaction.

Special rules apply in the case of certain contributions of U.S. property, the income from which, immediately before the contribution, was from U.S. sources, by an individual to a foreign corporation during the 10-year period that begins on the date of loss of U.S. citizenship or U.S. residency status.

Also, under section 2107, special estate tax treatment applies to certain former U.S. citizens and former long-term U.S. residents who die within 10 years following the date of loss of U.S. citizenship or U.S. residency status. A credit against the U.S. estate tax for foreign estate taxes paid with respect to property that is includable in the decedent's U.S. estate solely by reason of the expatriation estate tax provisions. The credit for the estate taxes paid to any foreign country generally is limited to the lesser of (1) the foreign estate taxes attributable to the property includable in the decedent's U.S. estate solely by reason of the expatriation estate tax provisions, or (2) the U.S. estate tax attributable to property that is subject to estate tax in such foreign country and is includable in the decedent's U.S. estate solely by reason of the expatriation tax provisions. The amount of taxes attributable to such property is determined on a pro rata basis.

Alternative Tax

An expatriate under section 877 is taxable for the taxable year as provided in section 1 or 55, except that the gross income includes only U.S. source income and gross income that is effectively connected with a trade

or business within the United States, and deductions are related to this gross income. The tax may be reduced (but not below zero) by the amount of any foreign income taxes paid to any foreign country or possession of the United States on any income of the taxpayer on which tax is imposed because of section 877.

Special Source Rules

The following items of gross income shall be treated as income from sources within the United States:

1. *Sale of property:* Gains on the sale or exchange of property (other than stock or debt obligations) located in the United States.
2. *Stock or debt obligation:* 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 or political subdivision thereof, or the District of Columbia.
3. *Income or gain derived from a controlled foreign corporation:* Any income or gain derived from stock in a foreign corporation if the individual satisfies an ownership requirement and an income or gain requirement. The income requirement is satisfied if the individual losing U.S. citizenship owned (within the meaning of section 958(a)), or is considered as owning (by applying the ownership rules of section 958(b)), at any time during the two-year period ending on the date of the loss of United States citizenship, more than 50 percent of the total combined voting power of all classes of voting stock or the total value of the stock of such corporation. The income or gain requirement is satisfied to the extent income or gain does not exceed the earnings and profits attributable to such stock that were earned or accumulated before the loss of citizenship and during periods that the two-year ownership requirement is met.

In the case of certain exchanges, the property will be treated as sold for its fair market value on the date of such exchange, and any gain must be recognized for the taxable year that includes such date. This provision applies to any exchanges during the 10-year period beginning on the date the individual loses U.S. citizenship if gain would not otherwise be recognized, income derived from such property was from sources within the United States (or, if no income was so derived, would have been from such sources), and income derived from the property acquired in the

exchange would be from sources outside the United States. An individual may postpone the recognition of gain if the individual enters into a gain recognition agreement with the IRS that specifies that any income or gain derived from the property acquired in the exchange (or any other property which has a basis determined in whole or part by reference to such property during such 10-year period shall be treated as from sources within the United States. If the property transferred in the exchange is disposed of by the person acquiring such property, the agreement shall terminate and any gain that was not recognized by reason of such agreement must be recognized as of the date of such disposition. Regulations may also require recognition of gain from the removal of appreciated tangible personal property from the United States, and any other occurrence that (without recognition of gain) results in a change in the source of the income or gain) from property from sources within the United States to sources outside the United States.

Property Contributed to Controlled Foreign Corporations

If an individual losing U.S. citizenship contributes property during the 10-year period beginning on the date the individual loses U.S. citizenship, which at the time of the contribution would be a CFC if the individual continued to be a U.S. citizen and income derived from such property immediately before such contribution was from sources within the United States (or, if no income was so derived, would have been from such sources), any income or gain on such property received or accrued by the corporation must be treated as received or accrued directly by such individual and not by such corporation.

If stock in the corporation is disposed of during the 10-year period referred and while the property transferred is held by the corporation, a pro rata share of such property (determined on the basis of the value of such stock) must be treated as sold by the corporation immediately before such disposition.

Lawful Permanent Residents

Any long-term resident of the United States who ceases to be a lawful permanent resident of the United States, or commences to be treated as a resident of a foreign country under the provisions of a tax treaty

between the United States and the foreign country and who does not waive the benefits of such treaty applicable to residents of the foreign country, will be treated in the same manner as if such resident were a citizen of the United States who lost United States citizenship on the date of such cessation or commencement.

A *long-term resident* for this purpose means any individual (other than a citizen of the United States) who is a lawful permanent resident of the United States in at least eight taxable years during the period of fifteen taxable years ending with the taxable year the individual is no longer a U.S. resident. An individual will not be treated as a lawful permanent resident for any taxable year during which the individual is treated as a resident of a foreign country for the taxable year under the provisions of a tax treaty between the United States and the foreign country, and such an individual does not waive the benefits of the treaty applicable to residents of the foreign country.

For purposes of determining any tax imposed on the long-term resident, property that was held by the long-term resident on the date the individual first became a resident of the United States will be treated as having a basis of not less than the fair market value of the property on the date residency was established. The individual may make an irrevocable election not to have this treatment apply.

Tax Avoidance Motives

If the individual's "average annual net income tax" or net worth exceeds certain thresholds, the tax avoidance purpose is deemed present. The taxpayer may overcome the tax avoidance presumption by requesting and receiving a favorable ruling from the IRS. An individual who falls below the average annual net income tax liability and net worth thresholds may be subject to tax under the Internal Revenue Code section 877 if a principal purpose for the loss of citizenship or termination of residency is avoidance of tax.

An individual is deemed to have tax avoidance motives if his or her average annual net income tax for the period of five taxable years ending before the date of the loss of U.S. citizenship is greater than $100,000, or if the individual's net worth is $500,000 or more (section 877(a)(2)).

A long-term U.S. resident terminates U.S. residency if the individual ceases to be a lawful permanent resident of the U.S. under Internal Revenue Code section 7701(b)(6) or becomes a resident of a foreign

country under a treaty tie-breaker rule and does not waive available treaty benefits. Expatriation occurs either on the date U.S. residence ends or foreign residence begins.

Tax avoidance not presumed the cases of dual citizens, long-term foreign residents, a minor who loses U.S. citizenship before reaching age 18 1/2, and persons specified in forthcoming regulations who submit a ruling request for the IRS's determination as to whether the loss of citizenship has as one of its principal purposes the avoidance of tax. A *dual citizen* is described as an individual who became at birth a citizen of the United States and a citizen of another country and continues to be a citizen of the other country and becomes (not later than the close of a reasonable period after loss of U.S. citizenship) a citizen of the country in which the individual was born; if the individual is married, the country in which the individual's spouse was born; or the country in which either of the individual's parents were born. A *long-term foreign resident* is an individual who was present in the United States for 30 days or less during each year in the 10-year period ending on the date of loss of U.S. citizenship.

Expatriation Filing Requirements

A U.S. citizen who loses U.S. citizenship under section 877(a) or a long-term U.S. resident who terminates U.S. residency under Code Sec. 877(e)(1) is required to provide an information statement (section 6039G(a)). This information statement must be filed not later than the earliest date the individual—

1. Renounces U.S. nationality before a U.S. diplomatic or consular officer;
2. Furnishes to the State Department a statement of voluntary relinquishment of U.S. nationality confirming an act of expatriation;
3. Is issued a certificate of loss of U.S. nationality by the State Department; or
4. Loses U.S. nationality because the individual's certificate of nationalization is cancelled by a U.S. court (section 6039G(c)).

A former U.S. citizen must provide the information statement to the American Citizen Services Unit, Consular Section of the nearest U.S. embassy or consulate or to a federal court, if the individual's certificate of nationality was cancelled by such a court (Notice 97-19, 1997-10 IRB 40, modified on other points by Notice 98-34, 1998-27 IRB 30).

A former long-term U.S. resident who terminates U.S. residency must file the information statement with the return of tax for the year in which the individual either ceases to be a lawful permanent resident of the United States or begins to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country and does not waive the benefits of the treaty applicable to residents of the foreign country (section 6039G(f)).

Nonresident Aliens Married to Citizens or Residents of the United States

Section 6013(g) permits a nonresident alien married to a U.S. citizen or resident to elect treatment as a U.S. resident. This provision allows the benefits of a joint return even though one spouse is a nonresident alien. The election may be made by a husband and wife who are both nonresident aliens during the year as long as one spouse is resident by the close of the taxable year. If a nonresident alien spouse elects treatment as a resident, it causes his or her worldwide income for the entire year to be taxed by the United States; without the election, the nonresident alien spouse would in general be taxed by the United States only on income from U.S. sources. Foreign taxes paid on foreign-source income can be used as a foreign tax credit in the joint return.

The election is made by attaching a statement to a joint return for the first taxable year for which the election will be effective. Once made (both individuals must consent), the election applies to that taxable year, and all subsequent years, until terminated. The election is suspended, however, for any taxable year subsequent to the election year if neither spouse is considered a U.S. spouse (for example, if both spouses are nonresident aliens for the entire taxable year). The election may be terminated under any of the following conditions:

1. Revocation by the taxpayer as of the first taxable year if revocation is before the due date of the return
2. Termination by the death of either spouse as of the beginning of the tax year following the taxable year in which the death occurred, unless the taxpayer who is a citizen or resident of the United States qualifies as a surviving spouse under section 2
3. Termination by the legal separation of the couple under a decree of divorce or separate maintenance as of the beginning of the taxable year in which the separation occurs

4. Termination by the Secretary of the Treasury for any taxable year if he or she determines that either spouse has failed to keep books and records, grant access to the books or records, or supply other information as may be reasonably necessary to ascertain the amount of liability for taxes of either spouse
5. Suspension for any taxable year if neither spouse is a citizen or resident of the United States at any time during the year

If the election is terminated, the two individuals are ineligible to make an election for any subsequent taxable year.

For residents of a country that has a tax treaty with the United States, an election under section 6013(g) may lead to double taxation on certain income. Treas. Reg. Sec. 1.6013-6 provides that an individual who makes the election may not, for U.S. income tax purposes, claim not to be a resident of the United States under any U.S. income tax treaty. Thus, the individual who makes the election will be subject to U.S. income tax on worldwide income even though, under a U.S. income tax treaty, he or she may have been exempt from U.S. tax on certain income before making the election.

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Dispositions of Foreign-Owned Real Estate

Prior to 1980, through a variety of tax planning techniques, foreign investors could easily escape income tax on sales or other dispositions of real estate in the United States. In order to establish equity in the tax treatment from dispositions of U.S. real property investments between foreign and domestic investors, the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)—together with amendments made by the Economic Recovery Tax Act of 1981 and subsequent amendments made by tax legislation in 1981, 1982, 1984, and 1986—dramatically changed the tax treatment of the disposition of foreign investment in U.S. real property. Section 897 of the Internal Revenue Code sets forth the general tax treatment of the disposition of foreign investment in U.S. real property. In summary, section 897 includes the following provisions:

1. Nonresident aliens and foreign corporations are taxed on dispositions of U.S. real property interests (USRPIs) after June 18, 1980, even though the dispositions may not otherwise be effectively connected with a U.S. trade or business. A disposition is taken into account if it is a type that constitutes a realization event under any principle of

federal income taxation. For example, severance of crops or timber and extraction of minerals alone do not constitute the disposition of a USRPI (Treas. Reg. Sec. 1.897-1(g)).

2. A real property interest includes stock of a domestic corporation that is a real property holding company but does not include stock of a foreign corporation that holds real property interests (section 897(c)(1)).
3. Distributions of USRPIs by foreign corporations produce a taxable gain to the foreign corporation equal to the excess of the fair market value of the interest over its adjusted basis. Exceptions may apply if the recipient would be subject to taxation on a subsequent disposition of the distributed property and receives a carryover basis in the property increased by the gain to the distributing corporation (section 897(d)).
4. A nonresident alien or foreign corporation disposing of part or all of an interest in a partnership, trust, or estate that holds USRPIs will be treated as disposing of the underlying USRPIs (section 897(c)(4)).
5. A distribution by a real estate investment trust (REIT) to a nonresident alien or foreign corporation traced to a disposition of a USRPI will be treated as a disposition of a USRPI (section 897(h)).
6. In certain cases a foreign corporation may elect to be treated as a domestic corporation (for purposes of sections 897 and 1445, and 6039C (section 897(i)).
7. Gain is recognized by a nonresident alien or foreign corporation upon a transfer of a USRPI to a foreign corporation as paid-in surplus or as a contribution to capital (section 897(j)).
8. In addition to the foregoing provisions of section 897, section 1445 requires withholding of tax equal to 10 percent of the amount realized on dispositions of USRPIs and section 6039C requires that a foreign person holding direct interests in USRPIs file a return with the Internal Revenue Service (IRS) as regulations may require (though no regulations have been issued nor are any anticipated).

The Tax Rate

In order to make the tax more comparable to what would be paid by a resident, a nonresident alien pays the tax similar to that imposed on U.S.

investors in similar circumstances, including a form of the alternative minimum tax. This is a minimum tax on taxable income of not less than the lesser of (1) the individual's alternative minimum taxable income (as defined in section 55(b)(2)) for the taxable year or (2) the individual's net U.S. real property gain for the taxable year (section 897(a)(2)).

U.S. property gains realized by a corporation are treated as effectively connected with a U.S. trade or business subject to the corporate tax rates (regular or alternative), with full use of effectively connected losses against those gains. For individuals as well, the individual tax rates apply to property gains net of U.S. effectively connected losses. In the case of corporations, U.S. effectively connected losses may be taken into account only to the extent they would be considered trade or business losses, losses on transactions entered into for profit, and in the case of individuals, only casualty or theft losses under section 165(c) may be taken into account against net U.S. real property gain (section 897(b)).

U.S. Real Property Interest

FIRPTA treats gains realized by a foreign person from the disposition of U.S. real property interest (USRPIs) in which the foreign person has an interest, other than an interest solely as a creditor, as subject to U.S. taxation. A USRPI includes stock in certain domestic corporations (defined as U.S. real property holding corporations) and three categories of property: (1) land and unsevered natural products of the land, (2) improvements, and (3) personal property associated with the use of real property. Local laws are not controlling for determining the meaning of real property (Treas. Reg. Sec. 1.897-1(b)(1)).

1. *Land and unsevered natural products of the land.* This category includes land, growing crops and timber, and mines, wells, and other natural deposits. Crops and timber cease to be real property at the time they are severed from the land. Ores, minerals, and natural deposits cease to be real property when they are extracted from the ground (Treas. Reg. Sec. 1.897-1(b)(2)).
2. *Improvements.* Improvements on land include a building, any other inherently permanent structure, or a structural component (such as wiring, plumbing, central heating and central air conditioning systems, pipes and ducts, and elevators and escalators) (Treas. Reg. Sec. 1.897-1(b)(3)).

3. *Personal property associated with the use of real property*. Movable walls, furnishings, and other personal property associated with the use of real property are included in this category. Personal property is associated with the use of real property when both the personal property and the USRPI with which it is associated are held by the same person or by related persons and whose ordinary and necessary use is a corollary of the use to which real property is put. For example, mining equipment used in connection with mining operations constitutes personal property associated with the use of real property (Treas. Reg. Sec. 1.897-1(b)(4)(i)(A)).

Interests in real property other than solely as a creditor include (1) fee ownership; (2) co-ownership; (3) leasehold interest in real property; (4) time-sharing interest in real property; (5) life estate, remainder, or reversionary interest in real property; (6) direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, real property; and (7) a right to an interest in production payments that conveys a right to share in appreciation in the value of mineral property (Treas. Reg. Sec. 1.897-1(d)(2)(i)), whether any such real property interests are located in the United States or the Virgin Islands (section 897(c)(1)(A)).

The gain realized by a nonresident alien individual or foreign corporation from the sale or exchange of an interest in a partnership, trust, or estate will be considered a gain realized from the sale or exchange of a USRPI to the extent the gain is attributable to a USRPI (section 897(g); Treas. Reg. Sec. 1.897-1(d)(3)). An interest in a partnership in which 50 percent or more of the value of the gross assets consists of USRPIs, and 90 percent or more of the value of the gross assets consists of USRPIs plus cash or cash equivalents, will be treated entirely as a USRPI for purposes of section 1445 and as a USRPI only to the extent that the gain on the disposition is attributable to USRPIs (and not cash, cash equivalents, or other property) for purposes of section 897 (Temp. Treas. Reg. Sec. 1.897-7T(a)).

Also constituting an interest in real property other than solely as a creditor are the following:

1. Installment obligations arising from the disposition of an interest in real property unless the transferor elects not to have the installment method of section 453(a) apply and tax is paid on a timely basis on any gain recognized (Treas. Reg. Sec. 1.897-1(d)(2)(ii)(A))

2. An option, a contract, or a right of first refusal to acquire any interest in real property (other than an interest solely as a creditor) (Treas. Reg. Sec. 1.897-1(d)(2)(ii)(B))
3. An indirect right where an interest in real property bears an interest rate that is tied to an index, the principal purpose of which is to reflect changes in real property values (Treas. Reg. Sec. 1.897-1(d)(2)(D))
4. A commission earned in connection with the purchase of real property that is contingent upon the amount of gain ultimately realized by the purchaser (Treas. Reg. Sec. 1.897-1(d)(2)(E))

Interests Not USRPIs

Interests that do not constitute interests in real property include a right to repossess or foreclose on real property under a mortgage, security agreement, financing statement, or other collateral instrument securing a debt or a right to payment of reasonable compensation for services rendered as a trustee, as an administrator of an estate, or in a similar capacity (Treas. Reg. Sec. 1.897-1(d)(2)(ii)(C) and (F)). Also not considered a USRPI is any interest in certain domestic corporations that did not hold any USRPIs as of the disposition date. However, if the corporation was a U.S. real property holding corporation (described subsequently) at any time during the five-year period ending on the disposition of the interest, the corporation's stock will be treated as a USRPI unless the corporation itself had disposed of all of its USRPIs in transactions in which the full amount of the gain was recognized, or if the stock interests it held ceased to be USRPIs by reason of the application of this rule to the corporations whose stock is held (section 897(c)(1)(B)). The term U.S. *real property interests* does not include an interest in a domestically controlled REIT (Treas. Reg. Sec. 1.897-1(c)(2)(i)).

Any class of stock of a corporation regularly traded on an established securities market (see Treas. Reg. Sec. 1.897-1(m)) is not treated as a USRPI if the person held 5 percent or less of such class of stock during the shorter of either (1) the period after June 18, 1980, when the taxpayer held the interest or (2) the five-year period ending on the disposition date of such interest (section 897(c)(3)). For purposes of determining if a person holds more than 5 percent of any class of stock, the attribution rules of section 318(a) apply, except that 5 percent is substituted for 50 percent in sections 318(a)(2)(C) and 318(a)(3)(C) (section

897(c)(6)(C)). There is a similar rule for publicly traded partnerships (Treas. Reg. Sec. 1.897-1(c)(2)(iv)).

An interest solely as a creditor either in real property or in a domestic corporation does not constitute a USRPI (see Treas. Reg. Sec. 1.897-1(d)(1)). For purposes of determining if a person has an interest other than solely as a creditor in real property or in an entity, the aggregate interests of that person in the real property or in the entity must be considered (Treas. Reg. Sec. 1.897-1(d)(4)). When one corporation holds an interest solely as a creditor in a second corporation or in a partnership, trust, or estate, that interest will be disregarded for purposes of determining whether the first corporation is a U.S. real property holding corporation, except to the extent that this interest constitutes an asset used or held for use in a trade or business (Treas. Reg. Sec. 1.897-1(d)(1)). These assets are property used or held for use in a trade or business, other than USRPIs (such as inventory, depreciable property, livestock, intangibles, and financial assets) (Treas. Reg. Sec. 1.897-1(f)).

U.S. Real Property Holding Company

U.S. real property holding corporation status is important for determining whether gain from the disposition by a foreign person of an interest in a corporation is taxable and whether withholding requirements apply. A person who buys stock of a U.S. real property holding corporation from a foreign person is required to withhold under section 1445 unless exemptions under section 1445(b) apply. Any corporation, domestic or foreign, is a U.S. real property holding company if the fair market value of its USRPIs is at least 50 percent of the fair market value of its U.S. real property interests, interests in real property located outside the United States, and assets used or held for use in trade or business (Treas. Reg. Sec. 1.897-2(b)(1)). As an alternative test, the fair market value of a corporation's USRPIs is presumed to be less than 50 percent of the fair market value of the aggregate of the assets discussed above if, on the applicable determination date, the total book value of the USRPIs held by the corporation is 25 percent or less of the book value (determined under generally accepted accounting principles) of the aggregate of the corporation's assets that are included in determining whether a corporation is a real property holding company (Treas. Reg. Sec. 1.897-2(b)(2)). The assets that must be included in the determination of whether a corporation is a real property holding company are—

1. USRPIs that are held directly by the corporation, including directly held interests in foreign corporations that are treated as U.S. real property holding companies pursuant to Treas. Reg. Sec. 1.897-2(e)(1). See also section 897(i)(4).
2. Interests in real property located outside the United States that are held directly by the corporation.
3. Assets used or held for use in a trade or business that are held directly by the corporation.
4. A proportionate share of assets held through a partnership, trust, or estate pursuant to Treas. Reg. Sec. 1.897-2(e)(2).
5. A proportionate share of assets held through a domestic or foreign corporation in which the corporation holds a controlling interest. A *controlling interest* means 50 percent or more of the fair market value of all classes of stock of the corporation (Treas. Reg. Sec. 1.897-2(e)(3)).

Example 20.1. Nonresident alien individual F holds all of the stock of domestic corporation DC. DC's only assets are 40 percent of the stock of foreign corporation FC, with a fair market value of $500,000, and a parcel of country W real estate, with a fair market value of $400,000. Foreign corporation FP, unrelated to DC, holds the other 60 percent of the stock of FC. FC's only asset is a parcel of U.S. real estate with a fair market value of $1,250,000. FC is a U.S. real property holding corporation because the fair market value of its U.S. real property interests ($1,250,000) exceeds 50 percent ($625,000) of the sum of the fair market values of its U.S. real property interests ($1,250,000), its interests in real property located outside the United States (zero), plus its other assets used or held for use in a trade or business (zero). Consequently DC's interest in FC is treated as a USRPI. DC is a U.S. real property holding corporation because the fair market value ($500,000) of its U.S. real property interest (the stock of FC) exceeds 50 percent ($450,000) of the sum ($900,000) of the fair market value of its U.S. real property interests ($500,000), its interests in real property located outside the United States ($400,000), plus its other assets used or held for use in a trade or business (zero). If F disposes of her stock within 5 years of the current determination date, her gain or loss on the disposition of her stock in DC will be treated as effectively connected with a U.S. trade or business under section 897(a).

However, FP's gain on the disposition of its FC stock would not be subject to the provisions of section 897(a) because the stock of FC is a USRPI only for purposes of determining whether DC is a U.S. real property holding corporation (Treas. Reg. Sec. 1.897-2(e)(1), example (1)).

If the IRS determines that the presumption of the alternative test may not accurately reflect the status of the corporation, then it will provide written notice to the corporation that it may not rely upon the presumption (Treas. Reg. Sec. 1.897-2(b)(2)(iii)).

Whether a corporation is a U.S. real property holding company is to be determined as of the following dates: (1) the last day of the corporation's taxable year, (2) the date on which the corporation acquires any USRPI interest, (3) the date on which the corporation disposes of an interest in real property located outside the United States or disposes of other assets used or held for use in a trade or business during the calendar year, and (4) in the case of a corporation treated as owning a portion of the assets held by an entity in which the corporation directly or indirectly holds an interest, the date on which that entity either acquires a USRPI, disposes of an interest in real property located outside the United States, or disposes of other assets used or held for use in a trade or business during the calendar year. The first determination need not be made until the 120th day after the later of the date of incorporation or the date the corporation first acquires a shareholder. In addition, no determination need be made during the twelve-month period beginning on the date on which a corporation adopts a plan of complete liquidation, provided that the assets are distributed during that period (Treas. Reg. Sec. 1.897-2(c)(1)).

Certain transactions by a corporation or by a corporation that is treated as owning a portion of the assets held by an entity in which the corporation directly or indirectly holds an interest do not trigger a determination date for purposes of U.S. real property holding corporation status (Treas. Reg. Sec. 1.897-2(c)(2)). Examples of these transactions are:

- Dispositions of inventory or livestock
- Satisfaction of accounts receivable arising from the disposition of inventory or livestock or from the performance of services
- The disbursement of cash to meet the regular operating needs of the business
- The disposition of assets used or held for use in a trade or business (as defined at Treas. Reg. Sec. 1.897-1(f)), other than inventory or livestock, not in excess of the limitation amount discussed subsequently
- Acquisition of USRPIs not in excess of the limitation amount discussed subsequently

The amount of assets used or held for use in a trade or business that may be disposed of, and the amount of U.S. real property interests that may be acquired by a corporation or other entity without triggering a determination date are determined from a comparison of the direct and indirect ownership of USRPIs to the aggregate fair market value of all assets held by such corporation or other entity on the most recent determination date. The applicable limitation amount is the percentage, as determined below, multiplied by the fair market value of all trade or business assets or all USRPIs held directly or indirectly.

Value of USRPIs/All Trade or Business Assets in United States	*Applicable Limitation Amount*
Less than 25%	10%
Between 25% and 35%	5%
35% or more	2%

If the corporation is not a real property holding corporation under the alternative test described above, then the applicable limitation is 10 percent of the book value of all trade or business assets or all USRPIs held directly or indirectly by the corporation (Treas. Reg. Sec. 1.897-2(c)(iii)). In addition, a corporation may choose to determine its U.S. real property holding corporation status monthly or under a transactional method (Treas. Reg. Sec. 1.897-2(c)(3)).

Example 20.2. DC is a domestic corporation, with no class of stock regularly traded on an established securities market, that knows that it has several foreign shareholders. As of December 31, 1999, DC holds U.S. real property interests (USRPIs) with a fair market value of $500,000, no real property interests located outside the United States, and other assets used in its trade or business with a fair market value of $1,600,000. Thus, the fair market value of DC's U.S. real property interests ($500,000) is less than 25 percent ($525,000) of the total ($2,100,000) of DC's U.S. real property interests ($500,000), interests in real property located outside the United States (zero), and assets used or held for use in a trade or business ($1,600,000). DC is not a U.S. real property holding corporation, and it may dispose of trade or business assets with a fair market value equal to 10 percent ($160,000) of the total fair market value ($1,600,000) of such assets held by it on its most recent determination date (December 31, 1999), without triggering a determination of its U.S. real property holding corporation status. Therefore, when DC disposes of $60,000 worth of trade or business assets (other than inventory or livestock) on March 1, 2000, and again on April 1, 2000, no determination of its status is required on either date. However, if DC dis-

poses of a further $60,000 worth of such trade or business assets on May 1, its total dispositions of such assets ($180,000) exceeds its applicable limitation amount, and DC is therefore required to determine its U.S. real property holding corporation status. On May 1, 2000, the fair market value of DC's U.S. real property interests ($500,000) is greater than 25 percent ($480,000) and less than 35 percent ($672,000) of the total ($1,920,000) of DC's U.S. real property interests ($500,000), interests in real property located outside the United States (zero), and assets used or held for use in a trade or business ($1,420,000). DC is still not a U.S. real property holding corporation, but must now compute its applicable limitation amount as of the May 1 determination date. DC could now dispose of trade or business assets other than inventory or livestock with a total fair market value equal to 5 percent of the fair market value of all trade or business assets held by DC on the May 1 determination date. Therefore, disposition of such trade or business assets with a fair market value of more than $71,000 (5 percent of $1,420,000) will trigger a further determination date for DC (based on Treas. Reg. Sec. 1.897-2(c)(2)(iii)(D), example (1).

Establishing That a Corporation Is Not a U.S. Real Property Holding Corporation

A foreign person who disposes of an interest in a domestic corporation must establish that the corporation is not a U.S. real property holding corporation for three reasons:

1. Failure to establish that a domestic corporation was not a U.S. real property holding corporation will result in the gain from the disposition being effectively connected with a U.S. trade or business taxed under sections 871(b) or 882.
2. It is necessary for purposes of determining if another corporation holding an interest in such domestic or foreign corporation is itself a U.S. real property holding corporation.
3. U.S. real property holding corporation status is important for determining whether the transferee of such an interest is required to deduct and withhold a tax under section 1445.

A foreign person disposing of an interest in a domestic corporation must establish that the interest was not a USRPI on the date of disposition either by obtaining a statement from the corporation or obtaining a determination by the foreign operations district director. The statement obtained from the corporation is not required to be forwarded to the IRS and taking any further action is not required to establish that the interest

disposed of was not a USRPI. This corporation's statement must be obtained no later than the date, including any extensions, on which a tax return would otherwise be due (Treas. Reg. Sec. 1.897-2(g)(1)(ii)(A)). The foreign person who transfers an interest in a domestic corporation and receives that corporation's statement that the interest was not a USRPI is not subject to withholding under section 1445 (Treas. Reg. Sec. 1.897-2(g)(1)(ii)(B)).

A determination from the director that the interest disposed of was not a USRPI may be requested by directing the request to Director, Foreign Operations District; 1325 K St. NW; Washington, DC 20225. The foreign person must nevertheless file a tax return and pay the otherwise due tax. The foreign person will be entitled to a refund after a determination is made if the claim for refund is filed on a timely basis (Treas. Reg. Sec. 1.897-2(g)(1)(iii)(A)). The determination made by the director may be based on information in his or her records (Treas. Reg. Sec. 1.897-2(g)(1)(iii)(B)), which may be made based on information supplied by the foreign person (Treas. Reg. Sec. 1.897-2(g)(1)(iii)(C)) or may be made by the director on his or her own motion (Treas. Reg. Sec. 1.897-2(g)(1)(iii)(D)).

A corporation that must determine whether it is a real property holding company and that holds a noncontrolling interest in another corporation must determine whether that interest was a USRPI as of the determination date by either obtaining a statement from the second corporation, obtaining a determination by the director, or making an independent determination. A corporation unable to determine whether it is a USRPI must presume that such an interest is a USRPI (Treas. Reg. Sec. 1.897-2(g)(2)).

A determination is not required for any person who holds any interest (other than an interest owned by a person who beneficially owned more than 5 percent of the total fair market value of that class of interests at any time during the five-year period ending on the earlier of the date of disposition of the stock or other applicable determination date) in a corporation if at any time during the calendar year any class of stock of the corporation is regularly traded on an established securities market (Treas. Reg. Sec. 1.897-2(g)(3)).

An *established securities market* means (1) a national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); (2) a foreign national securities exchange that is officially recognized, sanctioned, or supervised by governmental

authority; and (3) any over-the-counter market (Treas. Reg. Sec. 1.897-1(m)).

In order for trades to be considered regularly traded on one or more established foreign markets, they must be effected during the calendar quarter in question, in other than de minimis quantities, on at least fifteen days during the calendar quarter, the aggregate number of interests in each class traded must be at least 7.5 percent (or 2.5 percent if the number of shareholders is at least 2,500) or more of the average number of interests in such class outstanding during the calendar quarter, and the reporting requirements of Temp. Treas. Reg. Sec. 1.897-9T(d)(3) are satisfied (Temp. Treas. Reg. Sec. 1.897-9T(d)(1)(i)). The *regularly traded* requirement is not considered satisfied if at any time during the calendar quarter there are 100 or fewer shareholders who own 50 percent or more of the outstanding shares of a class of interest that are traded on foreign markets (Temp. Treas. Reg. Sec. 1.897-9T(d)(1)(ii)(B)). Furthermore, any trades between related parties are disregarded, as are trades that are effected merely to satisfy the *regularly traded* requirements (Temp. Treas. Reg. Sec. 1.897-9T(d)(1)(iii)). Interests traded on domestic markets must be regularly traded by brokers or dealers making a market in such interests. They need not satisfy the additional requirements as above for interests traded in foreign markets. See the subsequent discussion for reporting requirements for interests traded on foreign securities markets.

A domestic corporation must, within a reasonable period after it receives a request from a foreign person holding an interest in it, inform that person whether that interest constitutes a USRPI. No particular form is required for this statement. It must be signed and dated by a responsible corporate officer who must verify under penalties of perjury that the statement is correct to his or her knowledge and belief (Treas. Reg. Sec. 1.897-2(h)(1)(i)). For purposes of this statement, an interest in a corporation is a USRPI if the corporation was a U.S. real property holding corporation on any determination date during the five-year period ending on the date specified in the interest holder's request, or on the date such request was received if no date is specified (Treas. Reg. Sec. 1.897-2(h)(1)(ii)). The corporation providing a statement must also provide a notice to the IRS. No particular form is required for this notice, but the following must be provided: (1) a statement that the notice is provided pursuant to these requirements; (2) the name, address, and identifying number of the corporation providing the notice; (3) the name, address, and identifying number (if any) of the foreign interest holder

that requested the statement; (4) whether the interest in question is a USRPI; and (5) a statement signed by a responsible corporate officer verifying under penalties of perjury that the notice is correct to his or her knowledge and belief (Treas. Reg. Sec. 1.897-2(h)(2)).

These requirements do not apply to domestically controlled REITs, nor do they apply to a corporation that has any class of stock that is regularly traded on an established securities market at any time during the calendar year (Treas. Reg. Sec. 1.897-2(h)(3)). A corporation that determines that it is not a U.S. real property holding corporation on each of the applicable determination dates in a taxable year, or because it is an excluded corporation, may voluntarily choose to notify the IRS by attaching to its income tax return for the year a statement that informs the IRS of its determination (Treas. Reg. Sec. 1.897-2(h)(4)(i)).

Distributions of U.S. Real Property Interests

A domestic corporation or a foreign corporation that distributes a USRPI to its shareholders is subject to the provisions of section 897. A distribution of a USRPI by a domestic corporation includes dividend distributions under section 301, redemptions of stock, and distributions in liquidation. A distribution of a USRPI by a foreign corporation includes distributions that are dividends, section 355 distributions, redemptions of stock, and liquidations (Temp. Treas. Reg. Sec. 1.897-5T(a)).

If a domestic corporation distributes a USRPI that is a dividend to a foreign shareholder, the basis of the distributed USRPI in the hands of the foreign distributee will usually be fair market value (that is, equal to the adjusted basis of the property before the distribution in the hands of the distributing corporation, increased by the sum of any gain recognized by the distributing corporation on the distribution under section 311 and any U.S. tax paid by or on behalf of the distributee with respect to the distribution) (Temp. Treas. Reg. Sec. 1.897-5T(b)(1)).

If a distribution of property is made by a domestic corporation with respect to stock in a domestic corporation that is treated as a USRPI, the distributee is treated as having disposed of a USRPI and must recognize gain or loss on the stock as appropriate to the transaction for any of the following types of such distributions:

1. A distribution entirely or partially treated, pursuant to section 301(c)(3)(A), as a sale or exchange of stock

2. A distribution in redemption where part or all of the distribution is treated under section 302(a) as made in part or full payment in exchange for stock
3. A distribution in complete liquidation under section 331(a) treated as made in full payment in exchange for stock

Section 332 Liquidations

Subject to certain conditions, when a foreign corporation receives a distribution in liquidation by a domestic corporation under section 332, occurring after July 31, 1986, the foreign corporation is not required to recognize any gain under section 367(a) (which describes the treatment of transfers of property from the United States) or section 897(e)(1) (which coordinates section 897 with other nonrecognition provisions) on the receipt of property in this liquidation. The domestic corporation will not recognize gain under 367(e)(2) (which describes the treatment under section 367 of liquidations under section 332) on the distribution of USRPIs. The domestic corporation will recognize gain under section 367(e)(2) if the distribution is made of stock in a former U.S. real property holding corporation that is treated as a USRPI. Stock in a domestic corporation is not considered a U.S. real property interest if the corporation does not hold any USRPIs and has disposed of all of its USRPI owned within the previous five years in transactions in which the full amount of gain is recognized. If a gain is recognized at the corporate level on either a distribution of a USRPI of a sale of a USRPI in a liquidation, such distribution or sale is considered a taxable disposition for purposes of these rules. The basis of the distributed USRPIs in the hands of the foreign corporation is the same as it was in the hands of the domestic corporation. The basis of stock in a former U.S. real property holding corporation that is a USRPI in the hands of the foreign corporation is the same as it was in the hands of the domestic corporation, increased by any taxable gain recognized by the distributing corporation on the distribution (Temp. Treas. Reg. Sec. 1.897-5T(b)(3)(iv)(A)).

A foreign parent corporation that liquidates an 80-percent owned foreign subsidiary whose stock is treated as a USRPI because the subsidiary has made an election to be treated as a domestic corporation under section 897(i), must recognize gain on this stock if the parent company receives property that is not a USRPI and that is not used by the parent

company in the conduct of a U.S. trade or business (in a nontreaty situation) or in a U.S. permanent establishment (in case of a treaty). The gain on the stock of the foreign corporation recognized is calculated as follows:

$$\text{Gain realized on the distribution} \times \frac{\text{Fair market value of property received resulting in taxable gain}}{\text{Fair market value of all property received}}$$

The distributing foreign corporation will not recognize gain under section 367(e)(2) on the distribution of USRPIs to the distributee foreign corporation. Recognition of any other gains or losses on the distribution of property other than USRPIs is treated under section 367(e)(2). The basis of the distributed USRPIs in the hands of the foreign distributee is the same as it was in the hands of the distributing foreign corporation. The basis of the property on which the distributee foreign corporation recognized gain in the hands of the distributee foreign corporation is the same as the basis in the hands of the distributing foreign corporation, plus any gain recognized by the distributee foreign corporation on the receipt of such property. The gain recognized is allocated among such properties in proportion to the potential gain inherent in each such property at the time of the distribution. The basis of other property received by the distributee foreign corporation is determined under section 367(e)(2). The basis of each asset is limited to its fair market value (Temp. Treas. Reg. Sec. 1.897-5T(b)(3)(iv)).

If a nonresident alien individual or foreign corporation transfers stock of a foreign corporation that owns a U.S. real property interest to a domestic corporation in exchange for stock of the domestic corporation in a "B" reorganization or in an exchange under section 351, and if the foreign corporation then distributes the USRPI to the domestic corporation in a section 332 liquidation within five years of the transfer of stock of the foreign corporation to the domestic corporation, then the transfer of foreign corporation stock and the liquidation will be treated as a "C" or "D" reorganization unless the transfer of the foreign corporation stock and the section 332 liquidation are separate and independent transactions justified by substantial and verifiable business purposes (Temp. Treas. Reg. Sec. 1.897-5T(b)(3)(v)).

Distributions of USRPIs by Foreign Corporations

If a foreign corporation makes a distribution of a USRPI to any shareholder, then, except as described as follows, the distributing corporation must recognize gain (but cannot recognize loss) on the distribution (section 897(d)(1); Temp. Treas. Reg. Sec. 1.897-5T(i)(1)). The gain recognized is equal to the excess of the fair market value of the USRPI over its adjusted basis as of the time of the distribution. The distributee's basis in the distributed USRPI is determined under the appropriate Internal Revenue Code section that governs the transaction. The parent's basis in the USRPI received from a foreign subsidiary in a section 332 liquidation is the foreign subsidiary's basis in the distributed USRPI increased by any gain recognized by the foreign corporation on the distribution of the USRPI.

Gain is not required to be recognized by a distributing foreign corporation in the following circumstances:

1. At the time of the receipt of the distributed USRPI, the parent would be subject to U.S. income taxation on the subsequent disposition of the USRPI (Temp. Treas. Reg. Sec. 1.897-5T(c)(2)(i)(A));
2. The basis of the distributed USRPI in the hands of the parent is no greater than the adjusted basis of the property before the disposition, increased by the amount of gain (if any) recognized by the subsidiary upon the distribution that is properly added to the adjusted basis (Temp. Treas. Reg. Sec. 1.897-5T(c)(2)(i)(B)); and
3. The subsidiary corporation complies with the filing requirements prescribed at Temp. Treas. Reg. Sec. 1.897-5T(d)(1)(iii) and described subsequently under "procedural requirements" (Temp. Treas. Reg. Sec. 1.897-5T(c)(2)(i)(C)).

For certain section 332 liquidations, a foreign corporation must recognize gain on its distributions after May 5, 1988, of a USRPI to a domestic parent if (1) the foreign corporation has not made a section 897(i) election and any gain on the stock in the foreign corporation would be subject to U.S. taxation if the election were made on the date of the liquidation, (2) the distribution of the USRPI by the foreign subsidiary to the domestic parent in the section 332 liquidation occurs fewer than five years after the date of the last gain from the disposition of the stock of the foreign corporation, and (3) any gain on the stock of the foreign subsidiary would be subject to U.S. taxation if the section 897(i) election

were made by the foreign corporation on the date of its liquidation (Temp. Treas. Reg. Sec. 1.897-5T(c)(2)(ii)(B)).

Example 20.3. DC, a domestic corporation, owns 100 percent of the stock of FC, a foreign corporation. FC's asset is a USRPI, with a fair market value of $5 million and an adjusted basis of $1 million. FC liquidates under section 332(a) and transfers the USRPI to DC. Assuming that FC complies with the filing requirements and that DC will be subject to U.S. income taxation on a subsequent disposition of the USRPI, FC does not recognize any gain under section 897 and the basis of the property in the hands of DC is $1 million (Temp. Treas. Reg. Sec. 1.897-5T(c)(2)(iii), example (1)).

Section 355 Distributions

A foreign corporation that makes a section 355 distribution of stock in a domestic corporation that constitutes a USRPI will recognize gain on the distribution to the extent that the fair market value of the distributed stock exceeds its adjusted basis in the hands of the distributing foreign corporation. The gain recognized is limited to the amount by which the aggregate basis of the distributed stock in the hands of the distributee exceeds the aggregate basis of the distributed stock in the hands of the distributing corporation. The distributee's basis in the distributed USRPI is determined under section 358. Therefore, the distributee's basis in the distributed USRPI interest is determined without any increase for the gain recognized by the foreign corporation (Temp. Treas. Reg. Sec. 1.897-5T(c)(3)(i)).

Example 20.4. C is a citizen and resident of country F, which does not have an income tax treaty with the United States. C owns all of the stock of FC, a foreign corporation. The basis of the FC stock is $600,000, and it has a fair market value of $1 million. In a spin-off transaction qualifying under section 355, FC distributes all of the stock of DC, a U.S. real property holding corporation. The DC stock has an adjusted basis of $200,000 and a fair market value of $600,000. After the distribution the FC stock has a fair market value of $400,000. FC must recognize gain on the distribution of the DC stock to C equal to the difference between the fair market value of the DC stock ($600,000) and FC's adjusted basis in the DC stock ($200,000). This results in a potential gain of $400,000. Under section 358, C takes a $360,000 adjusted basis in the DC stock ($600,000 × $600,000/$1,000,000). Provided that FC complies with the filing requirements, the gain recognized by FC is limited to $160,000, because this is the amount by which the basis

of the DC stock in the hands of C exceeds the adjusted basis of the DC stock in the hands of FC ($360,000 − 200,000). At the time of receipt of the DC stock, C would be subject to U.S. taxation on a subsequent disposition of the stock. C's adjusted basis in the DC stock is not increased by the $160,000 recognized by FC (Temp. Treas. Reg. Sec. 1.897-5T(c)(3)(ii), example).

Distributions by Foreign Corporations in Reorganizations

A foreign corporation that transfers property to another corporation in a "C," "D," or "F" reorganization for stock of a domestic corporation that is a U.S. real property holding corporation must recognize gain on an actual or deemed distribution of the stock of the domestic corporation received by the foreign corporation and distributed to its domestic or foreign shareholders (Temp. Treas. Reg. Sec. 1.897-5T(c)(4)). No gain will be recognized by the foreign corporation on its distribution if at the time of the distribution (1) the exchanging shareholder in the section 354 exchange would be subject to U.S. taxation on a subsequent disposition of the stock of the domestic corporation, (2) the distributee's adjusted basis in the stock of the foreign corporation immediately before the distribution was no greater than the foreign corporation's basis in the stock of the domestic corporation determined under section 358, and (3) the distributing corporation complies with the regulatory filing requirements (Temp. Treas. Reg. Sec. 1.897-5T(c)(4)(ii)). The amount of gain recognized by the foreign corporation will not be greater than the excess of the distributee's adjusted basis in the stock of the foreign corporation immediately before the distribution over the foreign corporation's basis in the stock of the domestic corporation immediately before the distribution as determined under section 358 (Temp. Treas. Reg. Sec. 1.897-5T(c)(4)(iii)).

Example 20.5. A, a nonresident alien, organized FC, a country W corporation, in September 1992, to invest in U.S. real estate. In 1995, FC's only asset is Parcel P, a U.S. real property interest with a fair market value of $600,000 and an adjusted basis to FC of $200,000. Parcel P is subject to a mortgage with an outstanding balance of $100,000. The fair market value of the FC stock is $500,000, and A's adjusted basis in the stock is $100,000. FC does not have liabilities in excess of the adjusted basis in Parcel P. The United States does not have a treaty with country W that entitles FC to nondiscriminatory treatment as described in section 1.897-3(b)(2) of the regulations.

Pursuant to a plan of reorganization under section 368(a)(1)(D), FC transfers parcel P to DC, a newly formed domestic corporation, in exchange for DC stock. FC distributes the DC stock to A in exchange for A's FC stock. FC's exchange of parcel P for the DC stock is a disposition of a USRPI. There is an exchange of a USRPI (parcel P) for another USRPI (DC stock) so that no gain is recognized on the exchange under section 897(e). DC takes FC's basis of $200,000 in parcel P under section 362(b). Under section 358(a)(1), FC takes a $100,000 basis in the DC stock because FC's substituted basis of $200,000 in the DC stock is reduced by the $100,000 of liabilities to which parcel P is subject.

Under section 897(d)(1) and Treas. Reg. Sec. 1.897-5T(c)(4)(i), FC generally must recognize gain on the distribution of the DC stock received in exchange for FC's assets equal to the difference between the fair market value of the DC stock ($500,000) and FC's adjusted basis in the DC stock prior to the distribution ($100,000). This results in a potential gain of $400,000. Under section 358(a)(1), A takes a basis in the DC stock equal to its basis in the FC stock of $100,000. Provided that FC complies with the filing requirements, no gain is recognized by the FC on the distribution of the DC stock under the statutory exception to the general rule of section 897(d)(1) because A's basis in the DC stock ($100,000) does not exceed FC's adjusted basis in the DC stock ($100,000) immediately prior to the distribution, and A, at the time of receipt of the DC stock, would be subject to U.S. taxation on a subsequent disposition of the stock.

The FC stock in the hands of A is not a USRPI because FC is a foreign corporation that has not elected to be treated as a domestic corporation under section 897(i). Accordingly, the exchange of the FC stock by A for DC stock is not a disposition of a USRPI under section 897(a) (based on Temp. Treas. Reg. Sec. 1.897-5T(c)(4)(iv), example (1)).

Interests Subject to Later Taxation

Nonrecognition of gain or loss may apply with respect to certain distributions or exchanges of USRPIs if any gain from subsequent dispositions of the interests that are distributed or received by the transferor in the exchange would be included in the gross income of the distributee or transferor and be subject to U.S. taxation. Gain is considered subject to U.S. taxation if the gain is included on the income tax return of a U.S. taxpaying entity even if there is no U.S. tax liability (for example, because of a net operating loss). Gain is not considered subject to U.S. taxation if the gain is derived from a tax-exempt entity. A real estate investment trust is considered to be a pass-through entity for purposes of

the rule of taxability, so a tax-exempt entity that holds an interest in a real estate investment trust is not subject to tax (Temp. Treas. Reg. Sec. 1.897-5T(d)(1)).

Treaty Benefits

A U.S. real property interest will not be considered subject to U.S. taxation upon a subsequent disposition if at the time of its distribution or exchange the recipient is entitled (and the treaty benefits have not been waived), pursuant to the provisions of a U.S. income tax treaty, to an exemption from U.S. taxation upon a disposition of the interest (Temp. Treas. Reg. Sec. 1.897-5T(d)(1)(ii)(A)). If, at the time of the distribution or exchange, a distributee of a USRPI in a distribution or a transferor who receives a USRPI in an exchange would be entitled to a reduced tax rate under a U.S. income tax treaty, then a portion of the interest received is treated as an interest subject to U.S. taxation upon its disposition, and that portion is entitled to nonrecognition treatment. The portion of the interest that is treated as subject to U.S. taxation is determined using the following formula:

$$\text{Fair market value of the property interest} \times \frac{\text{Amount of tax that would be applicable under the U.S. income tax treaty}}{\text{Amount of tax that would be due in absence of a treaty}}$$

Procedural Requirements

If a USRPI is distributed or transferred after December 31, 1987, in a transaction that otherwise qualifies for nonrecognition under the Internal Revenue Code, the transferor or distributor may be required to file an income tax return for the taxable year of the distribution or transfer[1] (Temp. Treas. Reg. Sec. 1.897-5(d)(1)(iii)). The person filing the return (and any transferor or distributor exempted from the return filing requirements by Notice 89-57) must file a document with the following information:

[1]See Notice 89-57, 1989-1 C.B. 698.

1. A statement that the distribution or transfer is one to which section 897 applies
2. A description of the USRPI distributed or transferred, including the location, its adjusted basis in the hands of the distributor or transferor immediately before the distribution or transfer, and the date of the distribution or transfer
3. A description of the USRPI received in an exchange
4. A declaration signed by an officer of the corporation that the distributing foreign corporation has substantiated the adjusted basis of the shareholder in its stock if the distributing corporation has nonrecognition or recognition limitations because of the source of the income or because of earnings and profits limitations
5. The amount of any gain recognized and tax withheld by any person with respect to the distribution or transfer
6. Identification by name and address of the distributee or transferee, including the distributee's or transferee's taxpayer identification number (if any)
7. The treaty article or Code section under which the distributee or transferor would be exempt from U.S. taxation on the sale of the distributed USRPI or the USRPI received in the transfer
8. A declaration, signed by the distributee or transferor or its authorized legal representative, that the distributee or transferor shall treat any subsequent sale, exchange, or other disposition of the U.S. real property interest as a disposition that is subject to U.S. taxation, notwithstanding the provisions of any U.S. income tax treaty or any intervening change in circumstance

A person who has provided notice under section 1445 in connection with a transaction may satisfy these requirements by attaching to his or her tax return that notice together with any required information or declaration not contained in that notice (Temp. Treas. Reg. Sec. 1.897-5T(d)(1)(iii)).

Nonrecognition Exchanges

Section 897(e) coordinates the nonrecognition provisions under the Internal Revenue Code with nonrecognition provisions applying to transactions by foreign persons involving USRPIs. The nonrecognition provisions apply to a section 897 transaction in the case of a USRPI

exchanged for another USRPI that, immediately after the exchange, would be subject to U.S. taxation on its disposition. The only exceptions to this rule are distributions of a foreign corporation or transactions described subsequently. The transferor must also comply with the procedural requirements described above (see Temp. Treas. Reg. Sec. 1.897-6T(a)). No loss will be recognized under section 897(e) unless this loss is otherwise permitted to be recognized. In the case of an exchange of a USRPI for stock in a domestic corporation that is otherwise treated as a USRPI, this stock will not be considered a USRPI unless the domestic corporation is a U.S. real property holding corporation immediately after the exchange.

The nonrecognition provisions include sections 332, 351, 354, 355, 361, 721, 731, 1031, 1033, 1034, and 1036. For purposes of section 897(e), sections 121 and 453 are not nonrecognition provisions. If a nonrecognition provision does not apply to a transaction, the USRPI transferred is considered exchanged in a taxable transaction that is subject to U.S. taxation because of section 897. Transactions that qualify in part for nonrecognition and which trigger partial recognition of gain (e.g., because of boot) are treated under section 897 as "mixed transactions" that are partially taxable. Note that section 897 will not provide nonrecognition where it is not otherwise available or applicable under the Internal Revenue Code.

As an example, if a USRPI is exchanged for a partnership interest, nonrecognition under section 721 will apply only to the extent that the disposition of the partnership interest will be subject to U.S. taxation under section 897(g) (Temp. Treas. Reg. Sec. 1.897-6T(a)(1) to (3)).

If, in any of the exchanges to which the nonrecognition provisions apply, nonqualifying property (such as cash or property other than USRPIs) is received in addition to USRPIs, then the transferor must recognize gain equal to the lesser of the sum of the cash received plus the fair market value of the nonqualifying property received or the gain realized with respect to the USRPI transferred (Temp. Treas. Reg. Sec. 1.897-6T(a)(8)(i)). The amount of nonqualifying property considered received in exchange for a USRPI is determined by multiplying the fair market value of the nonqualifying property by the following fraction:

$$\frac{\text{Fair market value of the USRPI transferred in the exchange}}{\text{Fair market value of all property transferred in the exchange}}$$

The amount of gain subject to U.S. taxation is measured by the lesser of the nonqualifying property received or the gain or loss realized with respect to the USRPI exchanged.

Example 20.6. A is a citizen and resident of country F, which does not have an income tax treaty with the United States. A owns parcel P, a U.S. real property interest, with a fair market value of $500,000 and an adjusted basis of $300,000. A transfers parcel P to DC, a newly formed U.S. real property holding corporation wholly owned by A, in exchange for DC stock. A has exchanged a U.S. real property interest (parcel P) for another U.S. real property interest (DC stock) which is subject to U.S. taxation upon its disposition. The nonrecognition provisions of section 351(a) apply to A's transfer of parcel P. The basis of the DC stock received by A is determined in accordance with the rules generally applicable to the transfer. A takes a $300,000 adjusted basis in the DC stock under the rules of section 358(a)(1) (Temp. Treas. Reg. Sec. 1.897-6T(a)(7), example (1)).

Section 355

If the stock of a domestic corporation is treated as a USRPI and this corporation distributes stock in a foreign corporation or stock in a domestic corporation that is not a U.S. real property holding corporation to a foreign person under section 355(a), then the foreign person will be considered as having exchanged a proportionate part of the stock in the domestic corporation that is treated as a USRPI, for stock that is not treated as a USRPI (Temp. Treas. Reg. Sec. 1.897-6T(a)(4)).

Example 20.7. C is a citizen and resident of country F, which does not have an income tax treaty with the United States. C owns all of the stock of DC, a U.S. real property holding corporation. The fair market value of the DC stock is $500x, and C has a basis of $100x in the DC stock. In a transaction qualifying as a distribution of stock of a controlled corporation under section 355(a), DC distributes to C all of the stock of FC, a foreign corporation that has not made a section 897(i) election. C does not surrender any of the DC stock. The FC stock has a fair market value of $200x. After the distribution, the DC stock has a fair market value of $300x.

C is considered to have exchanged DC stock with a fair market value of $200x and an adjusted basis of $40x for FC stock with a fair market value of $200x. Because the FC stock is not a U.S. real property interest, C must recognize gain of $160x under section 897(a) on the distribution. C takes a basis of $200x in the FC stock. C's basis in the DC stock is reduced to $60x pursuant to section 358(c) (Temp. Treas. Reg. Sec. 1.897-6T(a)(7), example (5)).

Foreign-to-Foreign Exchanges

A foreign person will not recognize certain gains on the transfer of a USRPI to a foreign corporation in exchange for stock in the foreign corporation, but only if the transferee's subsequent disposition of the transferred U.S. real property interest would be subject to U.S. taxation, if the filing requirements are satisfied, if one of the following five conditions exists, and if any one of three forms of the exchange takes place (Temp. Treas. Reg. Sec. 1.897-6T(b)(1)).

1. Each of the interests exchanged or received in a transferor corporation or transferee corporation would not be a USRPI if the corporation were a domestic corporation.
2. The transferee corporation (and the transferee's parent in a parenthetical "B" or "C" reorganization) is incorporated in a foreign country that maintains an income tax treaty with the United States that contains an information exchange provision; the transfer occurs after May 5, 1988; and the transferee corporation (and the parent in a parenthetical reorganization) submits a binding waiver of all benefits of the respective income tax treaty (including a section 897(i) election), which must be attached to each of the transferor and transferee corporation's income tax returns for the year of the transfer.
3. The transferee foreign corporation (and the transferee's parent in the case of a parenthetical "B" or "C" reorganization) is a qualified resident as defined in section 884(e) and in any regulations thereunder of the foreign country in which it is incorporated.
4. The transferee foreign corporation (or its parent in the case of a parenthetical "B" or "C" reorganization) is incorporated in the same foreign country as the transferor foreign corporation, and there is an income tax treaty that contains an exchange-of-information provision in force between that foreign country and the United States at the time of the transfer.
5. The transferee foreign corporation is incorporated in the same foreign country as the transferor foreign corporation and the transfer is an "F" reorganization (Temp. Treas. Reg. Sec. 1.897- 6T(b)(2)).

The exchange must follow one of the following three forms: (1) The exchange is made by a foreign corporation in a "D" or "F" reorganization, and there is an exchange of the transferor corporation stock for the transferee corporation stock under section 354(a). (2) When the exchange is made by the foreign corporation in a "C" reorganization, there is an exchange of the transferor corporation's stock for the transferee corpora-

tion's stock (or stock of the transferee corporation's parent in the case of a parenthetical "C" reorganization) section 354(a), and the transferor corporation's shareholders own more than 50 percent of the voting stock of the transferee corporation or stock of its parent immediately after the reorganization. (3) The USRPI exchanged its stock in a U.S. real property holding corporation, the exchange qualifies under section 351(a) or section 354(a) in a "B" reorganization, and immediately after the exchange all of the outstanding stock of the transferee corporation or its parent in a "B" reorganization is owned in the same proportions by the same nonresident alien individuals and foreign corporations that owned the stock of the U.S. real property holding corporation immediately before the exchange. The nonresident alien individual or foreign corporation receiving the stock in the reorganization must hold it for three years. If the stock is disposed of within three years from the date of receipt, that individual or corporation must recognize that portion of the gain realized with respect to the stock in the U.S. real property holding corporation for which the foreign stock disposed of was received (Temp. Treas. Reg. Sec. 1.897-6T(b)(1)).

There is no exception to recognition of gain for the transfer of a USRPI by a foreign person to a foreign corporation in exchange for stock in a foreign corporation when (1) the exchange is made pursuant to section 351 and the USRPI transferred is not stock in a U.S. real property holding corporation or (2) such exchange is a reorganization transaction that does not qualify for nonrecognition of gain because it does not satisfy the rules explained above (Temp. Treas. Reg. Sec. 1.897-6T(b)(3)).

> *Example 20.8.* FC is a country F corporation that has not made a section 897(i) election. FC owns parcel P, a U.S. real property interest, with a fair market value of $450x and an adjusted basis of $100x. FC transfers parcel P to FS, its wholly owned country F subsidiary, in exchange for FS stock under section 351(a). FS has not made a section 897(i) election. FC must recognize gain of $350x under section 897(a) because the FS stock received in the exchange is not a U.S. real property interest. No exception to the recognition rule is provided for a transfer under section 351(a) of a USRPI (that is not stock in a U.S. real property holding corporation) by a foreign corporation to another foreign corporation in exchange for stock of the transferee corporation (Temp. Treas. Reg. Sec. 1.897-6T(b)(4), example (1)).

Contributions of Property

When a foreign person contributes a USRPI to a foreign corporation as paid-in surplus or as a contribution to capital, including a deemed con-

tribution in a section 304 redemption, the transaction will be treated as an exchange of the USRPI for stock in the foreign corporation (Temp. Treas. Reg. Sec. 1.897-6T(b)(5)).

Tax-Avoidance Transfers

Transfers to Domestic Corporations

If a foreign person transfers property that is not a USRPI to a domestic corporation in a nonrecognition exchange in which (1) the adjusted basis of such property exceeds its fair market value on the date of the transfer to the domestic corporation, (2) the property transferred will not be used immediately, or held by the domestic corporation for use, in the conduct of a trade or business, and (3) within two years of the transfer to the domestic corporation the property transferred is sold at a loss, then it will be presumed, absent clear and convincing evidence to the contrary, that the purpose for transferring the loss property was the avoidance of taxation on the disposition of a USRPI held by the domestic corporation. Any loss recognized by the domestic corporation on the sale or exchange of such property cannot be used by the domestic corporation either by direct offset or as part of a net operating loss or capital loss carryback or carryover to offset any gain recognized from the sale or exchange of a USRPI by the domestic corporation (Temp. Treas. Reg. Sec. 1.897-6T(c)(2)).

Rearrangement of Ownership to Gain Treaty Benefit

A foreign person who directly or indirectly owns a USRPI may not directly or indirectly rearrange the incidents of ownership of the USRPI through the use of nonrecognition provisions in order to gain the benefit of a treaty exemption from taxation. Nonrecognition will not apply to the foreign transferor in this situation, and the transferor will recognize gain but not loss on the transfer under section 897(a) (Temp. Treas. Reg. Sec. 1.897-6T(c)(4)).

Treatment of Certain Partnership Interests as Entirely USRPIs

An interest in a partnership in which, directly or indirectly, 50 percent or more of the value of the gross assets consist of USRPIs and 90 percent or more of the value of the gross assets consists of USRPIs plus any cash or cash equivalents will, for purposes of section 1445, be treated as entirely

a USRPI (Temp. Treas. Reg. Sec. 1.897-7T(a)). For purposes of section 897(g), however, these interests will be treated as USRPIs only to the extent that the gain on the disposition is attributable to USRPIs and not cash, cash equivalents, or other property. Consequently, a disposition of any portion of such partnership interest will be subject to partial taxation under section 897(a) and full withholding under section 1445(a). *Cash equivalent* means any asset readily convertible into cash, including bank accounts, certificates of deposit, money market accounts, commercial paper, U.S. and foreign treasury obligations and bonds, corporate obligations and bonds, and publicly traded instruments (Temp. Treas. Reg. Sec. 1.897-7T(a)).

Election by a Foreign Corporation to Be Treated as a Domestic Corporation

The United States is a party to many treaties providing that a permanent establishment of a foreign corporation in the United States may not be treated less favorably than a domestic corporation carrying on the same activities. While FIRPTA generally overrides prior-enacted U.S. treaty obligations, in certain cases a qualified treaty resident may elect to be treated as a U.S. corporation (section 897(i)(1)). The electing foreign corporation is treated as a domestic corporation for purposes of sections 897 and 1445 and is subject to all rules under such sections that apply to domestic corporations. Once the election is made, it may be revoked only with the consent of the Secretary of the Treasury (section 897(i)(2)). Such an election is the exclusive remedy for any person invoking its rights under a treaty by claiming discrimination under sections 897 and 1445 (section 897(i)(4)).

A foreign corporation may make a section 897(i) election only if it meets all four of the following conditions: (1) It must hold a USRPI, (2) it must be entitled to nondiscriminatory treatment with respect to its USRPIs under any treaty to which the United States is a party, (3) it must submit the election in proper form (Treas. Reg. Sec. 1.897-3(b)), and (4) the foreign corporation upon making the election must qualify as a U.S. real property holding corporation (Temp. Treas. Reg. Sec. 1.897-8T). The election is made by filing material related to five areas, which may be incorporated into a single document, with the Director, Foreign Operations District, 1325 K Street, NW, Washington, DC 20225 (Treas. Reg. Sec. 1.897-3(c)). The five areas, together with the material to be filed pertaining to each area, are as follows:

1. *General statement.* A general statement must be supplied indicating that an election under section 897(i) is being made, signed by a responsible corporate officer, and setting forth pertinent identification of the corporation, the treaty and article under which the corporation is seeking nondiscriminatory treatment, a description of the direct and indirect USRPIs held by the corporation, and a list of all dispositions of any interests in the foreign corporation between December 31, 1979, and June 19, 1980 (Treas. Reg. Sec. 1.897-3(c)(1)).
2. *A waiver of treaty benefits.* The foreign corporation must submit a binding waiver of any U.S. treaty with respect to any gain or loss from the disposition of a USRPI during the period in which the election is in effect (Treas. Reg. Sec. 1.897-3(c)(2)).
3. *Consent to be taxed.* The foreign corporation must submit a binding agreement to treat as though it were a domestic corporation (a) any gain or loss that is recognized upon the disposition of any USRPI during the period in which the election is in effect and (b) the disposition of any property that it acquired in exchange for a USRPI in a nonrecognition transaction during the period in which the election is in effect (Treas. Reg. Sec. 1.897-3(c)(3)).
4. *Interest holders' consent to election.* The foreign corporation must submit both a signed consent to the making of the election and a waiver of U.S. treaty benefits with respect to any gain or loss from the disposition of an interest in the corporation from each person that holds an interest in the corporation on the date the election is made (Treas. Reg. Sec. 1.897- 3(c)(4)).
5. *Statement regarding prior dispositions.* A foreign corporation must state that no interest in the corporation was disposed of during the shortest of three periods: (a) the period from June 19, 1980, through the date of the election, (b) the period from the date on which the corporation first holds a USRPI through the date of the election, or (c) the five-year period ending on the date of the election (Treas. Reg. Sec. 1.897-3(c)(5)). Effective for elections after July 31, 1989, the last of these periods will not apply.[2] Special rules may also apply to elections by taxpayers eligible for benefits under the income tax treaty between the United States and Canada.

[2]Notice 89-85, 1989-2 C.B. 403.

A foreign corporation that satisfies the general conditions necessary to make the section 897(i) election may make the election at any time before the first disposition of an interest in the corporation that would be subject to section 897. The election applies for the duration of time the corporation is in existence, unless revoked (Treas. Reg. Sec. 1.897-3(d)(1)).

An election may be made under section 897(i) after any disposition of an interest in the corporation that would have been subject to section 897 if the election had been made before that disposition if (1) any taxes are paid that would have been imposed under section 897 on all persons who had disposed of interests in the corporation had the corporation made the election prior to the dispositions, and (2) each person that acquired an interest in the electing corporation has a carryover basis increased by any gain recognized and tax paid by the person acquiring the interest (Treas. Reg. Sec. 1.897-3(d)(2)).

Example 20.9. Nonresident alien individual X owns 100 percent of the stock of foreign corporation L that was organized in 1989. L's only asset is a parcel of U.S. real property that it has held since 1990. The fair market value of the U.S. real property held by L on January 1, 1999, is $1,000,000. L's basis in the property is $200,000. X's basis in the L stock is $500,000. On June 1, 1999, M corporation, a foreign corporation owned by foreign persons who are unrelated to X, purchases the stock of L from X for $1,000,000 with title passing outside of the United States. Since the stock of L is not a USRPI, X's gain from the disposition of the L stock ($500,000) is not treated as effectively connected with a U.S. trade or business under section 897(a). In addition, since X was neither engaged in a U.S. trade or business nor present in the United States at any time during 1999, such gain is not subject to U.S. tax under section 871. On January 1, 2000, M liquidates L under a plan of liquidation adopted on that same date. Under section 332 of the Code, M recognizes no gain on receipt of the parcel of U.S. real property distributed by L in liquidation. Under section 334(b)(1), M takes $200,000 as its basis in the U.S. real property received from L. Under section 897(d)(1)(B), no gain would be recognized to L under section 897(d)(1)(A) on the liquidating distribution. As a consequence, no gain is recognized to L under section 336 of the Internal Revenue Code. After its receipt of the U.S. real property from L, M seeks to make an election to be treated as a domestic corporation. Thus, M acquired the L stock in a transaction in which it obtained a basis in the stock in excess of the adjusted basis of X in the stock; U.S. tax was not paid on the full amount of the gain realized by X; and M has received the property in a distribution to which section 897(d)(1)(B)

applied, to provide for nonrecognition of gain to L. Therefore, M may make the election only if it pays an amount equal to the tax on the full amount of X's gain (Treas. Reg. Sec. 1.897-3(e)(4), example (1)).

Interests Traded on Domestic Established Securities Markets

For purposes of sections 897, 1445, and 6039C, a class of interests that is traded on an established securities market located in the United States is considered to be regularly traded for any calendar quarter during which it is regularly quoted by brokers or dealers making a market in such interests. A broker or dealer makes a market in a class of interests only if the broker or dealer holds herself or himself out to buy or sell interests in such class at the quoted price (Temp. Treas. Reg. Sec. 1.897-9T(d)(2)).

Reporting Requirement for Interests Traded on Foreign Securities Markets

A class of interests in a domestic corporation that is traded on one or more established securities markets located outside the United States shall not be considered to be regularly traded on such market or markets unless such a class of interests is traded in registered form and the corporation registers such class of interests pursuant to section 12 of the Securities Exchange Act of 1934. In addition, the corporation must attach to its federal income tax return a statement providing the following:

1. A caption that states: "The following information concerning certain shareholders of this corporation is provided in accordance with the requirements of Section 1.897-9T"
2. The name under which the corporation is incorporated, the state in which such corporation is incorporated, the principal place of business of the corporation, and its employer identification number, if any
3. The identity of each person who, at any time during the corporation's taxable year, was the beneficial owner of more than 5 percent of any class of interests of the corporation
4. The title, and the total number of shares issued, of any class of interests so owned

5. With respect to each beneficial owner of more than 5 percent of any class of interests of the corporation, the number of shares owned, the percentage of the class represented thereby, and the nature of the beneficial ownership of each class of stock so owned

Interests in a domestic corporation that has filed a report because of interests traded on a foreign securities market will be considered to be regularly traded on an established securities market only for any taxable year with which a report is filed (Temp. Treas. Reg. Sec. 1.897-9T(d)(3)(ii)).

Coordination With Section 1445

For purposes of section 1445, a class of interests in a corporation will be presumed to be regularly traded during a calendar quarter if such interests were regularly traded on an established securities market during the previous calendar quarter (Temp. Treas. Reg. Sec. 1.897-9T(d)(4)).

Foreign Governments and International Organizations

A foreign government is treated as a foreign person with respect to U.S. real property interests and is subject to sections 897, 1445, and 6039C on the disposition of a USRPI except to the extent specifically otherwise provided in the regulations under section 892. An international organization as defined in section 7701(a)(18) is not a foreign person and is not subject to sections 897, 1445, and 6039C on the disposition of a USRPI. Buildings or parts of buildings and the land ancillary thereto (including the residence of the head of the diplomatic mission) used by the foreign government for the diplomatic mission is not a USRPI in the hands of the respective foreign government (Temp. Treas. Reg. Sec. 1.897-9T(e)).

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Branch Profits Tax

Prior to the Tax Reform Act of 1986, foreign corporations operating in the United States through branches had decided tax advantages over foreign-owned U.S. subsidiaries. A U.S. subsidiary had tax levied on current earnings and a withholding tax imposed on dividends or interest paid to foreign shareholders or security owners. A U.S. branch of a foreign corporation was similarly liable for income taxes on the U.S. operations; however, in many cases it could remit intercompany payments of profits or interest without tax consequence and, unless the U.S. operations of the foreign corporation produced U.S. effectively connected income of more than 50 percent of its gross income for a prior three-year period, withholding was not required on dividends or interest payments. Thus, only foreign-owned corporations paid a single corporate-level tax. Even if the 50-percent test was met, it was difficult for the Internal Revenue Service to monitor dividend payments by a foreign corporation to nonresident shareholders.

Changes made by the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) and the Small Business Job Protection Act of 1996 reflect in two ways a reduction of the disparity between the taxation of U.S. corporations owned by foreign persons and U.S. branches of foreign corporations. First, a branch profits tax of 30

percent of the dividend equivalent amount is imposed on foreign corporations conducting business in the United States (unless the tax is reduced or exempt by treaty), and second, interest paid by U.S. branches of foreign corporations engaged in business in the United States is treated as if paid by a domestic corporation. It is subject to U.S. withholding tax if the interest is paid to a foreign person not engaged in trade or business in the United States. If the interest allocable to effectively connected income (ECI) exceeds the interest paid, the excess is treated as if paid to the foreign corporation by a domestic corporation.

The branch profits tax does not apply to an international organization defined in section 7701(a)(18) (section 884(e)(5)). Section 7701(a)(18) defines *international organization* as a public international organization entitled to enjoy privileges, exemptions, and immunities as an international organization under the International Organizations Immunities Act (22 U.S.C. secs. 288 - 288f).

Tax on Dividend Equivalent Amount

In addition to the regular or alternative minimum tax otherwise imposed, a foreign corporation is liable for a branch profits tax of 30 percent on the dividend equivalent amount. The tax is payable as any other corporate tax, although estimated tax payments need not be made for the branch profits tax (Treas. Reg. Sec. 1.884-1(a)).

Dividend Equivalent Amount

The term *dividend equivalent amount* means the foreign corporation's effectively connected earnings and profits for the taxable year, adjusted for increases and decreases in net equity described at Treas. Reg. Sec. 1.884-1(b)(2) and (3). The dividend equivalent amount cannot be less than zero (Treas. Reg. Sec. 1.884-1(b)(1)).

> *Example 21.1.* Foreign Corporation A had $1,000 U.S. net equity as of the close of 1998 and $100 of effectively connected earnings and profits for 1998. A acquires $100 of additional assets during 1999, and its U.S. net equity as of the close of 1999 is $1,100. In computing A's dividend equivalent amount for 1999, A's effectively connected earnings and profits of $100 are reduced by the $100 increase in net equity between 1998 and 1999, and A has no dividend equivalent amount for 1998. If A has no effectively connected earnings and profits for 1998 and decreases net equity by $40 during

1999, A has a dividend equivalent amount of $40 for 1998 even though it has no effectively connected earnings and profits for 1998. A's effectively connected earnings and profits of $0 for 1998 are increased by the $40 reduction in U.S. net equity (Treas. Reg. Sec. 1.884-1(b)(4), examples (1) and (3)).

In general, if the U.S. net equity of the foreign corporation as of the close of the preceding taxable year exceeds the U.S. net equity of the foreign corporation as of the close of the current taxable year, the effectively connected earnings and profits for the current taxable year must be increased by the amount of the excess (section 884(b)(2)(A)). The increase in U.S. net equity cannot exceed the accumulated effectively connected earnings and profits as of the close of the preceding taxable year. Accumulated effectively connected earnings and profits are the excess of the aggregate effectively connected earnings and profits for preceding taxable years beginning after December 31, 1986, over the aggregate dividend equivalent amounts for these preceding years (section 884(b)(2)(B)). This provision removes from dividend-equivalent consideration the earnings and profits increases resulting from a fresh-start adjustment when discounting unpaid losses and a required adjustment to the unearned premium reserves outstanding at the end of the most recent tax year beginning before 1987.

Effectively Connected Earnings and Profits

The term *effectively connected earnings and profits* means the earnings and profits or deficit determined under section 312 that are attributable to income that is effectively connected with the conduct of a trade or business in the United States. These earnings and profits are further subject to modifications related to the incorporation or complete termination of a U.S. trade or business or the reorganization or liquidation of a foreign corporation or its domestic subsidiary under Temp. Treas. Reg. Sec. 1.884-2T. Effectively connected earnings and profits are not reduced by distributions made by the foreign corporation during any taxable year or by the amount of the branch profits tax or tax on excess interest paid by the foreign corporation (Treas. Reg. Sec. 1.884-1(f)(1)).

Effectively connected earnings and profits do not include the following income:

- Certain income derived from the operation of ships and aircraft excluded from gross income under section 883(a)(1) or (2)

- Income treated as effectively connected with the conduct of a trade or business in the United States of an foreign sales corporation (FSC) and certain dividends paid by an FSC to a foreign corporation or nonresident alien under sections 921(d) and 926(b)
- Gain on the disposition of a U.S. real property interest relating to certain interests in a domestic corporation under section 897(c)(1)(A)(ii)
- Income treated as effectively connected with the conduct of a trade or business in the United States under section 953(c)(3)(C)
- Income treated as effectively connected with the conduct of a trade or business within the United States under section 882(e) (section 884(d)(2)(E))
- Income that is tax exempt under section 892 relating to certain income from foreign governments (Treas. Reg. Sec. 1.884-1(f)(2)(vi))

Deductions and other adjustments must be allocated and apportioned under Treas. Reg. Sec. 1.861-8 between income that is effectively connected with the conduct of a trade or business in the United States and that gives rise to effectively connected earnings and profits and the income listed in the six categories just listed that does not give rise to effectively connected earnings and profits (Treas. Reg. Sec. 1.884-1(f)(3)).

U.S. Net Equity

The term *U.S. net equity* means the aggregate amount of the U.S. assets of a foreign corporation as of the determination date, reduced by (including below zero) the U.S. liabilities of the foreign corporation on that date. The term *determination date* means the close of the day on which the amount of U.S. net equity is required to be determined, usually the close of the foreign corporation's taxable year. *U.S. assets* means the U.S. asset's adjusted basis for computing earnings and profits multiplied by the proportion of the asset that is treated as a U.S. asset under Treas. Reg. Sec. 1.884-1(d)(1)-(4) (Treas. Reg. Sec. 1.884-1(c)). A U.S. asset includes an asset held at year-end if all income produced by the asset, or gain from its sale, is or would be effectively connected income. In addition, special rules apply to eleven classes as follows:

Depreciable and Amortizable Property. Depreciable personal property (other than a U.S. real property interest) and amortizable intangible property will be treated as a U.S. asset of a foreign corporation in the same proportion that the foreign corporation treats the amount of depreciation or amortization as a deduction or as part of cost of goods sold in the computation of income effectively connected with a U.S. trade or business (Treas. Reg. Sec. 1.884-1(d)(2)(i)). If the property produces both U.S.- and foreign-source income, the depreciation or amortization expense and the adjusted basis of the property is allocated (Treas. Reg. Sec. 1.884-1(d)(2)(xi), example (1)).

Inventory. Inventory is treated as a U.S. asset in the same proportion as the amount of gross receipts from that property is (or is anticipated to be) effectively connected with a U.S. trade or business (Treas. Reg. Sec. 1.884-1(d)(2)(ii)).

Installment Obligations. An obligation received in connection with an installment sale of a U.S. asset is treated as a U.S. asset in the same proportion as the amount of income from the asset that would be effectively connected with a U.S. trade or business had the sale been treated as an accrual sale (Treas. Reg. Sec. 1.884-1(d)(2)(iii)).

Accounts and Notes Receivable. An account or note receivable with a maturity not exceeding six months that arises from the sale or exchange of inventory, the performance of services, or the leasing of property in the ordinary course of trade or business is treated as a U.S. asset of the foreign corporation in the same proportion as the amount of effectively connected income from the receivable bears to the total gross income from the receivable (Treas. Reg. Sec. 1.884-1(d)(2)(iv)).

Bank and Other Deposits. A deposit or credit balance with a bank, savings and loan, or insurance company, or a federal reserve bank that is interest-bearing will be treated as a U.S. asset if all of the income derived by the foreign corporation with respect to the deposit is effectively connected income. Any other deposit or credit balance will be treated as a U.S. asset if the amount is needed in a U.S. trade or business (Treas. Reg. Sec. 1.884-1(d)(2)(v)).

Debt Instruments. A debt instrument is treated as a U.S. asset, notwithstanding the fact that the gain from the sale or exchange of the obliga-

tion on the determination date would not be effectively connected income, if all income derived by the foreign corporation from such obligation during the taxable year is effectively connected income and the yield for the period that the instrument was held during the taxable year exceeds the AFR for instruments of similar type and maturity (Treas. Reg. Sec. 1.884-1(d)(2)(vi)).

Securities Held by a Foreign Corporation Engaged in Banking, Financing, or Similar Business. Securities held by these businesses will be treated as U.S. assets in the same proportion that the gain or loss is effectively connected income for the year (Treas. Reg. Sec. 1.884-1(d)(2)(vii)).

Federal Income Taxes. An overpayment of federal income taxes is treated as a U.S. asset to the extent that the tax would reduce a foreign corporation's effectively connected earnings and profits for the taxable year but for the fact that the tax does not accrue during the taxable year (Treas. Reg. Sec. 1.884-1(d)(2)(viii)).

Losses Involving U.S. Assets. A foreign corporation that sustains a loss with respect to a U.S. asset and a deduction under section 165 is not allowed because there exists a reasonable prospect of recovering compensation for the loss is treated as having a U.S. asset from the date of the loss in the same proportion that the asset was treated as a U.S. asset immediately before the loss (Treas. Reg. Sec. 1.884-1(d)(2)(ix)).

Partnership Interests. In determining its U.S. assets, a foreign corporation that is a partner in a partnership must take into account its interest in the partnership (and not the partnership assets). A foreign corporation may elect to use either the asset method or the income method described subsequently, for purposes of determining the proportion of the partnership interest that is a U.S. asset.

Asset Method. A partner's interest in a partnership is treated as a U.S. asset in the same proportion that the sum of the partner's proportionate share of the adjusted bases of all partnership assets that are U.S. assets, bears to the sum of the partner's proportionate share of the adjusted bases of all partnership assets. Generally a partner's proportionate share of a partnership asset is the same as its proportionate share of all items of income, gain, loss, and deduction that may be generated by the asset.

If a partner's proportionate share of all items of income, gain, loss, and deduction that may be generated by a single asset of the partnership throughout the taxable year of the partner is not uniform, then, for pur-

poses of determining the partner's proportionate share of the adjusted basis of that asset, a partner must take into account the portion of the adjusted basis of the asset that reflects the partner's economic interest in that asset. A partner's economic interest in an asset of the partnership must be determined by applying the following rebuttable presumptions.

- If a partnership asset ordinarily generates directly identifiable income, a partner's economic interest in the asset is determined by reference to its proportionate share of income that may be generated by the asset for the partnership's taxable year ending with or within the partner's taxable year.
- If a partnership asset ordinarily generates current deductions and ordinarily generates no directly identifiable income, for example because the asset contributes equally to the generation of all the income of the partnership (such as an asset used in general and administrative functions), a partner's economic interest in the asset is determined by reference to its proportionate share of the total deductions that may be generated by the asset for the partnership's taxable year ending with or within the partner's taxable year.
- For other partnership assets, a partner's economic interest in the asset is determined by reference to its proportionate share of the total gain or loss to which it would be entitled if the asset were sold at a gain or loss in the partnership's taxable year ending with or within the partner's taxable year.

Income Method. Under the income method, a partner's interest in a partnership is treated as a U.S. asset in the same proportion that its distributive share of partnership ECI for the partnership's taxable year bears to its distributive share of all partnership income for that taxable year.

A foreign corporation must elect the asset method or income method on a timely filed return for the first taxable year beginning on or after March 5, 1996. An amended return does not qualify for this purpose. An elected method must be used for a minimum period of five years before the foreign corporation may elect a different method. To change an election before the end of the requisite five-year period, a foreign corporation must obtain the consent of the Commissioner of Internal Revenue or his or her delegate, although consent will be granted only in rare and unusual circumstances. A foreign corporation that is a partner in more than one partnership is not required to elect to use the same method for each partnership interest. If a foreign corporation fails to make an elec-

tion, the district director or the assistant commissioner (international) may make a binding election on behalf of the foreign corporation.

Example 21.2. Foreign corporation, FC, is a partner in partnership ABC, which is engaged in a trade or business within the United States. FC and ABC are both calendar year taxpayers. ABC owns and manages two office buildings located in the United States, each with an adjusted basis of $50. ABC also owns a non-U.S. asset with an adjusted basis of $100. ABC has no liabilities. Under the partnership agreement, FC has a 50 percent interest in the capital of ABC and a 50 percent interest in all items of income, gain, loss, and deduction that may be generated by the partnership's assets. FC's adjusted basis in ABC is $100. In determining the proportion of its interest in ABC that is a U.S. asset, FC elects to use the asset method.

FC's interest in ABC is treated as a U.S. asset in the same proportion that the sum of FC's proportionate share of the adjusted bases of all ABC's U.S. assets (50 percent of $100), bears to the sum of FC's proportionate share of the adjusted bases of all of ABC's assets (50 percent of $200). Under the asset method, the amount of FC's interest in ABC that is a U.S. asset is $50 ($100 × $50/$100) (Treas. Reg. Sec. 1.884-1(d)(3)(viii), example 1).

Interest in a Trust or Estate. A foreign corporation that is a beneficiary of a nongrantor trust or estate will not be treated as having a U.S. asset by virtue of its interest in the trust or estate. A foreign corporation treated as owning a portion of a trust under the grantor trust rules of section 671–678 is treated as owning a portion of a trust that includes all the income and gain that may be generated by a trust asset (or pro rata portion) for purposes of determining its U.S. assets (Treas. Reg. Sec. 1.884-1(d)(4)).

Property That Is Not a U.S. Asset. Property that is not a U.S. asset includes property that does not produce effectively connected earnings and profits, and assets acquired with a principal purpose of increasing net equity artificially (Treas. Reg. Sec. 1.884-1(d)(5)). Assets that arise from interbranch transactions are disregarded (Treas. Reg. Sec. 1.884-1(d)(5)(iii)).

U.S. Liabilities

The term *U.S. liabilities* means the amount of U.S.-connected liabilities of a foreign corporation under Treas. Reg. Sec. 1.882-5, decreased by liabilities the foreign corporation elects to reduce, and increased by insurance reserves of a foreign corporation carrying on an insurance business in the United States. This is illustrated by the following example.

Example 21.3. As of the close of 1999, foreign corporation A, a calendar year taxpayer computes its U.S.-connected liabilities using its actual ratio of liabilities to assets. For purposes of computing its U.S.-connected liabilities, A must determine the average total value of its assets that generate, have generated, or could reasonably have been or be expected to generate ECI. Assume that the average value of such assets is $100, while the amount of such assets as of the close of 1999 is $125. A must determine the ratio of the average of its worldwide liabilities for the year to the average total value of worldwide assets for the taxable year. Assume that A's average liabilities-to-assets ratio is 55 percent, while its liabilities-to-assets ratio at the close of 1998 is only 50 percent. A's U.S.-connected liabilities are $55 ($100 × 55%). However, A's U.S. liabilities are $62.50 for purposes of this section, the amount of its assets determined as of the close of December ($125) multiplied by the liabilities-to-assets ratio (50 percent) as of such date (Treas. Reg. Sec. 1.884-1(e)(5), example 1).

For any taxable year, a foreign corporation may elect to reduce the amount of its liabilities by an amount that does not exceed the excess, if any, of the amount of liabilities determined under Treas. Reg. Sec. 1.882-5 over the amount of liabilities shown on the books of the U.S. trade or business as of the determination date. The foreign corporation makes the election on its timely filed tax return for the taxable year by stating on that return that it has reduced the amount of its U.S. connected liabilities, and showing the amount of the reduction. This is illustrated by the following example.

Example 21.4. As of the close of 1998, foreign corporation A, a real estate company, owns U.S. assets with an earnings and profits basis of $1,000. A has $800 of liabilities, $300 which are liabilities shown on the books and records of its U.S. trade or business. A has accumulated effectively connected earnings and profits of $500 and in 1999, A has $60 of effectively connected earnings and profits that it intends to retain for future expansion of its U.S. trade or business. A elects to reduce its liabilities by $60 from $800 to $740. As a result of the election, assuming A's U.S. assets and U.S. liabilities would otherwise have remained constant, A's U.S. net equity as of the close of 1998 will increase by the amount of the decrease in liabilities ($60) from $200 to $260 and its effectively connected earnings and profits will be reduced to zero. A's interest expense for the taxable year is reduced by the amount of interest attributable to $60 of liabilities and A's excess interest is reduced by the same amount. A's taxable income and effectively connected earnings and profits are increased by the amount of the reduction in interest expense attributable to the liabilities, and A may make an election to further reduce its liabilities, thus increasing its U.S. net equity and

reducing the amount of additional effectively connected earnings and profits created by the election (Treas. Reg. Sec. 1.884-1(e)(5), example 2).

Imposition of the Branch Profits Tax and Tax Treaties

A foreign corporation may be exempted from the branch profits tax or receive a reduced rate of tax if it is eligible for relief under a tax treaty with the United States. To qualify for treaty relief, the foreign corporation must be a qualified resident of such foreign country (section 884(e)(1)).

A corporation that is a resident of a country with which the United States has an income tax treaty that contains a provision relating to the dividend equivalent amount will be either exempt from branch profits tax or subject to a lower rate as provided in the treaty (Treas. Reg. Sec. 1.884-1(g)). For treaties in effect as of the date of enactment of the branch profits tax, the tax will not be imposed on a portion of the dividend equivalent amount, as long as the income tax treaty between the United States and that country in effect on January 1, 1987, remains in effect, unless it is modified to expressly provide for imposition of the branch profits tax (Treas. Reg. Sec. 1.884-1(g)(3)).

A *foreign corporation* is a qualified resident of a foreign country with which the United States has an income tax treaty if one of the following requirements is met:

- The stock ownership and base erosion
- The publicly traded requirement
- The active-trade-or-business requirement
- The ruling requirement (Treas. Reg. Sec. 1.884-5(a))

The Stock Ownership and Base Erosion. A foreign corporation satisfies the stock ownership requirement if 50 percent or more of the value of its stock is beneficially owned during the last half of the corporation's taxable year by qualifying shareholders. Such ownership must be documented, and the documentation must be maintained and made available to the district director if requested (Treas. Reg. Sec. 1.884-5(b)(3)). The base erosion is satisfied if 50 percent or more of the foreign corporation's income is used (directly or indirectly) to meet liabilities to persons who are residents of such foreign country (or in the case of a foreign corporation, qualified residents) or citizens or residents of the United States (section 884(e)(4)(A)(ii)). A foreign corporation satisfies the base erosion test for the taxable year if it establishes that less than 50 percent of its

income for the taxable year is used (directly or indirectly) to make deductible payments in the current year to persons who are not residents in the same country as the foreign corporation and who are not citizens or residents of the United States.

The Publicly Traded Requirement. A foreign corporation that is a resident of a foreign country is treated as a qualified resident of that country if its stock (1) is primarily and regularly traded on one or more established securities markets in that country, in the United States, or both, (2) is owned by a publicly traded foreign corporation (90 percent of the voting power and value, or in the case of a foreign corporation, qualified residents) that is a resident of the same foreign country, or (3) is wholly owned (or in the case of a foreign corporation, qualified residents) by a domestic corporation and the stock of this domestic parent corporation is regularly traded on an established securities market (see Treas. Reg. Sec. 1.884-5(d)). A foreign corporation resident of a foreign country that is wholly owned by a domestic corporation whose stock is primarily and regularly traded on an established securities market in the United States will be treated as a qualified resident of that foreign country (section 884(e)(4)(C)).

The Active-Trade-or-Business Requirement. A foreign corporation that is a resident of a foreign country will be treated as a qualified resident of that country if (1) it is engaged in the active conduct of a trade or business in its country of residence, (2) it has substantial presence in its country of residence, and (3) the activities that give rise to the treaty exemption or rate reduction are part of a U.S. trade or business that is an integral part of an active trade or business conducted by the foreign corporation in its country of residence. In the case of interest received by the foreign corporation for which a treaty exemption or rate reduction is claimed, the interest must be derived in connection with or incidental to the trade or business in the country of residence. To be considered substantial presence, the average of the following three ratios must exceed 25 percent, and each ratio must equal at least 20 percent.

1. The ratio of assets used or held for use in the active conduct of the foreign corporation's trade or business in the foreign country to worldwide assets
2. The ratio of gross income from the active conduct of the foreign corporation's trade or business in its country of residence to worldwide gross income

3. The ratio of payroll expenses in the foreign corporation's country of residence to the foreign corporation's worldwide payroll expenses (Treas. Reg. Sec. 1.884-5(e)(3))

The Ruling Requirement. The commissioner, in his or her sole discretion, may rule that the establishment or maintenance of a foreign corporation in its country of residence does not have as one of its principal purposes obtaining benefits under the income tax treaty between the United States and that country of residence, if the foreign corporation has substantial business reasons for residing in its country of residence (Treas. Reg. Sec. 1.884-5(f)). If the commissioner so rules, the foreign corporation will be treated as having met the qualified residence test for the taxable year in which the ruling was obtained as well as the two succeeding years. The foreign corporation must notify the Commissioner whenever there is a material change in ownership or in the trade or business, in which case the commissioner will rule as to whether the change affects the foreign corporation's qualified resident status.

Branch-Level Interest Tax

If a foreign corporation is engaged in trade or business in the United States or has ECI, then any interest paid (called *branch interest*) will be treated as if it were paid by a domestic corporation (other than a 80-20 corporation). This interest will be subject to tax under section 871(a) or 881, and to withholding under section 1441 or 1442, in the same manner as interest paid by a domestic corporation. Interest includes original issue discount. A foreign corporation will also be treated as engaged in trade or business in the United States if, at any time during the taxable year, it owns an asset taken into account for purposes of determining the amount of the foreign corporation's interest expense allocated or apportioned to effectively connected income (Treas. Reg. Sec. 1.884-4(a)(1)).

A foreign corporation is liable for tax on excess interest in the same manner as if its excess interest were interest paid to the foreign corporation by a wholly owned domestic corporation on the last day of the foreign corporation's taxable year. The term excess interest means the amount of interest allocated or apportioned to effectively connected income of the foreign corporation, less the foreign corporation's branch interest for the taxable year, less the amount of interest relating to interest paid by a partnership. There is special treatment of a portion of the

excess interest of banks as interest on deposits (See Treas. Reg. Sec. 1.884-4(a)(2)(iii)).

The amount of tax due on excess interest of a foreign corporation must be reported on the foreign corporation's income tax return for the taxable year in which the excess interest is treated as paid to the foreign corporation and will be subject to withholding under section 1441 or 1442 (Treas. Reg. Sec. 1.884-4(a)(2)(C)(iv)).

> *Example 21.5.* Foreign corporation A, a calendar year taxpayer that is not a bank has $120 of interest allocated or apportioned to ECI under section 1.882-5 for 1999. A's branch interest for 1999 is as follows: $55 of portfolio interest to B, a nonresident alien; $25 of interest to foreign corporation C, which owns 15 percent of the combined voting power of A's stock, with respect to bonds issued by A; and $20 to D, a domestic corporation. B and C are not engaged in the conduct of a trade or business in the United States. A, B and C are residents of countries with which the United States does not have an income tax treaty. The interest payments made to B and D are not subject to tax under section 871(a) or 881 and are not subject to withholding under section 1441 or 1442. The payment to C, which does not qualify as portfolio interest because C owns at least 10 percent of the combined voting power of A's stock, is subject to withholding of $7.50 ($25 × 30%). In addition, because A's interest allocated or apportioned to ECI under §1.882-5 ($120) exceeds its branch interest ($100), A has excess interest of $20, which is subject to a tax of $6 ($20 × 30%) under section 881. The tax on A's excess interest must be reported on A's income tax return for 1999 (Treas. Reg. Sec. 1.884-4(a)(4), example 1).

The term *branch interest* means interest paid by a foreign corporation with respect to a liability that is (1) a U.S.-booked liability within the meaning of Treas. Reg. Sec. 1.882-5(d)(2) (other than a U.S.-booked liability of a partner (see Treas. Reg. Sec. 1.882-5(d)(2)(vii)); or (2) be a liability giving rise to interest expense that is directly allocated to income from a U.S. asset (Treas. Reg. Sec. 1.884-4(b)(1)).

A liability is identified as a liability of a U.S. trade or business only if the liability is shown on the records of the U.S. trade or business, or is identified as a liability of the U.S. trade or business on other records of the foreign corporation or on a schedule established for the purpose of identifying the liabilities of the U.S. trade or business.

Interest with respect to a liability will not be treated as branch interest unless the foreign corporation paying the interest either files a Form 1099 with respect to the interest payment; or sends a notice to the person who receives the interest in a confirmation of the transaction, a

statement of account, or a separate notice, within two months of the end of the calendar year in which the interest was paid, stating that the interest paid with respect to the liability is from sources within the United States (Treas. Reg. Sec. 1.884-4(b)(3)(ii)).

Liabilities that do not give rise to branch interest are (1) liabilities that are directly incurred in the ordinary course of the profit-making activities of a trade or business of the foreign corporation conducted outside the United States; or (2) a liability that is secured (during more than half the days during the portion of the taxable year in which the interest accrues) predominantly by property that is not a U.S. asset unless such a liability is secured by substantially all the property of the foreign corporation (Treas. Reg. Sec. 1.884-4(b)(3)(iii)).

If a foreign corporation with excess interest has U.S. assets as of the close of the taxable year that equal or exceed 80 percent of all money and the aggregate earnings and profits (E&P) basis of all property of the foreign corporation at that time, then all interest paid and accrued by the foreign corporation during the taxable year not related to foreign liabilities is treated as branch interest.

> *Example 21.6.* Foreign corporation A, a calendar year taxpayer, has $90 of interest allocated or apportioned to ECI for 1998. A has $40 of branch interest in 1998. A pays $60 of other interest during 1998, none of which is attributable to a liability incurred in the ordinary course of a foreign business and liabilities predominantly secured by foreign assets. As of the close of 1998, A has an amount of U.S. assets that exceeds 80 percent of the money and E&P bases of all A's property. Before application of the above rules, A would have $50 of excess interest (that is, the $90 interest allocated or apportioned to its ECI less $40 of branch interest). Under the above rules, the $60 of additional interest paid by A is also treated as branch interest. However, to the extent that treating the $60 of additional interest as branch interest would create an amount of branch interest that would exceed the amount of branch interest permitted (branch interest that exceeds a foreign corporation's interest allocated or apportioned to ECI) the amount of the additional branch interest is reduced. The foreign corporation will specify certain liabilities that do not give rise to branch interest, which are generally liabilities that do not give rise to branch interest beginning with the most-recently incurred liability (Treas. Reg. Sec. 1.884-4(b)(5), example).

If the amount of branch interest that is both paid and accrued by a foreign corporation during the taxable year exceeds the amount of interest allocated or apportioned to ECI of a foreign corporation for the tax-

able year, then the amount of the foreign corporation's branch interest is reduced by the amount of such excess as explained below. The amount of the excess first reduces branch interest attributable to liabilities identified as giving rise to branch interest and then, if the excess has not been reduced to zero, branch interest is attributable to the group of liabilities that are booked liabilities or liabilities giving rise to interest expense that is directly allocable to income from a U.S. asset. The reduction of branch interest attributable to each group of liabilities is made beginning with interest attributable to the latest-incurred liability and continuing, in reverse chronological order, with branch interest attributable to the next-latest incurred liability. The branch interest attributable to a liability must be reduced to zero before a reduction is made with respect to branch interest attributable to the next-latest incurred liability (Treas. Reg. Sec. 1.884-4(b)(6)).

Instead of using the above method a foreign corporation may elect for any taxable year to specify which liabilities will not be treated as giving rise to branch interest or will be treated as giving rise only in part to branch interest. Branch interest paid during the taxable year related to a specified liability must be reduced to zero before a reduction is made to branch interest attributable to the next-specified liability (Treas. Reg. Sec. 1.885-4(b)(5)(iii)).

Example 21.7. Foreign corporation A, a calendar year, accrual method taxpayer, has interest expense apportioned to ECI under §1.882-5 of $230 for 1998. A's branch interest for 1998 is as follows:

1. $130 paid to B, a domestic corporation, with respect to a note issued on March 10, 1998, and secured by real property located in the United States;
2. $60 paid to C, an individual resident of country X who is entitled to a 10 percent rate of withholding on interest payments under the income tax treaty between the United States and X, with respect to a note issued on October 15, 1996, which gives rise to interest subject to tax under section 871(a);
3. $80 paid to D, an individual resident of country Y who is entitled to a 15 percent rate of withholding on interest payments under the income tax treaty between the United States and Y, with respect to a note issued on February 15, 1998, which gives rise to interest subject to tax under section 871(a); and
4. $70 of portfolio interest (as defined in section 871(h)(2)) paid to E, a nonresident alien, with respect to a bond issued on March 1, 1998.

A's branch interest accrues during 1998 for purposes of calculating the amount of A's interest apportioned to ECI. A has identified the liabilities described in this example. A has not made an election to specify liabilities that do not give rise to branch interest. The amount of A's branch interest in 1998 is limited to $230, the amount of the interest apportioned to A's ECI for 1998. The amount of A's branch interest must thus be reduced by $110 ($340 − $230). The reduction is first made with respect to interest attributable to liabilities identified as giving rise to branch interest and, within the group of liabilities is first made with respect to the latest-incurred liability. Thus, the $70 of interest paid to E with respect to the bond issued on March 1, 1998, and $40 of the $80 of interest paid to D with respect to the note issued on February 15, 1998, are not treated as branch interest. The interest paid to D is no longer subject to tax under section 871(a), and D may claim a refund of amounts withheld with respect to the interest payments. There is no change in the tax consequences to E because the interest received by E was portfolio interest and was not subject to tax when it was treated as branch interest (Treas. Reg. Sec. 1.884-4(b)(6)(iv), example 1).

If a foreign corporation accrues an interest expense in a taxable year earlier than the taxable year of payment and elects to compute its excess interest as if the interest expense were branch interest paid in the year of accrual, the interest expense is treated as branch interest that is paid at the close of such year (and not in the actual year of payment). This interest will be subject to tax under section 871(a) or 881(a) and withholding under section 1441 or section 1442, as if paid on the last day of the taxable year of accrual (Treas. Reg. Sec. 1.884-4(b)(7)).

Effect of Treaties

Relief will be available under an article of an income tax treaty between the United States and the foreign corporation's country of residence relating to interest paid by the foreign corporation only if, for the taxable year in which the branch interest is paid (or if the branch interest is treated as paid in an earlier taxable year) the foreign corporation meets the requirements of the limitation on benefits provision, if any, in the treaty entered into force after December 31, 1986, and either—

1. The corporation is a qualified resident of that foreign country in such year; or
2. The corporation is presumed to continue as a qualified resident.

A foreign person (other than a foreign corporation) that derives branch interest is entitled to claim benefits under provisions of an income tax treaty between the United States and its country of residence relating

to interest derived by the foreign person. A foreign corporation may claim these benefits if it meets, with respect to the branch interest, the requirements of the limitation on benefits provision, if any, in the treaty entered into force after December 31, 1986 and the corporation is a qualified resident of that foreign country in such year or the corporation is presumed to continue as a qualified resident.

In the case of interest paid in a taxable year beginning after December 31, 1988, with respect to an obligation with a maturity of one year or less, each foreign corporation that beneficially owned the obligation prior to maturity was a qualified resident of a foreign country with which the United States has an income tax treaty or met the requirements of the limitation on benefits provision in a treaty with respect to the interest payment and such provision entered into force after December 31, 1986 (Treas. Reg. Sec. 1.884-4(b)(8)(ii)).

If a foreign corporation is a partner (directly or indirectly) in a partnership that is engaged in a trade or business in the United States and owns an interest of 10 percent or more in the capital, profits, or losses of the partnership at any time during the partner's taxable year, the relief that may be claimed under an income tax treaty with respect to the foreign corporation's distributive share of interest cannot exceed the treaty relief that available if the interest were branch interest of the foreign corporation (Treas. Reg. Sec. 1.884-4(b)(8)(v)).

> *Example 21.8.* The income tax treaty between the United States and country X provides that the United States may not impose a tax on interest paid by a corporation that is a resident of that country (and that is not a domestic corporation) if the recipient of the interest is a nonresident alien or a foreign corporation. Corporation A is a qualified resident of country X and meets the limitation on benefits provision in the treaty. A's branch interest is not subject to tax under section 871(a) or 881(a) regardless of whether the recipient is entitled to benefits under an income tax treaty (Treas. Reg. Sec. 1.884-4(b)(8)(vi), example 1).

> *Example 21.9.* A, a foreign corporation, and B, a nonresident alien, are partners in a partnership that owns and operates U.S. real estate and each has a distributive share of partnership interest deductions equal to 50 percent of the interest deductions of the partnership. There is no income tax treaty between the United States and the countries of residence of A and B. The partnership pays $1,000 of interest to a bank that is a resident of a foreign country, Y, and that qualifies under an income tax treaty in effect with the United States for a 5 percent rate of tax on U.S. source interest paid to a resident of country Y. However, the bank is not a qualified resident of country Y and the limitation on benefits provision of the treaty has not been

amended since December 31, 1986. The partnership is required to withhold at a rate of 30 percent on $500 of the interest paid to the bank (that is, A's 50 percent distributive share of interest paid by the partnership) because the bank cannot, under paragraph (b)(8)(iv) of this section, claim greater treaty benefits by lending money to the partnership than it could claim if it lent money to A directly and the $500 were branch interest of A (Treas. Reg. Sec. 1.884-4(b)(8)(vi), example 2).

If branch interest is paid in one or more taxable years before or after the year in which the interest accrues, a foreign corporation may elect to compute its excess interest as if such branch interest were paid on the last day of the taxable year in which it accrues, and not in the taxable year in which it is actually paid. The interest expense will thus reduce the amount of the foreign corporation's excess interest in the year of accrual rather than in the year of actual payment. If an election is made for a taxable year, it applies to all branch interest that is paid or accrued during that year (Treas. Reg. Sec. 1.884-4(c)(1)).

A foreign corporation makes this election by attaching to its income tax return (or to an amended income tax return) a statement that it elects to have these provisions apply, or provides written notice to the commissioner during an examination that it elects to apply these provisions. The election will be effective for the taxable year to which the return relates and for all subsequent taxable years unless the commissioner consents to revocation of the election (Treas. Reg. Sec. 1.884-4(c)(1)(ii)).

Example 21.10. Foreign corporation A, a calendar year, accrual method taxpayer, has $100 of interest allocated or apportioned to ECI for 1998. A has $60 of branch interest in 1998 before any election. A has an interest expense of $20 that properly accrues for tax purposes in 1998 but is not paid until 1999. When the interest is paid in 1998 it will meet the requirements for branch interest. A makes a timely election to treat the accrued interest as if it were paid in 1998. A will be treated as having branch interest of $80 for 1998 and excess interest of $20 in 1998. The $20 of interest treated as branch interest of A in 1998 will not again be treated as branch interest in 1999 (Treas. Reg. Sec. 1.884-4(c)(1)(vi), example 1).

Example 21.11. Foreign corporation A, a calendar year, accrual method taxpayer, has $60 of branch interest in 1998. The interest expense does not accrue until 1999 and the amount of interest allocated or apportioned to A's ECI is zero for 1998 and $60 for 1999. A makes an election with respect to 1998. As a result of the election, A's $60 of branch interest in 1998 reduces the amount of A's excess interest for 1999 rather than in 1998 (Treas. Reg. Sec. 1.884-4(c)(1)(vi), example 2).

If a foreign corporation is a partner in a partnership that is engaged in trade or business in the United States, the amount of the foreign corporation's distributive share of interest paid or accrued by the partnership will reduce (but not below zero) the amount of the foreign corporation's excess interest for the year to the extent such interest is taken into account by the foreign corporation in that year for purposes of calculating the interest allocated or apportioned to the ECI of the foreign corporation. A foreign corporation's excess interest must not be reduced by its distributive share of partnership interest that is attributable to a liability relating to interest on liabilities incurred in the ordinary course of a foreign business or secured predominantly by assets that are not U.S. assets or would meet that description if entered on the partner's books (Treas. Reg. Sec. 1.884-4(c)(2)).

Example 21.12. Foreign corporation A, a calendar year taxpayer, is not a resident of a foreign country with which the United States has an income tax treaty. A is engaged in the conduct of a trade or business both in the United States and in foreign countries, and owns a 50 percent interest in X, a calendar year partnership engaged in the conduct of a trade or business in the United States. For 1998, all of X's liabilities relate to liabilities on U.S. books and none relate to liabilities that may not give rise to branch interest. A's distributive share of interest paid by X in 1998 is $20. For 1998, A has $150 of interest allocated or apportioned to its ECI under Treas. Reg. Sec. 1.882-5, $120 of which is attributable to branch interest. Thus, the amount of A's excess interest for 1998 is $30. A's $30 of excess interest is reduced by $20, representing A's share of interest paid by X. Thus, the amount of A's excess interest for 1998 is reduced to $10. A is subject to a tax of 30 percent on its $10 of excess interest (Treas. Reg. Sec. 1.884-4(c)(4), example).

A foreign corporation treated as a domestic corporation because it is a stapled entity will continue to be treated as a foreign corporation for purposes of section 884(f) notwithstanding section 269B. Interest paid by this foreign corporation will be treated as paid by a domestic corporation and will be subject to the tax imposed by section 871(a) or 881(a), and to withholding under section 1441 and 1442, as applicable, to the extent such interest is not subject to tax by reason of section 884(f).

Interest Deductions of Foreign Corporations Whose Income Is Effectively Connected With U.S. Business

The amount of interest expense of a foreign corporation that is allocable to income that is effectively connected with the conduct of a trade or

business within the United States is the sum of the interest paid or accrued by the foreign corporation on its liabilities booked in the United States, as adjusted under the three-step process. These are the exclusive rules for allocating interest expense to the ECI of a foreign corporation. In step 1 of the three-step process, the total value of the U.S. assets of a foreign corporation is determined. In step 2 the amount of U.S.-connected liabilities is determined. In step 3 the amount of interest paid or accrued on liabilities booked in the United States, is adjusted for interest expense attributable to the difference between U.S.-connected liabilities and U.S. booked liabilities. Alternatively, a foreign corporation may elect to determine its interest rate on U.S.-connected liabilities by reference to its U.S. assets, using the separate currency pools method (Treas. Reg. Sec. 1.882-5(a)(1)).

A foreign corporation that has a U.S. asset and indebtedness may directly allocate interest expense from such indebtedness to income from such asset as provided in Treas. Reg. Sec. 1.861-10T. A foreign corporation that allocates its interest expense under the direct allocation rule must reduce the basis of the asset by the principal amount of the indebtedness that meets the requirements of Treas. Reg. Sec. 1.861-10T(b) and (c). A foreign corporation that is a partner in a partnership that has a U.S. asset and indebtedness may directly allocate its distributive share of interest expense from that indebtedness to its distributive share of income from that asset in the manner and to the extent provided in Treas. Reg. Sec. 1.861-10T. A foreign corporation that allocates its distributive share of interest expense under these direct allocation rule must disregard any partnership indebtedness that meets the requirements of §1.861-10T(b) and (c) in determining the amount of its distributive share of partnership liabilities and cannot take into account any partnership interest expense paid or accrued with respect to such a liability (Treas. Reg. Sec. 1.882-5(a)(1)(ii)).

The amount of interest expense computed under these provisions may not exceed the amount of interest on indebtedness paid or accrued by the taxpayer within the taxable year (translated into U.S. dollars at the weighted average exchange rate for each currency for the taxable year) (Treas. Reg. Sec. 1.882-5(a)(3)).

For each computation required under these provisions, the taxpayer must translate values and amounts into the relevant currency at a spot rate or a weighted average exchange rate using the method used consistently for financial reporting purposes. Interest expense paid or accrued, however, must be translated using the under the rules of Treas. Reg. Sec. 1.988-2.

Example 21.13. FC is a foreign corporation that conducts business through a branch, B, in the United States. Among B's U.S. assets is an interest in a partnership, P, that is engaged in airplane leasing solely in the United States. FC contributes 200x to P in exchange for its partnership interest. P incurs qualified nonrecourse indebtedness to purchase an airplane. FC's share of the liability of P, as determined under section 752, is 800x.

FC is permitted to directly allocate its distributive share of the interest incurred with respect to the qualified nonrecourse indebtedness to FC's distributive share of the rental income generated by the airplane. A liability the interest on which is allocated directly to the income from a particular asset is disregarded for these purposes. Consequently, for purposes of determining the value of FC's assets, FC's basis in P is reduced by the 800x liability as determined under section 752, but is not increased by the 800x liability that is directly allocated. Similarly, the 800x liability is disregarded for purposes of determining FC's liabilities for these purposes (Treas. Reg. Sec. 1.882-5(a)(8)).

There is a three step process for allocating interest expense for a foreign corporation engaged in a U.S. trade or business between income effectively connected with that business and other income. First, the total value of U.S.-connected assets must be determined. Second, the amount of U.S.-connected liabilities is determined. Third, the amount of interest on U.S.-booked liabilities is adjusted to reflect the difference between the amount of U.S.-booked liabilities and U.S.-connected liaiblities.

Step 1: Determination of Total Value of U.S. Assets for the Taxable Year. Items included in the definition of U.S. asset include—

1. U.S. real property held in a wholly owned domestic subsidiary of a foreign corporation that qualifies as a bank, provided that the real property qualifies as used in the foreign corporation's trade or business if held directly by the foreign corporation and either was initially acquired through foreclosure or similar proceedings or is U.S. real property occupied by the foreign corporation;
2. An asset that produces income treated as ECI relating to certain income of a FSC and certain dividends paid by a FSC to a foreign corporation;
3. An asset that produces income treated as ECI relating to certain income of a captive insurance company that a corporation elects to treat as ECI that is not otherwise ECI; and
4. An asset that produces income treated as ECI relating to certain interest income of U.S. possessions banks.

A transaction of any type between separate offices or branches of the same taxpayer does not create a U.S. asset. Excluded from the definition of U.S. assets are assets to the extent they produces income or gain from railroad rolling stock of foreign corporations or earnings derived from communications satellite systems. Also not treated as a U.S. asset are assets acquired if one of the principal purposes for acquiring or using that asset is to increase artificially the U.S. assets of a foreign corporation on the determination date. This is determined by all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes in acquiring or using an asset is to increase artificially the U.S. assets of a foreign corporation include the length of time during which the asset was used in a U.S. trade or business, whether the asset was acquired from a related person, and whether the aggregate value of the U.S. assets of the foreign corporation increased temporarily on or around the determination date. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

The value of a U.S. asset is the adjusted basis of the asset for determining gain or loss from the sale or other disposition of that item. A taxpayer may elect to value all of its U.S. assets on the basis of fair market value. Once elected, the fair market value must be used by the taxpayer for both Step 1 and Step 2 and must be used in all subsequent taxable years unless consent to change is granted by the IRS.

If a partner makes a fair market value election, the value of the partner's interest in a partnership that is treated as an asset must be the fair market value of his partnership interest, increased by the fair market value of the partner's share of the partnership liabilities.

Step 2: Determination of Total Value of U.S.-Connected Liabilities for the Taxable Year. In Step 2, the amount of U.S.-connected liabilities for the taxable year equals the total value of U.S. assets for the taxable year multiplied by the so-called *actual ratio* for the taxable year if the taxpayer so elects by the so-called *fixed ratio*. In general, a taxpayer's actual ratio for the taxable year is the total amount of its worldwide liabilities for the taxable year divided by the total value of its worldwide assets for the taxable year. The total amount of worldwide liabilities and the total value of worldwide assets for the taxable year is the average of the sums of the amounts of the taxpayer's worldwide liabilities and the values of its worldwide assets. In each case, the sums must be computed semiannually (beginning, middle, and end of taxable year) by a large bank and annually (beginning and end of taxable year) by any other taxpayer.

For purposes of computing the actual ratio, the value of a partner's interest in a partnership that will be treated as an asset is the partner's adjusted basis in its partnership interest, reduced by the partner's share of liabilities of the partnership as determined under section 752 and increased by the partner's share of liabilities. If the partner has made a fair market value election, the value of its interest in the partnership must be increased by the fair market value of the partner's share of the liabilities. A partner shares in any liability of a partnership in the same proportion that it shares, for income tax purposes, in the expense attributable to that liability for the taxable year. A partner's adjusted basis in a partnership interest cannot be less than zero.

The actual ratio must be computed in either U.S. dollars or the functional currency of the home office of the taxpayer, and that currency must be used consistently from year to year. For example, a taxpayer that determines the actual ratio annually using British pounds converted at the spot rate for financial reporting purposes must translate the U.S. dollar values of assets and amounts of liabilities of the U.S. trade or business into pounds using the spot rate on the last day of its taxable year. If the functional currency of the taxpayer's home office is a hyperinflationary currency that materially distorts the actual ratio, the district director or the Assistant Commissioner (International) may require that the actual ratio be computed in dollars.

Step 3: Determination of an Adjustment to Amount of Interest Expense on U.S. Liabilities. An adjustment to the amount of interest expense paid or accrued on U.S. booked liabilities is determined by comparing the amount of U.S.-connected liabilities for the taxable year with the average total amount of U.S. booked liabilities. If the average total amount of U.S.-booked liabilities equals or exceeds the amount of U.S.-connected liabilities or if the amount of U.S.-connected liabilities exceeds the average total amount of U.S.-booked liabilities, the adjustment to the amount of interest expense paid or accrued on U.S. booked liabilities is determined as explained below.

A liability is a *U.S.-booked liability* if it is properly reflected on the books of the U.S. trade or business. A liability, whether interest bearing or non-interest-bearing, is properly reflected on the books of the U.S. trade or business of a foreign corporation that is not a bank if—

1. The liability is secured predominantly by a U.S. asset of the foreign corporation;

2. The foreign corporation enters the liability on a set of books relating to an activity that produces ECI at a time reasonably contemporaneous with the time at which the liability is incurred; or
3. The foreign corporation maintains a set of books and records relating to an activity that produces ECI and the district director or assistant commissioner (international) etermines that there is a direct connection or relationship between the liability and that activity. Whether there is a direct connection between the liability and an activity that produces ECI depends on the facts and circumstances of each case.

U.S.-booked liabilities cannot include a liability if one of the principal purposes for incurring or holding the liability is to increase artificially the interest expense on the U.S.-booked liabilities of a foreign corporation. Whether a liability is incurred or held for the purpose of artificially increasing interest expense will depend upon all the facts and circumstances of each case. Factors to be considered in determining whether one of the principal purposes for incurring or holding a liability is to increase artificially the interest expense on U.S.-booked liabilities of a foreign corporation include whether the interest expense on the liability is excessive when compared to other liabilities of the foreign corporation denominated in the same currency and whether the currency denomination of the liabilities of the U.S. branch substantially matches the currency denomination of the U.S. branch's assets. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

A partner's share of liabilities of a partnership is considered a booked liability of the partner provided that it is properly reflected on the books of the U.S. trade or business of the partnership.

The average total amount of U.S.-booked liabilities for the taxable year is the average of the sums of the amounts of U.S.-booked liabilities. The amounts of U.S.-booked liabilities are to be computed at the most frequent, regular intervals for which data are reasonably available. In no event may the amount of U.S.-booked liabilities be computed less frequently than monthly by a large bank and semiannually by any other taxpayer.

If the average total amount of U.S.-booked liabilities exceeds the amount of U.S.-connected liabilities, the interest expense allocable to ECI is the product of the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S.-booked liabilities and the scaling ratio. The *scaling ratio* is a fraction the numerator of which

is the amount of U.S.-connected liabilities and the denominator of which is the average total amount of U.S.-booked liabilities. The reduction resulting from the application of the scaling ratio is applied pro rata to all interest expense paid or accrued by the foreign corporation. A similar reduction in income, expense, gain, or loss from a hedging transaction must also be determined by multiplying such income, expense, gain, or loss by the scaling ratio. If the average total amount of U.S.-booked liabilities equals the amount of U.S.-connected liabilities (as determined under step 2), the interest expense allocable to ECI is the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S.-booked liabilities.

If the amount of U.S.-connected liabilities exceeds the average total amount of U.S.-booked liabilities, the interest expense allocable to ECI is the total amount of interest paid or accrued within the taxable year by the U.S. trade or business on U.S.-booked liabilities, plus the excess of the amount of U.S.-connected liabilities over the average total amount of U.S.-booked liabilities multiplied by the interest rate determined under paragraph (d)(5)(ii) of this section.

The applicable interest rate on excess U.S.-connected liabilities is determined by dividing the total interest expense paid or accrued for the taxable year on U.S.-dollar liabilities shown on the books of the offices or branches of the foreign corporation outside the United States by the average U.S.-dollar denominated liabilities (whether interest-bearing or not) shown on the books of the offices or branches of the foreign corporation outside the United States for the taxable year.

Example 21.14. FC is a foreign corporation that is not a bank and that actively conducts a real estate business through a branch, B, in the United States. For the taxable year, FC's balance sheet and income statement is as follows:

	Value
Asset 1	$2,000
Asset 2	$2,500
Asset 3	$5,500

	Amount	*Interest Expense*
Liability 1	$ 800	$ 56
Liability 2	$3,200	256
Capital	$6,000	0

Asset 1 is the stock of FC's wholly owned domestic subsidiary that is also actively engaged in the real estate business. Asset 2 is a building in the

United States producing rental income that is entirely ECI to FC. Asset 3 is a building in the home country of FC that produces rental income. Liabilities 1 and 2 are loans that bear interest at the rates of 7 percent and 8 percent, respectively. Liability 1 is a booked liability of B, and Liability 2 is booked in FC's home country. Assume that FC has not elected to use the fixed ratio in Step 2.

Step 1. Assets 1 and 3 are not U.S. assets, while Asset 2 qualifies as a U.S. asset. Thus, the total value of U.S. assets for the taxable year is $2,500, the value of Asset 2.

Step 2. The amount of FC's U.S.-connected liabilities for the taxable year is determined by multiplying $2,500 (the value of U.S. assets determined under Step 1) by the actual ratio for the taxable year. The actual ratio is the average amount of FC's worldwide liabilities divided by the average value of FC's worldwide assets. The amount of Liability 1 is $800, and the amount of Liability 2 is $3,200. Thus, the numerator of the actual ratio is $4,000. The average value of worldwide assets is $10,000 (Asset 1 + Asset 2 + Asset 3). The actual ratio, therefore, is 40% ($4,000/$10,000), and the amount of U.S.-connected liabilities for the taxable year is $1,000 ($2,500 U.S. assets × 40%).

Step 3. Because the amount of FC's U.S.-connected liabilities ($1,000) exceeds the average total amount of U.S.-booked liabilities of B ($800), FC determines its interest expense by adding the interest paid or accrued on U.S.-booked liabilities, and the interest expense associated with the excess of its U.S.-connected liabilities over its average total amount of U.S.-booked liabilities. FC determines the interest rate attributable to its excess U.S.-connected liabilities by dividing the interest expense paid or accrued by the average amount of U.S.-dollar denominated liabilities, which produces an interest rate of 8% ($256/$3,200). Therefore, FC's allocable interest expense is $72 ($56 of interest expense from U.S.-booked liabilities plus $16 ($200 × 8%) of interest expense attributable to its excess U.S.-connected liabilities) (Treas. Reg. Sec. 1.882-6, example 1).

Example 21.15. Assume the facts are the same as in example 21.14, except that FC makes a fixed ratio election. The conclusions under step 1 are the same as in example 21.14.

Step 2. The amount of U.S.-connected liabilities for the taxable year is determined by multiplying $2,500 (the value of U.S. assets determined under step 1) by the fixed ratio for the taxable year, which is 50 percent. Thus, the amount of U.S.-connected liabilities for the taxable year is $1,250 ($2,500 U.S. assets × 50%).

Step 3. As in Example 1, the amount of FC's U.S.-connected liabilities exceed the average total amount of U.S.-booked liabilities of B, requiring FC to determine its interest expense as shown below. In this case FC has excess U.S.-connected liabilities of $450 ($1,250 of U.S.-connected liabilities − $800 U.S.-booked liabilities). FC therefore has allocable interest expense of $92 ($56 of interest expense from U.S.-booked liabilities plus $36 ($450 × 8%) of interest expense attributable to its excess U.S.-connected liabilities) (Treas. Reg. Sec. 1.882-5(d)(6), example 2).

Separate Currency Pools Method. If a foreign corporation elects to use the separate currency pool method, its total interest expense allocable to ECI is the sum of the separate interest deductions for each of the currencies in which the foreign corporation has U.S. assets. The separate interest deductions are determined under the following three-step process.

1. First, the foreign corporation must determine the amount of its U.S. assets in each currency pool. The foreign corporation may convert into U.S. dollars any currency pool in which the foreign corporation holds less than 3 percent of its U.S. assets. A transaction (or transactions) that hedges a U.S. asset shall be taken into account for purposes of determining the currency denomination and the value of the U.S. asset.
2. Second, the foreign corporation must determine the amount of its U.S.-connected liabilities in each currency pool by multiplying the amount of U.S. assets in the currency pool by the foreign corporation's actual ratio for the taxable year or, if the taxpayer has made an election to use the fixed ratio, by the fixed ratio.
3. Third, the foreign corporation must determine the interest expense attributable to each currency pool by multiplying the U.S.-connected liabilities in each currency pool by the prescribed interest rate.

For each currency pool, the prescribed interest rate is determined by dividing the total interest expense that is paid or accrued for the taxable year with respect to the foreign corporation's worldwide liabilities denominated in that currency, by the foreign corporation's average worldwide liabilities (whether interest bearing or not) denominated in that currency. The interest expense and liabilities are to be stated in that currency (Treas. Reg. Sec. 1.882-5(e)(1)).

Example 21.16. Bank Z, a resident of country X, has a branch in the United States through which it conducts its banking business. For its 1998 taxable

year, Z has U.S. assets that are denominated in U.S. dollars and in U, the country X currency. Accordingly, Z's U.S. assets are as follows:

	Average Value
U.S. dollar assets	$20,000
U assets	U 5,000

Z's worldwide liabilities are also denominated in U.S. dollars and in U. The average interest rates on Z's worldwide liabilities, including those in the United States, are 6% on its U.S. dollar liabilities, and 12% on its liabilities denominated in U. Assume that Z has properly elected to use its actual ratio of 95 percent to determine its U.S.-connected liabilities in step 2, and has also properly elected to use the separate currency pools method.

Z determines the interest expense attributable to its U.S.-connected liabilities according to the steps described below. First, Z separates its U.S. assets into two currency pools, one denominated in U.S. dollars ($20,000) and the other denominated in U (U5,000). Second, Z multiplies each pool of assets by the applicable ratio of worldwide liabilities to assets, which in this case is 95%. Thus, Z has U.S.-connected liabilities of $19,000 ($20,000 × 95%), and U4750 (U5000 × 95%). Third, Z calculates its interest expense by multiplying each pool of its U.S.-connected liabilities by the relevant interest rates. Accordingly, Z's allocable interest expense for the year is $1140 ($19,000 × 6%), the sum of the expense associated with its U.S. dollar liabilities, plus U570 (U4750 × 12%), the interest expense associated with its liabilities denominated in U. Z must translate its interest expense denominated in U in accordance with the rules provided in section 988, and then must determine whether it is subject to any other provision of the Internal Revenue Code that would disallow or defer any portion of its interest expense so determined (Treas. Reg. Sec. 1.882-5(e)(5), example 1).

Termination or Incorporation of U.S. Trade or Business

A foreign corporation will not be subject to the branch profits tax for the taxable year in which it completely terminates all of its U.S. trade or business. The foreign corporation's non-previously-taxed accumulated effectively connected earnings and profits as of the close of the year of complete termination are extinguished for purposes of section 884 and the regulations thereunder. The earnings and profits accounts are not extinguished for purposes of sections 312, 316, and 381 (Temp. Treas. Reg. Sec. 1.884-2T(a)(1)).

A foreign corporation is considered to have completely terminated all of its U.S. trade or business only if four conditions are satisfied, as follows. First, as of the close of the taxable year, the foreign corporation has no U.S. assets, or its shareholders have adopted an irrevocable resolution in that taxable year to completely liquidate and dissolve the corporation and, before the close of the immediately succeeding taxable year, all of its U.S. assets are either distributed, used to pay off liabilities, or cease to be U.S. assets (Temp. Treas. Reg. Sec. 1.884-2T(a)(2)(i)(A)).

Second, neither the foreign corporation nor a related corporation uses, directly or indirectly, any of the U.S. assets of the terminated U.S. trade or business during the year of termination or for three years after the termination in the conduct of a trade or business in the United States (Temp. Treas. Reg. Sec. 1.884-2T(a)(2)(i)(B)). A corporation that would be considered completely terminated except for reinvesting within the three-year period may make an election to designate an amount of marketable securities that will not be treated as U.S. assets (for the year of termination and the following taxable year only). The marketable securities must be identified within thirty days of the date an equivalent amount of U.S. assets cease to be U.S. assets. On the date a marketable security is identified, its adjusted basis cannot exceed its fair market value (Temp. Treas. Reg. Sec. 1.884-2T(b)).

Third, the foreign corporation has no income that is effectively connected with the conduct of trade or business in the United States during the three-year period after the year of complete termination. Effectively connected income from deferred payments and from sales of property used in the trade or business is an exception to the foregoing rule (Temp. Treas. Reg. Secs. 1.884-2T(a)(2)(i)(C) and 1.884-2T(a)(4)).

Fourth, the foreign corporation attaches to its income tax return for each year of complete termination a waiver of the period of limitations for a period of six years after the year of termination (Temp. Treas. Reg. Secs. 1.884-2T(a)(2)(i)(D) and 1.884-2T(a)(2)(ii)).

If a foreign corporation fails to completely terminate all of its U.S. trade or business because of the failure to meet any of these requirements, then its branch profits tax liability for the taxable year and all subsequent taxable years shall be determined under the usual rules, taking into account any reduction in U.S. net equity that results from a U.S. trade or business of the foreign corporation ceasing to have U.S. assets. Any additional branch profits tax liability that may result, together with interest

thereon, and applicable penalties, if any, will be the liability of the foreign corporation (Temp. Treas. Reg. Sec. 1.884-2T(a)(2)).

Termination With a Section 338 Election

A foreign corporation whose stock is acquired by another corporation that makes an election under section 338 is treated as having completely liquidated as of the close of the acquisition date and to have completely terminated all of its U.S. trade or business as long as the requirements of the second and fourth conditions discussed in the preceding section are satisfied (Temp. Treas. Reg. Sec. 1.884-2T(a)(3)).

Termination With Deemed Effectively Connected Income

A foreign corporation that has terminated its U.S. business but continues to be treated as having effectively connected trade or business income because of the receipt of deferred payments under section 864(c)(6), or gain attributable to property used or held in connection with its U.S. business under section 864(c)(7), will not be subject to the branch profits tax if the following three conditions are satisfied. First, except for the section 864(c)(6) and (7) income, no income of the foreign corporation for the taxable year is effectively connected with a U.S. trade or business. Second, the foreign corporation has no U.S. assets as of the close of the taxable year. Third, the effectively connected earnings and profits would not have been subject to the branch profits tax pursuant to the provisions if a complete termination of the gain treated under section 864(c)(6) had not been deferred, or if the property giving rise to the section 864(c)(7) treatment had been sold immediately prior to the date the property ceased to be used in the conduct of a U.S. trade or business (Temp. Treas. Reg. Sec. 1.884-2T(a)(4)).

Election to Remain Engaged in a U.S. Trade or Business

A foreign corporation that would be considered to have completely terminated all of its U.S. trade or business for the taxable year except for the provisions that prohibit reinvestment within a three-year period, may make an election for the taxable year in which it completely terminates all its U.S. trade or business and, if it so chooses, may do so for the following taxable year (but not for any succeeding taxable year). The election by the foreign corporation is to designate an amount of marketable

securities as U.S. assets for branch profits purposes. The marketable securities identified pursuant to the election will be treated as being U.S. assets in an amount equal, in the aggregate, to the lesser of the adjusted basis of the U.S. assets that ceased to be U.S. assets during the taxable year in which the election is made (determined on the date or dates the U.S. assets ceased to be U.S. assets) or the adjusted basis of the marketable securities as of the end of the taxable year. The securities must be held from the date that they are identified until the end of the taxable year for which the election is made, or if disposed of during the taxable year, must be replaced on the date of disposition with other marketable securities that are acquired on or before that date and that have a fair market value as of the date of substitution not less than their adjusted basis (Temp. Treas. Reg. Sec. 1.884-2T(b)(1)).

In order to qualify for this election, the marketable securities must be identified on the books and records of the U.S. trade or business within 30 days of the date an equivalent amount of U.S. assets ceases to be U.S. assets; and on the date a marketable security is identified, its adjusted basis must not exceed its fair market value (Temp. Treas. Reg. Sec. 1.884-2T(b)(3)).

The income or gain from the marketable securities (or replacement securities) subject to this election will be treated as effectively connected income, and losses from the disposition of such marketable securities must be allocated entirely to income that is effectively connected income. In addition, all such securities shall be treated as if they had been sold for their fair market value on the earlier of the last business day of a taxable year for which an election is in effect or the day immediately prior to the date of substitution by the foreign corporation of a U.S. asset for the marketable security, and any gain (but not loss) and accrued interest on the securities shall also be treated as effectively connected income. The adjusted basis of such property is also increased by the amount of any gain recognized (Temp. Treas. Reg. Sec. 1.884-2T(b)(4)).

A foreign corporation may make this election by attaching to its income tax return for the taxable year a statement identifying the marketable securities treated as U.S. assets, setting forth the earnings and profits bases of the securities, and agreeing to treat any income, gain or loss as explained above. This statement must be filed on or before the due date (including extensions) of the foreign corporation's income tax return for the taxable year. A foreign corporation can make this election only once (Temp. Treas. Reg. Sec. 1.884-2T(b)(5)).

Liquidation or Reorganization of a Foreign Corporation

If a foreign corporation engaged in the conduct of a U.S. trade or business transfers its U.S. assets to another corporation in a complete liquidation or reorganization described in section 381(a), several rules apply with respect to the transfer (Temp. Treas. Reg. Sec. 1.884-2T(c)).

The foreign corporation is not deemed to have completely terminated its U.S. business, and the branch profits tax applies to the taxable year in which the section 381(a) transaction occurs or in any succeeding taxable year (Temp. Treas. Reg. Sec. 1.884-2T(c)(1)).

The dividend equivalent amount for the taxable year, including a short taxable year, for the taxable year must be computed under the provisions of Treas. Reg. Sec. 1.884-1 as modified by Temp. Treas. Reg. Sec. 1.884-2T(c)(2). In addition, the transferor's dividend equivalent amount for any taxable year succeeding the taxable year in which the section 381(a) transaction occurs must be calculated (Temp. Treas. Reg. Sec. 1.884-2T(c)(3) and (4)).

If the transferee is a foreign corporation, adjustments must be made to the U.S. net equity on account of the section 381(a) transaction (Temp. Treas. Reg. Sec. 1.884-2T(c)(5)).

There is also a special rule in cases of the disposition of stock or securities in a domestic transferee or in the transferor (Temp. Treas. Reg. Sec. 1.884-2T(c)(6)).

Incorporation Under Section 351

If a foreign corporation is engaged in the conduct of a U.S. trade or business and transfers part or all of its U.S. assets to a U.S. corporation in a section 351 transaction and the transferee is a controlled subsidiary after the transfer, this transfer will not be considered a complete termination, the transfer will not be exempted from the branch profits tax for the year of transfer, and the transfer may not be exempt for any subsequent taxable year of the transferor in which it owns stock or securities of a transferee as of the close of the transferor's taxable year (Temp. Treas. Reg. Sec. 1.884-2T(d)(1) and (2)). The transferor's dividend equivalent amount is calculated using the principles in Temp. Treas. Reg. Sec. 1.884-2T(d)(3), (4), and (5).

The dividend equivalent amount is computed using the general principles described above and modified, provided that (1) the transferee elects to be allocated a proportionate part of the transferor's effectively

connected earnings and profits and (2) the foreign corporation files a statement with a timely filed income tax return of the transferor for the taxable year in which the section 351 transaction occurs and complies with the agreement included in that statement with respect to a subsequent disposition of the transferee's stock. Basically, the transferee does not begin its existence with zero earnings and profits but is allocated the dividend potential associated with the predecessor business that is incorporated.

The U.S. net equity (that is, assets and liabilities, for purposes of computing the dividend equivalent amount) is determined as if a section 351 transfer had not occurred. The *transferor's adjusted basis* for earnings and profits purposes in U.S. assets transferred pursuant to the section 351 exchange is the adjusted basis of those assets for earnings and profits purposes immediately prior to the section 351 transaction, increased by any gain recognized that is taken into account for earnings and profits purposes.

For purposes of computing the transferor's dividend equivalent amount for taxable years subsequent to the section 351 transaction, this dividend equivalent amount is taken into account by reducing the transferor's effectively connected earnings and profits for the year in which the section 351 transaction occurs, its non-previously-taxed accumulated effectively connected earnings and profits, and its non-previously-taxed accumulated effectively connected earnings and profits of which the transferee elects to increase its earnings and profits. The above dividend equivalent amount cannot exceed the sum of the transferor's effectively connected earnings and profits and non-previously-taxed accumulated effectively connected earnings and profits after taking into account the allocation to the transferee of the transferor's earnings that the transferee elects to include in its earnings and profits (Temp. Treas. Reg. Sec. 1.884-2T(d)(3)).

The agreement executed by the transferor must state that upon the disposition of part or all of the stock or securities it owns in the transferee, it will treat as a dividend equivalent amount for the taxable year in which a disposition occurs an amount equal to the lesser of the amount realized on the disposition or the total amount of effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits that were allocated from the transferor. A disposition is deemed not to occur in a section 332(b) liquidation or an "F" reorganization. All other transfers are treated as dispositions unless

the taxpayer obtains a ruling stating that a particular transfer is not a disposition, or unless the Internal Revenue Service (IRS) issues other published guidance stating that certain transactions are not dispositions. The rules regarding allocations of earnings and profits in corporate separations do not apply to a section 355 distribution that is not part of a "D" reorganization and will not apply to reduce the transferor's effectively connected earnings and profits or non-previously taxed accumulated effectively connected earnings and profits.

Example 21.17. Foreign corporation X is a calendar-year taxpayer. X's only assets are U.S. assets, and X computes its interest deduction using the actual ratio of liabilities to assets. A's U.S. net equity as of the close of its 1998 taxable year is $2,000, resulting from the following amounts of U.S. assets and liabilities:

U.S. Assets		*U.S. Liabilities*	
U.S. building A	$1,000	Mortgage A	$ 800
U.S. building B	2,500	Mortgage B	1,500
Other U.S. assets	800		
Total	$4,300	Total	$2,300

X's adjusted basis in its assets is equal to X's adjusted basis in its assets for earnings and profits purposes. On September 30, 1999, X transfers building A, which has a fair market value of $1,800, to a newly created U.S. corporation Y in exchange for 100 percent of the stock of Y with a fair market value of $800, other property with a fair market value of $200, and the assumption of mortgage A. A tax of $30 is imposed with respect to the $200 of other property received by X. X's non-previously-taxed accumulated effectively connected earnings and profits as of the close of its 1998 taxable year are $200, and its effectively connected earnings for its 1999 taxable year are $330, including $170 of gain recognized minus $30 of gain recognized to X on the transfer as adjusted for earnings and profits. Y takes a basis of $1,200 in the building transferred from X, equal to the basis in the hands of X, increased by the $200 gain recognized to X. Y makes an election to increase its earnings and profits, and X files the statement regarding disposition of Y's shares. The branch profits tax consequences to X and Y in the taxable year in which the section 351 transaction occurs and in subsequent years are computed by the following method: X's dividend equivalent amount for 1999 is computed by first, determining X's U.S. net equity as of the close of 1999; second, determining the amount of X's effectively connected earnings and profits for the year; and third, applying the limitation to these earnings and profits.

X's net U.S. equity as of the close of its 1999 taxable year is calculated without regard to the section 351 transaction except that any gain that is

recognized as resulting from the section 351 transaction will increase earnings and profits. Assume that X's net equity as of the close of its 1999 taxable year decreased by $130 relative to its equity as of the close of 1998. X's effectively connected earnings and profits and non-previously-taxed accumulated effectively connected earnings and profits for the taxable year are determined without taking into account the allocation to Y of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits pursuant to the election by Y. Thus X's effectively connected earnings and profits for its 1999 taxable year are $330 and X's non-previously taxed accumulated effectively connected earnings and profits are $200. Therefore, but for the limitation, effectively connected earnings and profits for the taxable year would be $460, equal to X's effectively connected earnings and profits for the taxable year ($330), increased by the decrease in X's U.S. net equity of $130.

X's dividend equivalent amount for its 1999 taxable year may not exceed the sum of the transferor's effectively connected earnings and profits and non-previously-taxed accumulated effectively connected earnings and profits, determined as of the close of its 1999 taxable year, after taking into account the allocation of the transferor's earnings and profits pursuant to the election by Y to have earnings and profits allocated to it. Therefore, X's dividend equivalent amount for its 1999 tax year cannot exceed $446, which is equal to the total amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits (determined as of the close of its 1999 taxable year without regard to the allocation of earnings and profits to Y pursuant to Y's election ($530)), reduced by the amount of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits allocated to Y pursuant to Y's election ($84). Thus X's dividend equivalent amount for the 1999 taxable year is limited to $446.

Pursuant to Y's election, Y increases its earnings and profits by the sum of X's effectively connected earnings and profits and non-previously taxed accumulated effectively connected earnings and profits determined immediately before the section 351 transaction, without regard to X's dividend equivalent amount for the year, allocated in the same proportion that X's basis in the U.S. assets transferred to Y bears to the bases of all of X's U.S. assets determined immediately prior to the section 351 transaction. The amount of X's earnings and profits immediately before the section 351 transaction is $160. The total amount of effectively connected earnings and profits ($160) and non-previously-taxed accumulated effectively connected earnings and profits ($200) determined immediately before the section 351 transaction is $360. The portion of the $360 that is allocated to Y pursuant to Y's election is $84, calculated as $360 multiplied by a fraction, the numerator of which is the basis of the U.S. assets transferred to Y pursuant to the section 351 transaction ($1,000) and the denominator of which is the basis

of X's U.S. assets determined immediately before the section 351 transaction ($4,300). The amount of $84 of X's effectively connected earnings and profits and non-previously-taxed accumulated effectively connected earnings and profits allocated to Y constitutes non-previously-taxed accumulated effectively connected earnings and profits of Y.

X's non-previously-taxed accumulated effectively connected earnings and profits as of the close of its 1999 taxable year for purposes of computing its dividend equivalent amount for its taxable year 2000 are zero (that is, $530 of effectively connected earnings and profits reduced by $84 of effectively connected earnings and profits allocated to Y, and further reduced by X's $446 dividend equivalent amount for its 1999 taxable year).

For 2000, X must determine its U.S. net equity as of December 31, 1999, in order to determine whether there has been an increase or decrease in its U.S. net equity as of December 31, 1996. For this purpose, X's U.S. net equity as of December 31, 1999 is determined after the assets and liabilities that were transferred to Y are removed from the books of X. (The preceding discussion is based on the example at Temp. Treas. Reg. Sec. 1.884-2T(d)(6).)

22

Filing Requirements and Record Keeping

A person or business entity that has income from foreign transactions or foreign sources is likely to be burdened with record-keeping requirements significantly greater than those of entities with income entirely from sources within the United States. Not only must every U.S. person subject to U.S. taxes keep records or make returns as the Internal Revenue Service (IRS) may require, but he or she may also be faced with record-keeping and filing requirements from a foreign country as well.

The records that must be kept for U.S. tax purposes are not required to be kept in any particular form, but they must be kept accurately and in such a manner that the IRS can determine if any tax liability is incurred and the extent thereof (Treas. Reg. Sec. 31.6001-1(a)). The records must be kept at an accessible location and be available to Internal Revenue Service officers for inspection at all times.

A U.S. taxpayer must also be aware of filing requirements for returns and statements. If a return is not filed by the due date, the taxpayer may be subject to interest or penalties or may lose a benefit to which he or she might otherwise be entitled. This chapter examines the principal filing and record-keeping requirements for various transactions or provisions

with U.S. tax implications for the various entities doing business abroad. Filing requirements for various foreign persons with businesses or investments in the United States are also examined.

Foreign Tax Credit

A taxpayer entitled to a foreign tax credit claims the credit by filing Form 1116 in the case of an individual or Form 1118 in the case of a corporation. Unless the district director is satisfied that it is impossible to furnish certain evidence to support the claim for the credit, the carefully filled-out form must have attached to it primary evidence (such as follows) supporting the credit claimed: (1) the receipt for each such tax payment if credit is sought for taxes already paid, or (2) the return on which each such accrued tax was based if credit is sought for taxes accrued. This receipt or return must be the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. If the receipt or return is in a foreign language, a certified translation must be furnished by the taxpayer (Treas. Reg. Sec. 1.905-2(a)(2)). If it is impossible to furnish a receipt for foreign tax payment, the foreign tax return, or direct evidence of the tax withheld at the source, the district director may accept secondary evidence (Treas. Reg. Sec. 1.905-2(b)).

In the absence of a receipt for payment of foreign taxes, the taxpayer must submit a photocopy copy of a check, draft, or other medium of payment showing the amount and date, with certification identifying it with the tax claimed to have been paid, together with evidence establishing that the tax was paid for taxpayer's account as his or her own tax on his or her own income. If credit is claimed on an accrual method, it must be shown that the tax accrued in the taxable year (Treas. Reg. Sec. 1.905-2(b)(1)).

If the foreign tax return is not available, the foreign tax has not been paid, and credit is claimed on an accrual method, the following must be submitted:

1. A certified statement of the amount claimed to have accrued
2. Excerpts from the taxpayer's account showing amounts of foreign income and tax accrued on its books
3. A computation of the foreign tax, based on income from the foreign country, carried on the books and at current rates of tax with data such as excerpts from foreign law, assessment notices, or other documentary evidence

4. A bond, if deemed necessary by the district director, filed in a manner provided in cases where the foreign return is available, or in case a bond is not required, a specific agreement wherein the taxpayer will recognize its liability to report the correct amount of tax when ascertained as required under section 905(c)

When the foreign tax receipts or foreign tax returns become available to the taxpayer, they must be promptly submitted to the district director (Treas. Reg. Sec. 1.905-2(b)(2)).

In the case of taxes withheld at the source from dividends, interest, royalties, compensation, or other form of income, if evidence of withholding cannot be secured from those who have made the payments, the district director may, in his discretion, accept secondary evidence of such withholding and of the amount of tax withheld, having due regard to the taxpayer's books of account and to the rates of taxation prevailing in the particular foreign country during the period involved (Treas. Reg. Sec. 1.905-2(b)(3)).

A taxpayer that is claiming a credit for a tax accrued but not paid may not be required by the district director to furnish a bond as a condition for allowing the credit. If such a bond is required, Form 1117 must be used by both individuals and corporations (Treas. Reg. Sec. 1. 905-2(d)).

If a taxpayer fails to notify the IRS on a timely basis of a foreign tax redetermination as required under section 905(c), unless it is shown that the failure was due to reasonable cause and not due to willful neglect, an amount will be added to the deficiency attributable to the redetermination of 5 percent of the deficiency for a failure of one month or less. There will be an additional 5 percent of the deficiency for each month (or fraction thereof) during which the failure continues, up to 25 percent of the deficiency (section 6689).

Treaty-Based Return Positions

Section 6114 requires disclosure by each taxpayer who takes the position that any treaty of the United States overrules or modifies an internal revenue law of the United States. The disclosure must be made with a statement attached to the return effected. A return otherwise not required to be filed must nonetheless be filed for purposes of making the disclosure. For this purpose, this return will include only the taxpayer's name, address, taxpayer identifying number, the disclosure and be signed under penalties of perjury. Also, the taxpayer's taxable year will be deemed to be

the calendar year unless the taxpayer has established a different taxable year.

Example 22.1. X, a Country A corporation, claims the benefit of a provision of the income tax treaty between the United States and Country A that modifies a provision of the Internal Revenue Code. This position does not result in a change of X's U.S. tax liability for the current tax year but does give rise to, or increases, a net operating loss which may be carried back (or carryforward) such that X's tax liability in the carryback (or forward) year may be affected by the position taken by X in the current year. X must disclose this treaty-based return position with its tax return for the current tax year. (Treas. Reg. Sec. 301.6114-1(a)(3), example 1)

Example 22.2. Z, a domestic corporation, is engaged in a trade or business in Country B. Country B imposes a tax on the income from certain of Z's petroleum activities at a rate significantly greater than the rate applicable to income from other activities. Z claims a foreign tax credit for this tax on its tax return. The tax imposed on Z is specifically listed as a creditable tax in the income tax treaty between the United States and Country B; however, there is no specific authority that such tax would otherwise be a creditable tax for U.S. purposes under sections 901 or 903 of the Code. Therefore, in the absence of the treaty, the creditability of this petroleum tax would lack a substantial probability of successful defense if challenged, and Z must disclose this treaty-based return position. (Treas. Reg. Sec. 301.6114-1(a)(3), example 2)

The following is a list of particular positions for which reporting is specifically required:

1. A nondiscrimination provision of a treaty precludes the application of any otherwise applicable Code provision, other than with respect to the making of or the effect of an election under section 897(i);
2. A treaty reduces or modifies the taxation of gain or loss from the disposition of a U.S. real property interest;
3. A treaty exempts a foreign corporation from (or reduces the amount of tax with respect to) the branch profits tax or the tax on excess interest;
4. A treaty exempts from tax, or reduces the rate of tax on, interest or dividends paid by a foreign corporation that are from sources within the United States by reason of section 861(a)(2)(B) or section 884(f)(1)(A);

5. A treaty exempts from tax, or reduces the rate of tax on, fixed or determinable annual or periodical income subject to withholding under section 1441 or 1442 that certain foreign persons receive from a U.S. person;
6. Income that is effectively connected with a U.S. trade or business of a foreign corporation or a nonresident alien is not attributable to a permanent establishment or a fixed base of operations in the United States and, thus, is not subject to taxation on a net basis, or that expenses are allowable in determining net business income so attributable, not withstanding an inconsistent provision of the Code;
7. A treaty alters the source of any item of income or deduction;
8. A treaty grants a credit for a specific foreign tax for which a foreign tax credit would not be allowed by the Code; or
9. For returns relating to taxable years for which the due date for filing returns (without extensions) is after December 15, 1997, residency of an individual is determined under a treaty and apart from the Internal Revenue Code (Treas. Reg. Sec. 301.6114-1(b)).

Reporting is waived for any of the following return positions taken by the taxpayer:

1. A treaty has reduced the rate of withholding tax otherwise applicable to a particular type of fixed or determinable annual or periodical income subject to withholding under section 1441 or 1442, such as dividends, interest, rents, or royalties to the extent such income is beneficially owned by an individual or a state (including a political subdivision or local authority);
2. Residency of an individual is determined under a treaty and apart from the Internal Revenue Code for taxable years for which the due date for filing returns (without extensions) is on or before December 15, 1997;
3. A treaty reduces or modifies the taxation of income derived from dependent personal services, pensions, annuities, social security and other public pensions, or income derived by artists, athletes, students, trainees, or teachers;
4. Income of an individual is resourced (for purposes of applying the foreign tax credit limitation) under a treaty provision relating to elimination of double taxation;

5. A nondiscrimination provision of a treaty allows the making of an election under section 897(i);
6. A Social Security totalization agreement or a diplomatic or consular agreement reduces or modifies the taxation of income derived by the taxpayer; or
7. A treaty exempts the taxpayer from the excise tax imposed by section 4371 in certain circumstances (Treas. Reg. Sec. 301.6114-1(c)).

Controlled Foreign Corporations

Filing Requirements

Form 5471 is due when the U.S. person's income tax return is due, including extensions. Two copies of the form and required schedule must be filed. One copy is attached to the U.S. person's income tax return and the second copy is to be sent to the Internal Revenue Service Center, Philadelphia, PA 19255. The return on Form 5471 must contain the following information for the foreign corporation:

1. The name, address, and employer identification number, if any
2. The principal place of business
3. The date of incorporation and the country under whose laws it was incorporated
4. The name and address of the foreign corporation's statutory or resident agent in the country of incorporation
5. The name, address, and identifying number of any branch office or agent of the foreign corporation located in the United States
6. The names and addresses of the person or persons having custody of the books of account and records of the foreign corporation, and the location of such books and records
7. The nature of the corporation's business and the principal places where it is conducted
8. A description of each class of the corporation's stock and the number of shares of each class outstanding at the beginning and end of the annual accounting period
9. A list showing the name, address, identifying number, and number of shares of each class of the corporation's stock held by each U.S. person owning at any time during the accounting period 5 percent or more of any class of the corporation's outstanding stock

10. The amount of the corporation's current earnings and profits, foreign income, war profits, excess profits taxes paid or accrued, distributions out of current earnings, profits for the period, and other distributions and their sources
11. A summary showing the total amounts of each of the following types of transactions that took place during the annual accounting period with the person required to file this return, any other corporation controlled by that person, or a U.S. person owning, at the time of the transaction, 10 percent or more of the value of any class of stock outstanding of the foreign corporation, or any corporation controlling that foreign corporation:
    a. Sales and purchase of stock in trade
    b. Purchases of tangible property other than stock in trade
    c. Sales and purchases of patents, inventions, models or designs, copyrights, trademarks, secret formulas or processes or any similar property rights, and similar property
    d. Compensation paid and compensation received for rendering technical, managerial, engineering, construction, scientific, or similar services
    e. Commissions paid and commissions received
    f. Rents and royalties paid and rents and royalties received
    g. Amounts loaned and amounts borrowed (other than open accounts that arise and are collected in the ordinary course of business)
    h. Dividends paid and dividends received
    i. Interest paid and interest received
    j. Premiums received for insurance or reinsurance (Treas. Reg. Sec. 1.6038-2(f))

Form 5471 requires the following financial statements prepared in accordance with generally accepted accounting principles:

1. A profit-and-loss statement
2. A balance sheet showing assets, liabilities, and net worth
3. An analysis of earnings and profits

Treas. Reg. Sec. 1.6038(h) and 1.6046-1(g) require all amounts reported on Form 5471 to be stated in U.S. dollars. However, section 985 and 986 require that, for post-86 tax years, U.S. tax determinations are based on computations made in the foreign corporation's functional cur-

rency. To enable the IRS to process the form, the taxpayer must first compute the relevant information in the foreign corporation's functional currency and then translate all amounts to U.S. dollars at the weighted average exchange rate for the year (see Treas. Reg. section 1.989(b)-1). All statements must be in English and must be filed with the U.S. person's income tax return on the date required by law.

Failure to File

There are two possible civil penalties for failure to furnish the information required by section 6038. The first type of penalty is a $10,000 fine for each failure to furnish information for an annual accounting period (generally a taxable year) of the foreign corporation. If the failure continues for more than ninety days after notification by the secretary, then there is an additional $10,000 penalty for each thirty-day period (or fraction thereof) during which the taxpayer continues not to produce the requested information. In no event, however, can accumulated penalties for failure to furnish information for any one accounting period of any one foreign corporation exceed $50,000 (section 6038). No penalty is due if it can be shown that reasonable cause exists for a failure to furnish the required information on time.

The second type of penalty is a reduction in the foreign tax credit when the IRS considers it appropriate. The penalty for failure to furnish any required information is a 10-percent reduction of the U.S. person's creditable foreign taxes. There are additional 5-percent reductions if the failure continues for ninety days or more after notification. Creditable foreign taxes may be reduced by 5 percent for each three-month period or fraction thereof during which the failure continues, up to a maximum penalty of $10,000 on the income of the foreign corporation for the annual accounting period to which the failure applies (section 6038(c)(1) and (2)). When both the $10,000 penalties and the reduction in the foreign tax credit penalties are applied, the amount of the reduction in the foreign tax credit is reduced by the fixed-dollar penalty imposed (section 6038(c)(3)). It is intended that the reduction in foreign tax credit penalty may be waived in cases in which the flat $10,000 penalty will be imposed. In addition, criminal penalties for failure to file may be imposed under sections 7203, 7206, and 7207.

General Record-Keeping Requirements

The earnings and profits of a controlled foreign corporation (CFC) for purposes of sections 951 through 964 are computed substantially as if the

foreign corporation was a domestic corporation. This computation is made by performing the procedures specified in chapter 11.

Accounting Adjustments. Under Treas. Reg. Sec. 1.964-1(b), physical assets, including inventory, must be reflected at historical cost computed either for individual assets or groups of similar assets. Depreciation, depletion, and amortization must be based on the historical cost, and no amount determined on the basis of a factor other than historical cost will be allowed. Any accounting practice that results in a systematic undervaluation of assets or overvaluation of liabilities, even though expressly permitted or required under foreign law, is not allowed. Reserves or similar provisions that have the effect of equalizing income over more than one accounting period are not allowed.

Tax Adjustments. Under Treas. Reg. Sec. 1.964-1(c), the methods of accounting must reflect the provisions of section 446. Inventories must be taken into account in accordance with the provisions of sections 471 and 472. Depreciation must be computed in accordance with section 167 under these circumstances: (1) for any tax year beginning before July 1, 1972, and (2) for any tax year beginning after June 30, 1972, when less than 20 percent of gross income is from sources within the United States. Depreciation must be computed in accordance with Treas. Reg. Sec. 1.312-15 for any tax year beginning after June 30, 1972, when 20 percent or more of gross income is from sources within the United States.

Records Required of U.S. Shareholders

In order for the district director to verify the income tax liability from amounts included in income under section 951, every U.S. shareholder of a CFC has the responsibility to provide records within a reasonable time after demand by the district director. The record-keeping requirement is considered satisfied if the books and records are sufficient to verify (1) subpart F income, (2) the previously excluded subpart F income withdrawn from investment in shipping operations and less developed countries, (3) the previously excluded export trade income withdrawn from investment, (4) investment of earnings in U.S. property (Treas. Reg. Sec. 1.964-3(b)), and (5) earnings invested in excess passive assets.

Verification of Classes of Income

Subpart F Income. Books or records sufficient to verify the subpart F income must include (1) gross income and deductions, (2) insurance

income, (3) foreign base company income, and (4) information related to the case of a U.S. shareholder claiming the benefit of the exclusion in section 952(b) or the limitation in section 952(c).

Insurance Income. Books or records must be sufficient to verify the insurance income of a CFC.

Foreign Personal Holding Company Income. Books or records sufficient to verify gross income of a foreign personal holding company (FPHC) from the following sources must be maintained:

1. All rents and royalties
2. Rents and royalties received from an unrelated person in the active conduct of a trade or business
3. Rents and royalties received from a related person for the use of property in the country of incorporation of the CFC
4. All dividends, interest, and (except where the CFC is a regular dealer in stock or securities) gains and losses from the sale or exchange of stock or securities
5. Dividends, interest, and gains from the sale or exchange of stock or securities received from an unrelated person in the conduct of a banking, financing, or insurance business
6. Dividends and interest received from a related corporation organized in the country of incorporation of the CFC
7. Interest received from a related person in the conduct of a banking or other financing business
8. All annuities
9. All gains from commodities transactions
10. All income from estates and trusts
11. All income from personal service contracts
12. All compensation for the use of corporate property by shareholders (Treas. Reg. Sec. 1.964-4(d)(1))

Foreign Base Company Sales Income. Books or records must be sufficient to establish the gross income from foreign base company sales income, including the following:

1. All sales by a CFC of its personal property and purchases or sales of personal property on behalf of another person
2. Purchases or sales of personal property in connection with transactions not involving related persons, or both purchases and sales of such property

3. Purchases or sales of personal property manufactured or produced in the country of the CFC's incorporation, or both purchases and sales of such property
4. Purchases or sales of personal property for use in the country of the CFC's incorporation, or both purchases and sales of such property
5. Sales of personal property manufactured or produced by the CFC (Treas. Reg. Sec. 1.964-4(d)(2))

Foreign Base Company Services Income. Books or records must be sufficient to establish the gross income from foreign base company services income as follows:

1. All services performed by the CFC
2. Services other than those performed for or on behalf of a related person
3. Services performed in the country of incorporation of the CFC
4. Services performed in connection with the sale or exchange of personal property manufactured or produced by the CFC (Treas. Reg. Sec. 1.964-4(d)(3))

Foreign Base Company Shipping Income. The foreign base company shipping income books and records must be sufficient to establish the following:

1. Gross income derived from, or in connection with, the use of any aircraft or vessel in foreign commerce
2. Gross income derived from, or in connection with, the performance of services directly related to the use of any aircraft or vessel in foreign commerce
3. Gross income incidental to the use or performance of services for the use of any aircraft or vessel in foreign commerce
4. Gross income derived from the sale, exchange, or other disposition of any aircraft or vessel used in foreign commerce
5. Dividends, interest, and certain other gains
6. Income from partnerships
7. Exchange gain, to the extent allocable to foreign base company shipping income (Treas. Reg. Sec. 1.964-4(d)(6))

Income Subject to High Foreign Taxes. In the case of a CFC that is subject to high foreign taxes, books and records must be sufficient to establish the gross income excluded from foreign base company income, income taxes or other similar taxes incurred with respect to such income, and all other

factors necessary to verify the application of the exclusion under section 954(b)(4) (Treas. Reg. Sec. 1.964-4(d)(7)).

Deductions. Books or records must be sufficient to establish the deductions allocable to each of the aforementioned classes and subclasses of gross income (Treas. Reg. Sec. 1.964-4(d)(10)).

Withdrawal of Previously Excluded Subpart F Income From Qualified Investment. Books or records sufficient to verify the previously excluded subpart F income of the CFC withdrawn from investment in foreign base company shipping operations or less developed countries must show the following:

1. The sum of the amounts of excluded foreign base company shipping income or less developed countries income for all prior years
2. The sum of the amounts of previously excluded subpart F income withdrawn from investment in foreign base company shipping operations or less developed countries for all prior years
3. The amount withdrawn from investment in foreign base company shipping operations or less developed countries for the taxable year (Treas. Reg. Secs. 1.964-4(g-1) and (g-2))

Withdrawal of Previously Excluded Export Trade Income From Investment. Books or records sufficient to verify the previously excluded CFC export trade income withdrawn from investment for the taxable year must establish the U.S. shareholder's proportionate share of the following:

1. The sum of the amounts by which the subpart F income was reduced for all prior taxable years under section 970 (Treas. Reg. Sec. 1.970-1(b))
2. The sum of the amounts described in section 970(b)(1)(B)
3. The sum of the amounts of previously excluded export trade income of such corporation from investment under section 970(b) and Treas. Reg. Sec. 1.970-1(c) for all prior taxable years
4. The amount withdrawn from investment under section 970(b) and Treas. Reg. Sec. 1.970-1(c) for the taxable year (Treas. Reg. Sec. 1.964-4(h))

Investment of Earnings in U.S. Property. Books or records sufficient to verify, for the taxable year, earnings invested in U.S. property must establish the following:

1. The amount of the CFC's earnings invested in the U.S. property at the close of the current and preceding taxable years
2. The amount of excluded property held by the CFC at the close of the current and preceding taxable years
3. The earnings and profits distributed by the CFC during the preceding taxable year
4. The amount of increases in earnings invested by the CFC in U.S. property that is excluded from the U.S. shareholder's gross income for the taxable year by section 959(a)(2) and Treas. Reg. Sec. 1.959-1(c) (Treas. Reg. Sec. 1.964-4(i))

Foreign Ownership of a U.S. Trade or Business

Section 6038A(a) prescribes that a *reporting corporation* must report to the IRS the *reportable transactions* for any open year. Any corporation that is 25-percent-owned by one foreign person and is either a domestic corporation or a foreign corporation that conducts a trade or business in the United States is a *reporting corporation*. *Reportable transactions* are transactions carried out directly or indirectly with certain foreign persons treated as related to the reporting corporation. A *related person* is a 25-percent shareholder as well as any person that is treated as related to the reporting corporation or related to a 25-percent shareholder of the reporting corporation, and any other person who is related within the meaning of section 482 to the reporting corporation, under sections 267(b), 482, or 707(b)(1) (section 6038A(c)(2)). Such reporting is made on Form 5472 Information Return of a 25% Foreign-Owned U.S. Corporation Engaged in a U.S. Trade or Business.

A reporting corporation is also required to maintain any records deemed appropriate to determine the correct tax treatment of reportable transactions. These records must be maintained at the location, in the manner, and to the extent prescribed by regulations.

General IRS summons authority extends to certain persons who are not themselves subject to tax in the United States. Furthermore, to avoid the consequences of noncompliance provisions (discussed below) with respect to certain reportable transactions, each foreign person that is a related party of a reporting corporation must agree to authorize the latter to act as its agent in connection with any request or summons by the IRS to examine records or produce testimony related to any reportable transactions, solely for the purpose of determining the tax liability of the reporting corporation (section 6038A(e)(1)).

Failure to maintain records or to furnish the IRS with information as required by section 6038A is subject to a $10,000 penalty and additional penalties of $10,000 for each thirty-day period (or fraction thereof) after the ninetieth day following IRS notification. A taxpayer who demonstrates to the satisfaction of the Secretary of the Treasury that reasonable cause exists for the failure to furnish required information or maintain required records may not be liable for the penalty (section 6038A(d)).

A noncompliance rule may also be applied for certain payments to related parties in connection with reportable transactions. This noncompliance rule permits the IRS to allow the reporting corporation only those deductions and amounts of cost of any property acquired from a related party as shall be determined by the secretary in the secretary's sole discretion, based on the secretary's knowledge or from any information that the secretary may obtain through testimony or otherwise (section 6038A(e)(3)).

Section 6038C subjects all foreign corporations that carry on trades or businesses in the United States to information-reporting and record-maintenance rules that are similar to the section 6038A rules applicable to certain 25-percent foreign-owned corporations. The section 6038C rules apply to related party transactions in the case of any foreign corporation with a U.S. trade or business, whether or not the foreign corporation is 25-percent foreign-owned. Section 6038C applies to information, records, and summonses regarding other information the secretary may prescribe by regulations relating to any item not directly connected with a related-party transaction.

DISCs and Former DISCs; FSCs and Former FSCs

Section 6011(c) requires that a domestic international sales corporation (DISC) or former DISC or a foreign sales corporation (FSC) or former FSC must keep records as required by the regulations and must furnish any information, as the regulations may require, to the DISC shareholders and the IRS. A DISC must file an information return on Form 1120-IC-DISC, including Schedule K, Shareholder's Statement of IC-DISC Distributions; Schedule P, Intercompany Transfer Price or Commission; Schedule Q, Borrower's Certificate of Compliance With the Rules for Producer's Loans; and Form 8404, Interest Charge on DISC-Related Deferred Tax Liability. This information return must be filed before the fifteenth day of the ninth month following the end of the taxable year.

An FSC files 1120-FSC and Schedule P, "Transfer Price or Commission DISCs and FSCs."

A taxpayer who fails to file returns or supply information of a DISC or FSC must pay a penalty of $100 for each failure to supply information (with a maximum of $25,000 during any calendar year), or a penalty of $1,000 for each failure to file a return, unless the taxpayer can show that the failure was due to reasonable cause (section 6686).

Foreign Personal Holding Companies

Section 6035 describes certain requirements for an annual filing of a return by officers, directors, and 10-percent shareholders of a foreign personal holding corporation (FPHC). The shareholder report includes the following information on Form 5471: (1) name and address and taxpayer identification number (TIN) of each person who held shares, options, and convertible securities during the taxable year; (2) a description of each class of shares and the total number of shares of each class outstanding at year's end; (3) the number of shares of each class, options, or convertible securities held by each person; and (4) any changes in the holdings of shares, options, or convertible securities during the year and any other information required by Form 5471 (Treas. Reg. Sec. 1.6035-1(a)(3)).

General corporate information that must be supplied includes (1) the name, address, taxpayer identification (if any) of the corporation; (2) the kind of business in which the corporation is engaged; (3) the date of its incorporation; (4) the country under the laws of which the corporation is incorporated; (5) a description of each class of stock issued and outstanding by the corporation for the beginning and end of the annual accounting period; (6) the number of shares and par value of the common and preferred stock issued and outstanding as of the beginning and end of the taxable year (for the preferred stock, the rate of dividend on such stock and whether the dividend is cumulative or noncumulative must be shown); and (7) any other information required by Form 5471 and its instructions (Treas. Reg. Sec. 1.6035-1(a)(2)).

Reports relating to FPHCs must be filed with the shareholder's income tax return and on or before the due date of that return. There is a $1,000 civil penalty for failure to file a proper FPHC information return. This penalty does not apply, however, if the failure is shown to be

due to reasonable cause. Criminal penalties may also be imposed for failure to file a return and for filing a false or fraudulent return.

U.S. Possessions Income

Form 5735, Computation of Possessions Corporation Tax Credit Allowed Under Section 936, should be attached to the corporation's regular tax return filed on Form 1120 for every year that an election under section 936 is in effect. In addition, a possessions corporation may be required to file Form 5712-A, Election and Verification of the Cost Sharing or Profit Split Method Under Section 936(h) and Form 5735 Schedule P, Allocation of Income and Expenses Under Section 936(h)(5).

A U.S. citizen with income from a possession must file Form 4563, Exclusion of Income For Bona Fide Residents of American Samoa; Form 5074, Allocation of Individual Income Tax to Guam or Commonwealth of the Northern Mariana Islands (CNMI); or Form 8689, Allocation of Individual Income Tax to the Virgin Islands.

Interests in Foreign Partnerships

A return is required by a U.S. person who acquires or disposes of an interest in a foreign partnership except to the extent regulations provide otherwise. This requirement extends to substantial changes in the proportionate interest of a U.S. person in a foreign partnership. The return is to be in such form as regulations (which have not been issued at the time of this writing) require and must be filed within ninety days after the date the U.S. person becomes liable to file this return unless the Secretary, by regulation, prescribes a later date (section 6046A).

In addition to any criminal penalty provided by law, any person who fails to file a complete return will be subject to a penalty of $10,000 unless it is shown that the failure was due to reasonable cause. If any failure continues more than 90 days after a notice is mailed there is an additional $10,000 amount for each 30-day period the failure continues, up to $50,000 (section 6679(a)).

Returns for Certain Foreign Trusts

Section 6048 requires that on or before the ninetieth day (or such later day as the Secretary of the Treasury may prescribe) after any reportable

event, the responsible party shall provide written notice of such event to the IRS. The notice required must contain certain prescribed information including the amount of money or other property (if any) transferred to the trust in connection with the reportable event, and the identity of the trust and of each trustee and beneficiary (or class of beneficiaries) of the trust. (section 6048(a)(2))

The term *reportable event* means the creation of any foreign trust by a U.S. person, the transfer of any money or property (directly or indirectly) to a foreign trust by a U.S. person, including a transfer by reason of death, and the death of a citizen or resident of the United States if the decedent was treated as the owner of any portion of a foreign trust or any portion of a foreign trust was included in the gross estate of the decedent. Exceptions to the reportable event requirements include transfers of property to a trust in exchange for consideration of at least the fair market value of the transferred property, a deferred compensation trust, or a section 501(c)(3) trust. (section 6048(a)(3))

The term *responsible party* means the grantor in the case of the creation of an inter vivos trust, the transferor in the case of a reportable event other than a transfer by reason of death, and the executor of the decedent's estate in any other case. (section 6048(a)(4))

U.S. Owner of Foreign Trust

A U.S. person treated at any time during any taxable year as the owner of any portion of a foreign trust is responsible to ensure that that trust files a return that sets forth a full and complete accounting of all trust activities and operations for the year, the name of the U.S. agent for such trust, and such other information as prescribed, and that the trust furnishes all information prescribed to each U.S. person who is treated as the owner of any portion of such trust or who receives (directly or indirectly) any distribution from the trust (section 6048(b)(1)).

Trusts Not Having U.S. Agent

The above rules also apply to any foreign trust unless the trust agrees to authorize a U.S. person to act as such trust's limited agent solely for purposes of applying sections 7602, 7603 , and 7604 with respect to any request by the IRS to examine records or produce testimony related to the proper treatment of amounts required to be taken into account, or any summons by the IRS for records or testimony (section 6048(b)(2)).

Reporting by U.S. Beneficiaries of Foreign Trusts

Any United States person that receives (directly or indirectly) any distribution from a foreign trust must file a return with respect to such trust for that year which includes the name of such trust, the aggregate amount of the distributions so received from such trust during such taxable year, and any other information as may be prescribed (section 6048(c)(1)).

Inclusion in Income If Records Not Provided

If adequate records are not provided to the IRS to determine the proper treatment of any distribution from a foreign trust, that distribution must be treated as an accumulation distribution includible in the gross income of the distributee (section 6048(c)(2)).

Failure to File Information With Respect to Certain Foreign Trusts

Section 6677 provides that in addition to any criminal penalty provided by law, if any notice or return required to be filed by section 6048 is not filed on or before the time provided in such section, or does not include all the information required or includes incorrect information, the person required to file such notice or return must pay a penalty equal to 35 percent of the gross reportable amount. If any failure continues for more than 90 days after the day on which the notice is mailed, an additional penalty of $10,000 for each 30-day period (or fraction thereof) up to the amount of the gross reportable amount. In the case of a return required under section 6048(b) the U.S. person is liable for a penalty of 5 percent the gross value of the property involved in the event (determined as of the date of the event) in the case of a failure relating to section 6048(a), the gross value of the portion of the trust's assets at the close of the year treated as owned by the U.S. person in the case of a failure relating to section 6048(b)(1), and the gross amount of the distributions in the case of a failure relating to section 6048(c).

Reasonable Cause Exception

No penalty will be imposed on any failure which is shown to be due to reasonable cause and not due to willful neglect. The fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the required information is not reasonable cause.

Acquisition, Organization, Reorganization, and Disposition of Foreign Operations

Section 1248

A taxpayer who sells or exchanges stock to which section 1248 applies must attach a schedule showing the taxpayer's name, address, and identifying number to the taxpayer's income tax return for the taxable year in which the stock is exchanged or sold. The schedule must also include the following information on first-tier and lower-tier corporations: the names of each corporation, the country under whose laws it is organized, and the last day of the taxable year that the corporation regularly uses in computing its income. A schedule of earnings and profits attributable to the stock sold must also be included (Treas. Reg. Sec. 1.1248-7).

Section 367

A taxpayer who wishes to establish that a transfer of property from the United States was not undertaken to avoid taxes must present a statement, executed under penalties of perjury, setting forth the facts and circumstances relating to the exchange, together with the details of the exchange, to the commissioner (section 6038B). The transferor must attach the required information to Form 926, Return by Transferor of Property to a Foreign Corporation, Foreign Trust or Estate, or Foreign Partnership. Form 926 must be filed at the Internal Revenue Service center where the transferor is required to file its federal income tax return. The form and its attachments must be filed with the transferor's tax return for the taxable year that includes the date of the transfer (Temp. Treas. Reg. Sec. 1.6038B-1T(b)).

If the transferor fails to comply with the applicable reporting requirements, then with respect to the particular property as to which there was a failure to comply, that property will not be considered to have been transferred for use outside of the United States for purposes of section 367(a), a penalty of 25 percent of the amount of gain realized on the exchange of that property will be assessed, and the period of limitations on assessment of tax upon the transfer of that property will not begin to run until the date on which the transferor does comply with the reporting requirements (Temp. Treas. Reg. Sec. 1.6038B-1T(f)(1)).

The foregoing consequences from failure to file will not apply if the transferor shows that the failure to comply was due to reasonable cause and not willful neglect. A written statement must be provided to the district director having jurisdiction of the taxpayer's return for the year of the transfer setting forth the reasons for failure to comply (Temp. Treas. Reg. Sec. 1.6038B-1T(f)(3)).

Organization and Reorganization of Foreign Corporations and Acquisitions of Stock

Each U.S. citizen or resident who is an officer or director of a foreign corporation must file Form 5471 for each U.S. person who meets either of these requirements: (1) owns 10 percent or more of the total value of a corporation's stock or (2) owns 10 percent or more of the total combined voting power of all stock with voting rights. (section 6046(a)(1))

An officer or director otherwise required to file Form 5471 need not file if three or fewer U.S. persons own 95 percent or more in value of the outstanding stock and the shareholders are required to file because of the acquisition (Treas. Reg. Sec. 1.6046-1(e)(4)).

Regarding shareholders, each U.S. citizen or resident must file a Form 5471 if any of the following events takes place:

1. Outstanding stock in a foreign corporation is acquired so that 5 percent or more of its value is owned.
2. An additional 5 percent or more in value of the outstanding stock of a corporation is acquired.
3. An interest of 5 percent or more in value of the foreign corporation is owned when the foreign corporation is reorganized.
4. Sufficient stock is disposed of to reduce interest in the foreign corporation to less than 5 percent of the outstanding stock.
5. A person becomes a U.S. citizen or resident while owning 5 percent or more of the outstanding stock of the foreign corporation (Treas. Reg. Sec. 1.6046-1(c)(2)).

A shareholder otherwise required to file Form 5471 need not file if all of the following conditions are satisfied:

1. The shareholder does not have any direct interest in the foreign corporation.
2. The requirement to file was due solely to attribution of stock ownership.
3. The person from whom the stock ownership is attributed furnishes all the information required by the return (Treas. Reg. Sec. 1.6046-1(e)(4)).

A shareholder required to file Form 5471 is not required to furnish certain items of information on it if such information is furnished by another person having an equal or greater stock interest in the foreign corporation (Treas. Reg. Sec. 1.6046-1(e)(5)). In such a case the share-

holder should file a statement with the return, both indicating that the liability for furnishing the information has been satisfied and identifying the return in which the information was included.

Form 5471 must be filed within ninety days after the day on which a U.S. person becomes liable for filing or on or before a later date as the Secretary of the Treasury may prescribe by forms or regulations (section 6046(d)).

The following information must be included on Form 5471:

1. The name, address, and identifying number of each shareholder for whom the return is filed
2. A statement showing that the shareholders meet the requisite ownership requirements
3. The date, if any, on which the shareholder or shareholders last filed Form 5471
4. The date the shareholder became a U.S. citizen or resident if the return is filed for this reason
5. The date and method of disposition of stock and the person to whom the disposition was made if the return is filed for this reason

If Form 5471 is filed because of the organization or reorganization of the foreign corporation, the following must also be included:

1. A statement showing a detailed list of the classes, kinds, and description of the assets transferred to the foreign corporation; the fair market value of each asset transferred; the adjusted basis if the assets are transferred by a U.S. person; the date of the transfer; the name, address, and identifying number of the owner immediately prior to the transfer; and the consideration paid by the foreign corporation for the transfer
2. A statement showing the assets transferred and the notes or securities issued by the foreign corporation; the name, address, and identifying number of each person to whom such transfer or issue was made; and the consideration paid to the foreign corporation for the transfer or issue
3. An analysis of the changes in the corporation's surplus account occurring on or after July 1, 1963 (Treas. Reg. Sec. 1.6046-1(c)(3))

Reporting Requirements of U.S. Target Company. In order for a U.S. person that transfers stock or securities of a domestic corporation to qualify for relief from the general rule of section 367(a)(1), reporting require-

ments must be satisfied. These are satisfied if the U.S. target company attaches a statement titled Section 367(a)—Reporting of Cross-Border Transfer Under Reg. §1.367(a)-3(c)(6) to its timely filed U.S. income tax return for the taxable year in which the transfer occurs. The return must be signed under penalties of perjury by an officer of the corporation to the best of the officer's knowledge and belief, disclosing the following information—

1. A description of the transaction in which a U.S. person or persons transferred stock or securities in the U.S. target company to the transferee foreign corporation in a transfer otherwise subject to section 367(a)(1);
2. The amount (specified as to the percentage of the total voting power and the total value) of stock of the transferee foreign corporation received in the transaction, in the aggregate, by persons who transferred stock or securities of the U.S. target company;
3. The amount (if any) of transferee foreign corporation stock owned directly or indirectly immediately after the exchange by the U.S. target company;
4. A statement that there is no control group;
5. A list of U.S. persons who are officers, directors or 5-percent target shareholders and the percentage of the total voting power and the total value of the stock of the transferee foreign corporation owned by such persons both immediately before and immediately after the transaction; and
6. A statement that includes the a statement that the active trade or business test is satisfied, a description of such business, a statement that on the day of the transaction, there was no intent on the part of the transferors or the transferee foreign corporation (or any qualified subsidiary or any qualified partnership, if relevant) to substantially dispose of or discontinue its active trade or business, and a statement that the substantiality test (see Treas. Reg. Sec. 1.367(a)-3(c)(3)(iii)) is satisfied, and other documentation tests are satisfied (see Treas. Reg. 1.367(a)-3(c)(3)) (Treas. Reg. Sec. 1.367(a)-3(c)(6)).

Agreement to Recognize Gain

A transferor's agreement to recognize gain on a section 367(a) transaction must be attached to, and filed by the due date (including extensions) of, the transferor's income tax return for the taxable year that includes the date of the transfer. The agreement to recognize gain must

be signed under penalties of perjury by a responsible party. The agreement must set forth the following information, with the heading "Gain Recognition Agreement Under Section 1.367(a)-8," and with the following information:

1. A statement that the document submitted constitutes the transferor's agreement to recognize gain;
2. A description of the property transferred;
3. The transferor's agreement to recognize gain;
4. A waiver of the period of limitations;
5. An agreement to file a certification with the transferor's tax returns for the 5 full taxable years following the year of the transfer;
6. A statement that arrangements have been made in connection with the transferred property to ensure that the transferor will be informed of any subsequent disposition of any property that would require the recognition of gain under the agreement; and
7. A statement as to whether, in the event all or a portion of the gain recognition agreement is triggered, the taxpayer elects to include the required amount in the year of the triggering event rather than in the year of the initial transfer. If the taxpayer elects to include the required amount in the year of the triggering event, such statement must be included with all of the other information required, and filed by the due date (including extensions) of the transferor's income tax return for the taxable year that includes the date of the transfer (Treas. Reg. Sec. 1.367(a)-8(b)).

The U.S. transferor must file with its income tax return for each of the five full taxable years following the taxable year of the transfer a certification that the property transferred has not been disposed of by the transferee in a transaction that is considered to be a disposition. The U.S. transferor must include with its annual certification a statement describing any taxable dispositions of assets by the transferred corporation that are not in the ordinary course of business. The annual certification must be signed under penalties of perjury by a person who would be authorized to sign the agreement. (Treas. Reg. Sec. 1.367(a)-8(b)(5))

Section 355 Distribution

The agreement to recognize gain on a section 355 distribution provided by the distributing corporation must set forth the following items, under

the heading "Gain recognition agreement under Section 1.367(e)-1T(c)(3)(iii)," with paragraphs labeled to correspond with such items:

1. A declaration that the distribution is one to which recognition applies;
2. A description of each qualified foreign distributee, which must include the qualified foreign distributee's name, address, taxpayer identification number (if any), and residence and citizenship (in the case of an individual) or place of incorporation and country of residence (in the case of a qualified foreign distributee that is a corporation;
3. A description of the stock and securities of the distributing and controlled corporations owned (directly or indirectly) by each qualified foreign distributee, including the number or amount of shares and the type of stock or securities;
4. The fair market values of the stock and securities of the controlled corporation owned (directly or indirectly) by the qualified foreign distributee(s), determined immediately before and immediately after the distribution;
5. The distributing corporation's adjusted basis (immediately before the distribution) in the stock and securities of the controlled corporation distributed to the qualified foreign distributees;
6. The fair market value of the distributing corporation (fair market value of its assets, less all liabilities of the distributing corporation) immediately after the distribution;
7. For each applicable valuation, a summary of the method (including appraisals, if any) used for determining the fair market values;
8. The distributing corporation's agreement to recognize gain;
9. The controlled corporation's agreement to be secondarily liable for the distributing corporation's tax liability, pursuant to the gain recognition agreement;
10. A waiver of the period of limitations by both the distributing and controlled corporation;
11. An attached statement from each qualified foreign distributee declaring that the qualified foreign distributee will provide to the distributing corporation the annual certifications for each of the taxable years of the distributing corporation, beginning with the taxable year of the distribution and ending with the taxable year that includes the close of the 120-month period following the tax-

able year of the distributing corporation in which the distribution was made;

12. An agreement by the distributing corporation to attach to its tax returns the annual certifications of the qualified foreign distributees and the controlled corporation, respectively, and to meet any other reporting requirement in Treas. Reg. Sec. 1.367(e)-1T(c)(3)(v) (Treas. Reg. Sec. 1.367(e)-1T(c)(3)(iii)).

    The distributing corporation and the controlled corporation must file, with the gain recognition agreement, a waiver of the period of limitation on the assessment of tax upon the gain realized on the distribution to the qualified foreign distributee(s). The waiver is executed on Form 8838.

    For each of the taxable years of the distributing corporation, beginning with the taxable year of the distribution and ending with the taxable year that includes the close of the 120-month period following the end of the taxable year of the distributing corporation in which the distribution was made, the distributing corporation must file with its federal income tax return the annual certifications for that year. The controlled corporation must provide a certification to the distributing corporation, signed under penalties of perjury by an authorized officer of the corporation, that lists each current qualified foreign distributee holding (directly or indirectly) stock of the controlled corporation and its direct or indirect ownership interest in the controlled corporation at both the first day and the last day of the taxable year for which the distributing corporation files its federal income tax return, and certifies the accuracy of that list. The distributing corporation must attach to the annual certifications a statement signed under penalties of perjury by an authorized officer of the corporation, in which the corporation declares that, to the best of its knowledge, the annual certifications are true.

13. The distributing corporation must file, within 90 days of a recognition transaction, an amended return for the year of the distribution and must recognize gain realized but not recognized upon that distribution, if, prior to the close of the 120-month period following the end of the taxable year of the distributing corporation in which the distribution was made, either a qualified foreign distributee sells (or otherwise disposes of) the stock or securities of the distributing or controlled corporation that the qualified foreign distributee owned (directly or indirectly); or any other transaction (for exam-

ple, a public offering or reorganization) results in a substantial transformation in either the distributing or controlled corporation (or both). A disposition includes, but is not limited to, any disposition treated as a sale or exchange (for example, section 301(c)(3)(A), 302(a), 351(b) or 356(a)(1)) (Treas. Reg. Sec. 1.367(e)-1T(c)(3)(vii)).

U.S. Citizens or Residents Employed Abroad

A U.S. citizen or resident claiming an exclusion under section 911 for earned income while in a foreign country must compute gross income without regard to the exclusion that is provided. Consequently, a U.S. citizen or resident abroad must file a tax return using the same gross income requirements as a resident of the United States (section 6012(c)). Form 1040 must be filed if the gross income requirements are met.

A taxpayer whose tax home is outside the United States on the tax return due date is granted an automatic two-month extension until the fifteenth day of the sixth month following the close of the taxpayer's taxable year. If a taxpayer wishes an extension in addition to the automatic extension (for example, to determine if the 330-day requirement or bona fide foreign resident requirement will be satisfied), he or she must make application on Form 2350, which shall set forth the reasons the extension is needed and the earliest date the taxpayer expects to be in a position to determine if he or she qualifies under the 330-day requirement or bona fide foreign resident requirement. In general, an extension may be granted for up to thirty days beyond the date that the taxpayer can reasonably expect to qualify under either the bona fide foreign resident requirement or the physical presence requirement.

A U.S. citizen or resident claiming the exclusion of earned income or the housing allowance will do so by attaching Form 2555 to Form 1040 or Form 1040X. Form 2555 details the requirements for bona fide foreign resident and physical presence status, how much earned income is excluded, and how to compute the amount of the housing allowance.

If a taxpayer files a return before the period has passed to qualify for the 330-day or bona fide foreign resident status, the exclusion will be disregarded in the calculation of taxable income. If the taxpayer subsequently qualifies for the exclusion, a claim for refund for any overpayment of tax should be filed on Form 1040X.

Information Concerning Resident Status

Any individual who applies for a U.S. passport (or a passport renewal), or applies to lawfully reside permanently in the United States as an immigrant in accordance with the immigration laws, must include with any application a statement which includes the required information. Information which must be provided includes the taxpayer's taxpayer identification number (TIN) (if any), in the case of a passport applicant, any foreign country in which such individual is residing, in the case of an individual seeking permanent residence, information with respect to whether such individual is required to file an income tax return for the three most recent taxable years, and any other required information (section 6039E(b)).

An individual who fails to provide a statement with this information will be subject to a penalty equal to $500 for each such failure, unless it is shown that such failure is due to reasonable cause and not to willful neglect (section 6039E(c)).

Any agency of the United States that collects (or is required to collect) the individual's required information must provide that information to the IRS and provide the IRS with the name (and any other identifying information) of any individual refusing to comply with these provisions (section 6039E(d)).

Notice of Large Gifts Received From Foreign Persons

If the value during any taxable year of the aggregate foreign gifts received by a U.S. person (other than a 501(c) organization) section 501(a)) exceeds $10,000 (adjusted for cost of living), then that U.S. person must furnish such information as the Secretary of the Treasury may prescribe regarding each foreign gift received during such year.

The term *foreign gift* means any amount received from a person other than a U.S. person that the recipient treats as a gift or bequest. It does not include any qualified transfer under section 2503(e)(2)) or any distribution properly disclosed in a return under section 6048(c) .

If a U.S. person fails to furnish the information on the gifts required within the time prescribed therefor (including extensions) the tax consequences of the receipt of such gift will be determined by the IRS, and the U.S. person must pay upon notice and demand an amount equal to 5 percent of the amount of such foreign gift for each month for which the fail-

ure continues (not to exceed 25 percent of such amount in the aggregate) (section 6039F).

Information on Individuals Losing United States Citizenship

Any individual who loses United States citizenship must provide a statement with the following information:

1. Taxpayer's TIN,
2. Mailing address of such individual's principal foreign residence,
3. Foreign country in which such individual is residing,
4. Foreign country of which such individual is a citizen,
5. In the case of an individual having a net worth of at least the dollar amount applicable under section 877(a)(2)(B), information detailing the assets and liabilities of such individual, and
6. Other information as may be prescribed (section 6039G(b)).

The information must be provided not later than the earliest date of any act that causes the loss of citizenship and must be provided to the person or court handling the matter.

The acts referred causing loss of citizenship include the following:

1. The individual's renunciation of his or her United States nationality before a diplomatic or consular officer of the United States pursuant to paragraph (5) of section 349(a) of the Immigration and Nationality Act (8 U.S.C. 1481(a)(5)),
2. The individual's furnishing to the United States Department of State a signed statement of voluntary relinquishment of United States nationality confirming the performance of an act of expatriation specified in paragraph (1), (2), (3), or (4) of section 349(a) of the Immigration and Nationality Act (8 U.S.C. 1481(a)(1)-(4)),
3. The issuance by the United States Department of State of a certificate of loss of nationality to the individual, or
4. The cancellation by a court of the United States of a naturalized citizen's certificate of naturalization (section 6039G(c)).

Any individual failing to provide the required statement will be subject to a penalty for each year (of the 10-year period beginning on the date of loss of U.S. citizenship) during any portion of which such failure continues in an amount equal to the greater of 5 percent of the tax

required to be paid under section 877 for the taxable year ending during such year, or $1,000, unless it is shown that such failure is due to reasonable cause and not to willful neglect. (section 6039G(d))

Reporting by Long-Term Lawful Permanent Residents Who Cease to Be Taxed as Residents

Any individual who is required to provide a statement under this section must provide the statement with the tax return for the taxable year during which the taxpayer ceases to be a lawful permanent resident (section 6039G(f)).

Foreign Persons Holding Direct Investments in U.S. Real Property Interests

Any foreign person holding direct investments in U.S. real property interests for the calendar year must file a return showing the name and address of such person, a description of all U.S. real property interests held by such person at any time during the calendar year, and any other information required by forthcoming regulations (section 6039C(a)). A foreign person is treated as holding direct investments in U.S. real property interests during the calendar year if such person did not engage in a trade or business in the United States at any time during the calendar year and the fair market value of the real property interests (defined at section 897(c)) held directly by such person at any time during such year equals or exceeds $50,000 (section 6039C(b)).

In the case of sales by foreign persons of U.S. real property interests, withholding is required, and Form 8288, U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests, and Form 8288-A, Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests, must be filed. Form 8288-B, Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests, is used to apply for a withholding certificate to reduce or eliminate withholding on dispositions by foreign persons of U.S. real property interests.

Payment of Tax

A nonresident alien individual or foreign corporation subject to tax under section 897(a) and any person required to withhold tax under

section 1445 must pay such tax to the United States if the property is located in the United States and to the Virgin Islands if the tax is levied on disposition of real property located in the Virgin Islands (section 6039C(d)).

Failure to File a Return or Furnish a Statement Required Under Section 6039C

The failure to file a timely return or furnish a statement, unless it is shown to be due to reasonable cause and not to willful neglect, will carry an assessment of $25 for each day during which the failure continues (section 6652(f)), a maximum penalty of the lesser of $25,000 or 5 percent of the aggregate fair market value of the U.S. real property interests owned at any time during the year (section 6652(f)(3)).

Admissibility of Evidence Maintained in Foreign Countries

Section 982 provides a formal document request procedure intended to discourage taxpayers from delaying or refusing disclosure of certain foreign-based information to the IRS. If the taxpayer fails to substantially comply with any formal document request arising out of the examination of the tax treatment of any item within ninety days from the date the request is mailed, then any court having jurisdiction in a civil proceeding involving the tax treatment of the examined item will prohibit the taxpayer's introduction of any foreign-based documentation after the prescribed period (section 982(a)).

Substantial Compliance

Whether a taxpayer has substantially complied with a formal document request will depend on all the facts and circumstances. For example, when the IRS issues multiple requests in the course of an audit and the taxpayer fails to comply with one particular request for only one document, the taxpayer's timely satisfaction of other requests is one factor, but not the only factor, to be considered in determining whether overall compliance has been substantial. If overall compliance has been substantial, the document requested but not supplied could be admissible.

On the other hand, if the IRS presents a taxpayer with a formal document request for ten items and the taxpayer produces nine of them but fails (without reasonable cause) to produce the tenth, which appears to a court to be the most significant item, a court may decide that there has not been substantial compliance and may exclude all of the items.

Reasonable Cause

The nonadmissibility-of-documents sanction does not arise if the taxpayer establishes that the failure to provide the document requested is due to reasonable cause (section 982(b)(1)). In determining if there was reasonable cause for failure, a court will take into account whether the request was reasonable in scope, whether the requested documents or copies of requested documents are available within the United States, and whether the taxpayer is within a reasonable distance of the requested place within the United States where these documents are to be produced.

The fact that a foreign jurisdiction may impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the requested documentation is not reasonable cause (section 982(b)(2)). The effect of this provision is that the taxpayer cannot introduce at a trial records that allegedly could not be earlier produced during the course of the audit.

Frequently, minority status may prevent a taxpayer from being able to produce certain requested records held by a foreign entity. Because in some unwarranted situations a taxpayer may allege that minority status prevents the production of certain records, whether minority status is reasonable cause will be determined by the facts and circumstances of the case.

The IRS can request that formal documents be translated into English, which may be a further example of reasonable cause for failure to produce a document on a timely basis; such translation may not be reasonably possible within ninety days.

Formal Document Request

The term *formal document request* means any request made in the course of an audit and after the normal request procedures have failed to produce the documentation. The following conditions apply to a formal document request:

1. The request must be mailed by registered or certified mail to the taxpayer at his or her last known address (section 982(c)(1)).
2. The request must set forth the time and place for the presentation of the documentation (section 982(c)(1)(A)).
3. The request must state why the documentation previously produced (if any) is not sufficient (section 982(c)(1)(B)).
4. The request must describe the documentation being sought (section 982(c)(1)(C)).

5. The request must explain the consequences to the taxpayer of failure to produce the requested documentation (section 982(c)(1)(D)).

A formal document request procedure is not intended to be used as the routine beginning of an examination. A procedure for administrative review of proposed formal document requests before issuance must be established. *Foreign-based documentation* (including books and records) is any documentation that is outside the United States and that may be relevant or material to the tax treatment of the examined item (section 982(d)).

Proceedings to Quash

The taxpayer has the right to have the reasonableness of a demand for the production of a formal document judicially reviewed. Any person to whom a formal document request is mailed has a right to begin a proceeding to quash that request no later than the ninetieth day after the request was mailed (section 982(b)(2)(A)). During the proceeding, the running for the ninety-day period for compliance with a formal document request is suspended (section 982(c)(2)(C)). The taxpayer may contend, for example, that all or part of the documentation requested is not relevant to the tax issue, that the place of requested presentation within the United States is unreasonable, or that there is reasonable cause for failure to produce or for delay in producing.

The reasonableness of a demand for the production of originals of foreign documents rather than copies may be resolved in judicial proceedings to quash the request. If the foreign country makes it impossible to remove the original documents requested, true copies may be sufficient.

In any proceeding to quash, the Secretary of the Treasury may seek to compel compliance with the request (section 982(b)(2)(A)). Jurisdiction over a proceeding to quash is retained in the U.S. district court for the district in which the person to whom the formal document request is mailed resides or is found (section 982(c)(2)(B)). If the person resides and is found outside the United States, the U.S. District Court for the District of Columbia has jurisdiction.

Under the current rules for administrative summonses, the commissioner has the burden of showing relevance and materiality of the requested records in a proceeding to quash. The commissioner must also show that the investigation will be conducted pursuant to a legitimate

purpose, that the information sought is not already within his or her possession, and that the administrative steps required by the Internal Revenue Code have been followed. If the U.S. district court rules against the taxpayer, the taxpayer may appeal the court's order immediately.

The Ninety-Day Period

The taxpayer generally has ninety days from the day of mailing to comply with a formal document request. However, the Secretary of the Treasury or a court having jurisdiction over a motion to quash the request may extend the period. The court may extend the period in response to a motion to extend the period that is not part of a motion to quash (section 982(d)(4)). For example, a court could find that a taxpayer had reasonable cause for failure to produce an item within ninety days and set a later date for presentation.

Other Non-Tax Reporting Requirements

In addition to reporting requirements for tax purposes, foreign investment in agricultural lands must be disclosed to the U.S. Department of Agriculture; foreign investment in U.S. business enterprises, including the ownership of real estate, is subject to reporting requirements of the U.S. Department of Commerce.

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