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Tax Issues in Planning Transnational Transactions: The U.S. Perspective

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Most industrial nations reserve the right to tax citizens, residents, nonresident aliens, and foreign businesses on income earned within their territorial borders. In the case of the United States, the Sixteenth Amendment to the Constitution approaches taxation from an even broader jurisdictional principle, stating:

> The Congress shall have the power to lay and collect taxes on income, *from whatever source* derived without apportionment among the federal states, and without regard to any census or enumeration.[1] (emphasis added).

Consequently, U.S. taxpayers are subject to U.S. taxation on their *worldwide income.*

With few exceptions, the United States exerts its taxing jurisdiction over the income of U.S. citizens and U.S. corporations regardless of

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1. U.S. Const. amend. XVI.

their place of residence, and regardless of where their activities legally (*de jure*) and economically (*de facto*) occur. This policy sometimes results in the same income being taxed at several levels. First, foreign-earned income of a U.S. person is usually taxed by the host jurisdiction. Second, most countries withhold taxes on dividends, interest, and royalty payments that leave their borders. Third, gross income (income before deduction of foreign income taxes and withholding taxes) is taxable in the United States when it is constructively received by a U.S. citizen or corporation. Finally, this income may be subject to state and possibly local income taxes, in both the host country and the United States.

This article begins by reviewing briefly the regime of tax rules affecting U.S. individuals and corporations investing and doing business abroad. The second part of the article addresses U.S. tax rules affecting foreign individuals and foreign corporations investing and doing business in the United States. The article provides an initial understanding of the treatment accorded various investment scenarios so that practitioners can plan transnational transactions to minimize U.S. income taxation.

I. Taxation of U.S. Citizens and Domestic Corporations

A. *Taxation of U.S. Citizens*

To alleviate the potential multiple tax burdens on U.S. citizens and residents upon their foreign source income, U.S. law provides three options. First, direct foreign income taxes may be reported as a deduction on the U.S. citizen's U.S. income tax return, reducing taxable income and lowering the total "tax take."[2] Second, instead of claiming a deduction, a taxpayer may apply direct foreign income taxes as a credit against U.S. income taxes.[3] Finally, under certain circumstances, qualifying individuals may elect to exclude foreign-earned income up to certain statutory amounts.[4] If this final option is elected, foreign taxes applicable to the amounts excluded cannot be claimed as a tax credit or deduction.[5] Also, both the tax credit option and the foreign-earned income exclusions are subject to lim-

2. I.R.C. § 164(a)(3) (1986).
3. *Id.* § 901(a).
4. *Id.* § 911(a).
5. *Id.* § 911(d)(6).

itations based on total foreign source income in the case of the foreign tax credit,[6] and on foreign source earned income in the case of the foreign-earned income exclusion.[7]

1. *Foreign Source Income*

Whether a taxpayer's earned income is considered to be from U.S. or foreign sources depends upon the place where the work is actually performed. This determination is unaffected by either the location of the employer (or other contractor) or the method of payment.[8] For example, salary received by U.S. citizens for work performed in Saudi Arabia is foreign source income even if payment is made by a U.S. corporation to the employees in their U.S. bank accounts. Besides salaries, earned income includes professional fees, commissions, employee benefits, and reimbursements.[9]

Unearned income (*e.g.*, dividends, interest, pensions, annuities, capital gains, gambling winnings, and alimony), usually qualifies as foreign source income when it is received from a foreign resident or from property used in a foreign country, and is not effectively connected with a U.S. trade or business.[10] For example, interest may be foreign source income even if the income is received in the United States and paid by a U.S. citizen who is a resident of a foreign country. In contrast, rents and royalties are foreign source income only if the property from which the income is derived is used in a foreign country.[11] Thus, the location of the property, not the residency of the payor, determines the source of rents and royalties.

2. *Foreign Tax Deductions or Credits*

If a U.S. taxpayer elects to credit foreign income taxes against his or her U.S. income tax, the amount of foreign source income he or she reports must be "grossed up" by the foreign taxes paid on that

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6. *Id.* § 904(a).
7. I.R.C. § 911(b)(2)(A) (1986).
8. Treas. Reg. § 1.911-3(a), (b) (1985).
9. I.R.C. § 911 (d)(2)(A) (1986); Treas. Reg. § 1.911-3(b) (1985). In the case of an individual engaged in a trade or business in which both his or her personal services and his or her capital are material income producing factors, a reasonable allowance, not to exceed 30 percent of the individual's share of the net profits of the trade or business, is considered earned income. I.R.C. § 911(d)(2)(B) (1986).
10. I.R.S. Pub. No. 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad* (Rev.) (Nov. 1987), at 7.
11. I.R.C. §§ 861(a)(1)(A), 862(a)(4) (1986).

income.[12] In most cases, a tax credit provides more benefits than does a deduction. A deduction may be more advantageous, however, if the foreign effective tax rate is high and foreign income is small when compared to worldwide income.

> *EXAMPLE*: *A*, a single individual, is a U.S. citizen living and working in the United States. During the current year *A* received an $850 dividend from a foreign corporation having no U.S. business or U.S. source income. A statement enclosed with the check showed the dividend to actually be $1,000 less withholding tax by the jurisdiction of the foreign corporation. Using 1988 tax rates and assuming *A* has $20,000 of U.S. source taxable income, *A* saves $108 if he elects the foreign tax credit.

	Tax Credit	Tax Deduction
U.S. source taxable income	$20,000	$20,000
Foreign source taxable income	1,000	1,000
Deduction for foreign tax		(150)
Taxable income	21,000	20,850
Tentative tax	3,559	3,517
Foreign tax credit	(150)	
Net tax	3,409	3,517

When the foreign effective tax rate does not exceed the U.S. effective tax rate, foreign taxes may be claimed as a credit without limit. In the event that the foreign tax rate *exceeds* the U.S. rate, however, the foreign tax credit is limited to the U.S. effective rate. In other words, foreign taxes may be used to offset U.S. taxes up to, but not exceeding, the amount of U.S. taxes attributable to foreign source income.

The formula for the tax credit limitation is:

$$\left[\frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}}\right] \text{U.S. Tax}$$

> *EXAMPLE*: For taxable year 1988, taxpayer *A* has income of $10,000 from Country *X* which imposes a 15% tax, and $20,000

12. *Id.* § 78.

from Country *Y* which imposes a 50% tax. *A* has taxable income of $70,000 from within the United States. The U.S. tax on $100,000 of taxable income before the credit is $22,500. The overall limitation is:

$$\left[\frac{\$\ 30{,}000}{\$\ 100{,}000}\right]\$\ 2{,}500 = \$\ 6{,}675$$

Thus, taxpayer *A* has an excess foreign tax credit of $4,825.[13]

Excess foreign tax credits may be carried over to years when the foreign tax credits are less than U.S. taxes on foreign source income. The carry-over credit is limited to a two year carryback and a five year carry-forward.[14]

Only foreign income taxes, war profits taxes, and excess profits taxes[15]—or taxes paid in lieu of such taxes[16]—qualify for the credit. When determining whether the tax is an income tax, U.S. criteria are applied.[17] Because they are not regarded as taxes on income, value added taxes, severance taxes, property taxes, and sales taxes do not qualify.[18] Such taxes, however, may be deductible.

3. *Foreign-Earned Income Exclusion*

Qualifying individuals (those who meet either the bona fide resident or the physical presence tests discussed below)[19] may separately elect to exclude up to $70,000 of their foreign-earned income,[20] as well as any employer-provided foreign housing income.[21] An individual may also exclude from gross income employer-provided housing and meals attributable to an employer-owned camp where the individual resides.[22] Elections to exclude foreign-earned income and employer-provided foreign housing income are made separately,[23] but indivi-

13. *Id.* § 904(a).
14. *Id.* § 904(c).
15. *Id.* § 901(b)(1).
16. I.R.C. § 903 (1986).
17. Treas. Reg. § 1.901-2(a)(1)(ii) (1983).
18. *See* Treas. Reg. § 1.901-2(a)(2).
19. *See infra* notes 25-37 and accompanying text.
20. *See* I.R.C. § 911(a)(1) (1986) (allowing the election); I.R.C. § 911(b)(2)(A) (1986) ($70,000 limitation).
21. I.R.C. § 911(a)(2) (1986).
22. *Id.* § 119(c).
23. Treas. Reg. § 1.911-7(a)(1) (1985).

duals may not obtain tax benefits for the same income under both exclusions.[24]

a. *Bona Fide Resident and Physical Presence Test.*

While U.S. citizens may qualify for the foreign-earned income exclusion under either the bona fide resident or physical presence tests, U.S. residents who are citizens of another country may qualify only under the physical presence test unless a U.S. tax treaty with their country provides otherwise.[25] The bona fide resident test requires that, during an uninterrupted period that includes an entire tax year, the individual must: (1) maintain the status of a bona fide resident in one or more foreign countries;[26] (2) have foreign-earned income from personal services;[27] (3) receive the foreign income no later than the year following the service;[28] and (4) be paid by an entity other than the United States government or one of its agencies or instrumentalities.[29]

If taxpayers continue to own a home in the United States or make brief business or personal trips to the United States, they do not jeopardize their bona fide status. The taxpayer, however, must have a clear intent to return to the foreign tax home or a new one without unreasonable delay.[30] The bona fide foreign resident generally is expected to work outside the United States for an extended or indefinite period and establish a permanent family residence in the work area.[31] An intention eventually to return to the United States is not relevant to the test.[32] Residency status is denied any taxpayer who makes a statement to authorities in the foreign country that he is not a resident of the foreign country and, consequently, is exempt from taxation as resident of that country.[33]

24. I.R.C. § 911(d)(6) (1986).
25. *Id.* § 911(d)(1)(A). The bona fide resident alternative is only available to U.S. citizens.
26. *Id.* § 911(d)(1).
27. *Id.* § 911(d)(2)(A).
28. *Id.* § 911(b)(1)(B)(iv).
29. I.R.C. § 911(b)(1)(B)(ii) (1986). Pensions and annuities also do not constitute foreign earned income. *Id.* § 911(b)(1)(B)(i), (iii).
30. Treas. Reg. § 1.911-2(b) (1985).
31. *Id.* § 1.911-2(c). Principles set out in I.R.C. § 871 (1986) and Treas. Reg. § 1.871-2(6) (1986) are adopted to determine if an individual is a bona fide resident of a jurisdiction. In general, this determination is based upon the acts and statements of the individual to show whether he has a definite intention to acquire residence within a jurisdiction.
32. Treas. Reg. § 1.871-2(b) (1957).
33. I.R.C. § 911(d)(5) (1986).

To qualify under the physical presence test, the taxpayer's "tax home" must not only be in a foreign country, but the individual must have been present in one or more foreign countries for at least 330 days during *any* twelve consecutive months.[34] Unlike the bona fide resident test, exclusions under the physical presence test apply only to those months that fall into one or more of the qualifying twelve month periods.[35] Taxpayers are allowed considerable freedom in selecting the twelve months. They may be any consecutive twelve months and two periods may overlap.[36]

EXAMPLE: The taxpayer made trips to and from a foreign country in connection with his work as follows:

Arrived in Foreign County	Arrived in United States
March 10, 1988	February 1, 1989
March 7, 1989	June 1, 1989

During the 12 consecutive months ending on March 10, 1989, the taxpayer was present in the foreign country for at least 330 full days (365 days less 28 days in February and 7 days in March, 1989). Therefore, all income earned in the foreign country through March 10, 1989 remains eligible for the exclusion. Income earned from March 11, 1989 through May 31, 1989 is also eligible for the exclusion because the taxpayer was present in the foreign country for 330 days during the 12 consecutive months ending on May 31, 1989.

If neither the bona fide resident nor the physical presence test is met solely because the taxpayer was forced to leave the foreign tax home due to war, civil unrest, or other adverse conditions, the minimum time requirement may be waived. The U.S. Treasury Department grants waivers, based on information provided by the U.S. State Department.[37]

b. *Excludable Amounts*

In addition to salaries, many U.S. corporations provide housing or housing allowances for their expatriate employees. Basically, em-

34. *Id.* § 911(d)(1)(B). An individual's "tax home" for this purpose is considered to be his or her regular or principal place of business or, if there is no such place, then his or her regular place of abode. Treas. Reg. § 1.911-2(b) (1985).

35. Treas. Reg. § 1.911-2(d)(2) (1985).

36. *Id.* § 1.911-2(d)(3).

37. I.R.C. § 911(d)(4) (1986).

ployees living in employer-provided housing must report on their income tax returns, foreign-earned income equal to the housing costs. Individuals may exclude a portion of the employer housing costs limited to the "housing cost amount" which is computed as "qualifying foreign housing expenses" less sixteen percent of the GS-14 (Step 1) salary level of a U.S. government employee (prorated on a daily basis if the taxpayer does not qualify for the exclusion the entire year).[38]

Qualifying foreign housing expenses include all reasonable costs incurred to house an employee and, where appropriate, the spouse and all dependents living with the employee.[39] Examples of acceptable expenses are rent, insurance, utilities, repairs, and other costs related to the housing and its furnishings, plus parking fees and local telephone charges. Acceptable expenses do not include capital expenditures, depreciation, domestic help, or expenses that can be claimed as itemized deductions, such as interest and property taxes.[40]

In most instances, the housing must be near the foreign work place. Where living conditions in the area are dangerous, unhealthy or otherwise adverse, however, housing expenses also include costs of maintaining a separate foreign home for the spouse and the dependents.[41] Taxpayers who pay qualifying housing expenses and are not reimbursed by their employer may deduct the expenses.[42] This deduction, however, may not exceed the excess of the taxpayer's includable foreign-earned income over the foreign-earned income and housing cost exclusions allowed.[43] Any excess expenses may be carried forward one year and deducted to the extent there remains taxable foreign-earned income in that year.[44]

The third special exclusion is available to employees living in employer-provided camps, generally located in hardship areas. These individuals qualify as living and eating on the business premises at the convenience of the employer; and, as a result, all of their employer-provided meals and lodging are excludable income.[45]

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38. *Id.* § 911(c)(1).
39. *Id.* § 911(c)(2).
40. *Id.*; Treas. Reg. § 1.911-4(b)(2) (1985).
41. I.R.C. § 911(c)(2)(B) (1986); Treas. Reg. § 1.911-4(b)(5) (1985).
42. I.R.C. § 911(c)(3)(A) (1986); Treas. Reg. § 1.911-4(d) (1985).
43. I.R.C. § 911(c)(3)(B) (1986); Treas. Reg. § 1.911-4(e)(1) (1985).
44. I.R.C. § 911(c)(3)(C) (1986); Treas. Reg. § 1.911-(4)(e)(2) (1985).
45. I.R.C. § 119(c) (1986).

B. *Taxation of U.S. Corporations Doing Business Abroad*

When a U.S. corporation engages in international operations, additional considerations are added to an already complex subject of taxation. As might be expected, the tax rules of each country differ regarding the types of taxes, rate structures, tax bases, and special provisions. These rules may also be modified through bilateral treaties negotiated between the United States and other countries. In determining the conduct of overseas operations, a U.S. corporation must not only take into account the U.S. tax consequences of its business but, also, the tax regimes of other jurisdictions.

1. *Foreign Tax Credits or Deductions*

Regardless of the form of operation used by a U.S. corporation in its overseas operations, all direct foreign taxes deemed paid or accrued by the U.S. corporation may be claimed as either a business deduction or a tax credit.[46] These calculations for a corporation differ from those for an individual because creditable foreign taxes include not only those paid directly by the U.S. corporation (*e.g.*, foreign withholding taxes on dividends) but also those paid indirectly by it on foreign source income (*e.g.*, foreign income taxes paid by its subsidiary).[47] In order to claim a credit for foreign taxes paid by its subsidiary, the U.S. corporation must own at least ten percent of the foreign corporation's voting stock at the time the U.S. corporation receives a distribution from the foreign corporation.[48] The foreign source income is "grossed up" in the same manner for the corporation as for the individual except that the corporate gross income includes all foreign taxes deemed paid by the U.S. corporation on its includable foreign income.[49]

The rule governing foreign taxes deemed paid by U.S. corporations through their foreign subsidiaries extends to foreign taxes paid by foreign corporations owned by the foreign subsidiaries. If a ten percent or more U.S.-owned foreign corporation (first tier) owns at least ten percent of another foreign corporation (second tier) and the second tier corporation owns at least ten percent of a third foreign

46. *See id.* §§ 164(a)(3), 275(a)(4)(A), 27(a), 901(a).
47. I.R.C. § 902(a) (1986).
48. *Id.*
49. *Id.* § 78; Treas. Reg. § 1.78-1(a), (b) (as amended in 1984).

corporation (third tier), a percentage of foreign taxes incurred by all of these corporations may qualify as a foreign tax credit or deduction.[50] A first tier corporation, however, must meet the ownership test before a second tier corporation can qualify.[51] Similarly, both the first and second tier corporations must meet the test before a third tier corporation can qualify.[52] In addition, the U.S. corporation must own indirectly at least five percent of the foreign corporation in order to claim a share of its taxes.[53] As in the ten percent requirement, the five percent ownership test must be met at the first tier before the second tier can qualify,[54] and at the first and second tiers before the third tier can qualify.[55] Thus, in a three-tier case, 50 percent ownership at the first level, twenty percent at the second level and 50 percent at the third level, would meet minimal ownership thresholds.

> *EXAMPLE*: *X*, a U.S. corporation, owns 40% of foreign corporation *A* (first tier). *A* owns 30% of foreign corporation *B* (second tier) and *B* owns 80% of foreign corporation *C* (third tier). The 10% test is met at all levels and *X* has an indirect ownership of at least 5% in each tier as determined below:
>
> *X* owns [40% x 30%] = 12% indirectly of *B*
> *X* owns [12% x 80%] = 9.6% indirectly of *C*
>
> Thus, *X* may claim a portion of the foreign taxes incurred by *A*, *B* and *C*. If, however, *B* owned only 35% of *C*, *X* would not be entitled to credit any portion of *C*'s foreign taxes because the 5% test would not be met (*i.e.*, *X* owns only 4% indirectly of *C*). If *A* only owned 8% of *B*, the 10% test between *A* and *B* is not met, which breaks the chain of required ownership altogether.

If the foreign operation is a branch, rather than a subsidiary, total foreign source income and total foreign taxes for the year are included in the U.S. corporation's calculations, regardless of how much income is received currently by the U.S. corporation. When there is more than one subsidiary or branch, foreign source income and foreign taxes from all operations in all countries are totalled and calculations are made on an overall basis. When income is includable from both

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50. I.R.C. § 902(b) (1986).
51. *Id.* § 902(b)(1).
52. *Id.* § 902(b)(2).
53. *Id.* § 902(b)(3).
54. *Id.* § 902(b)(3)(A).
55. I.R.C. § 902(b)(3)(B) (1986).

high and low (compared to the United States) tax rate countries, this approach proves particularly beneficial. Consequently, to avoid abuse, the law establishes separate foreign tax credit "baskets" in which separate calculations and foreign tax credit limitations are made for different types of income earned overseas.[56] The creation of these foreign tax credit limitation "baskets" is expected to result in greater U.S. taxation of passive, financial services, and shipping income which is normally taxed at low rates in foreign countries, while depriving U.S. taxpayers of using high foreign taxes imposed against high withholding tax interest to shelter lightly taxed foreign income from U.S. taxation.

2. *Tax Incentives for Foreign Operations*

A U.S. corporation may establish one or more separately taxed entities for the conduct of its business overseas. When a company exports products from the United States, it may be possible to reduce U.S. tax on such sales by channeling them through a special corporation known as a "foreign sales corporation" (FSC). In other instances, a company may choose to generate sales through a foreign subsidiary or branch located near the customer. Although numerous factors must be considered when deciding which entity should make the sale to the foreign customer, it is essential that U.S. exporters adopt a policy for such sales in order to minimize U.S. taxes.

a. *Domestic International Sales Corporations and Foreign Sales Corporations*

Most industrial nations provide tax incentives to exporters. The General Agreement on Tariffs and Trade (GATT), however, placed restrictions on the type of tax incentives the signatory nations may provide.[57] Primarily, GATT members may not exempt exports from direct taxes. In order to remain "GATT-legal," the United States, unlike its major trading partners, has centered its export tax incentives upon special corporations, namely, the Domestic International Sales Corporation (DISC)[58] and the FSC.[59] After 1984, the DISC may be

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56. *Id.* § 904(d).
57. *See Foreign Sales Corporations*, Tax Mgmt. (BNA) 264-4th, at A-3 (Aug. 29, 1988), *citing* Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade, GATT Doc. No. MTN/NTM/W236 (1979).
58. I.R.C. §§ 991-997 (1986).
59. *Id.* §§ 921-927.

used to defer tax on income attributable to no more than $10 million of "qualified export gross receipts."[60] In addition, the shareholders are charged interest on their potential tax that would be assessed if the deferred DISC income were distributed at the end of the current year.[61]

Because of these restrictions on a DISC, a U.S. exporter may want to use an FSC, whereby a portion of the taxable income of the entity attributable to export sales is exempt from U.S. income taxation. In order to qualify for the exemption, however, the FSC must meet the following rules:

— Be created or organized under the laws of a U.S. possession (other than Puerto Rico) or a foreign country which has an exchange of information agreement with the United States;[62]

— Have no more than 25 shareholders on any day throughout the year;[63]

— Have no preferred stock outstanding on any day throughout the year;[64]

— Maintain permanent books of account at an office outside the United States in addition to all records of the corporation being kept at a U.S. office;[65]

— Have at least one non-U.S. resident (who may be a U.S. citizen) on its board of directors at all times during the year;[66]

— Not be a member of a controlled group that includes a DISC;[67]

— Make a timely FSC election;[68] and

— Adopt the taxable year used by the shareholder with the greatest percentage of voting stock.[69]

In addition, an FSC must meet foreign management and foreign economic process tests.[70] The foreign management test is met if the United States is not the site for: (1) formal meetings of the directors and shareholders; (2) the principal bank account of the FSC; and (3) the bank account used to pay all dividends, legal and accounting fees, and officer and director salaries.[71] The foreign economic process

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60. *Id.* § 995(b)(1)(E).
61. *Id.* § 995(f).
62. *Id.* § 922(a)(1)(A); *see also* I.R.C. § 927(e)(3) (1986).
63. I.R.C. § 922(a)(1)(B) (1986).
64. *Id.* § 922(a)(1)(C).
65. *Id.* § 922(a)(1)(D).
66. *Id.* § 922(a)(1)(E).
67. *Id.* § 922(a)(1)(F).
68. I.R.C. § 922(a)(2) (1986).
69. *Id.* § 441(h)(1).
70. *Id.* § 924(b)(1).
71. *Id.* § 924(c).

test is met if: (1) the FSC or its agent conducts the solicitation (other than advertising), negotiation or contracting related to an export sale outside the United States; and (2) the foreign direct costs of an export sale are at least half of the total direct costs consisting of five categories.[72] Alternatively, foreign direct costs must be 85 percent of the total direct costs of any two of the following five categories:[73] (1) advertising and sales promotion; (2) processing customer orders and arranging for delivery; (3) transportation from the time the property is acquired by the FSC until delivery to the customer; (4) determination of a final invoice or statement of account and its transmittal and collection; and (5) assumption of the credit risk.[74]

Exporters are not subject to either the foreign management or the foreign economic process test if they elect "small FSC" status.[75] The small FSC's annual tax exemption is limited to the taxable income attributable to no more than $5 million of foreign trading gross receipts.[76] The FSC, however, must still satisfy the foreign economic tests to use the statutory pricing rules described below.

If the FSC meets all the above requirements, a portion of the FSC's foreign trade income is exempt from tax.[77] If the FSC utilizes either of the statutory pricing formulas described below and has a corporate shareholder, 15/23 (approximately 65 percent) of foreign trade income is excluded.[78] In calculating the foreign trade income of the FSC, the U.S. supplier/shareholder may select a transfer price which results in FSC taxable income that does not exceed the greater of: (1) 23 percent of the combined taxable income that the U.S. supplier/shareholder derives from the export sales; or (2) 1.83 percent of such export sales limited to twice the amount determined in the combined taxable income method.[79]

> *EXAMPLE*: FSC purchases qualifying export property from a supplier/shareholder and resells it to an unrelated foreign buyer for $1,000. The FSC's expenses are $230 and the supplier/shareholder's

72. *Id.* § 924(d)(1).
73. I.R.C. § 924(d)(2) (1986).
74. *Id.* § 924(e).
75. *Id.* § 924(b)(2)(A).
76. *Id.* § 924(b)(2)(B)(i).
77. *Id.* § 921(a).
78. I.R.C. § 923(a)(3) (1986). 16/23 of foreign trade income is excluded from taxable income. However, this fraction is reduced to 15/23 in the case of a FSC owned by a C corporation. *Id.* § 291 (a)(4).
79. *Id.* § 925(a).

cost of goods sold is $520 and its selling expenses are $110. The statutory transfer price is determined as follows:

Gross receipts	$1,000
Cost of goods sold	(520)
FSC's expenses	(230)
Supplier/shareholder selling expenses	(110)
Combined taxable income	$140

	23% Method	1.83% Method
Sales price	$1,000	$1,000
FSC expenses	(230)	(230)
FSC taxable income		
23% x $140	(32.20)	
1.83% x $1,000		(18.30)
Transfer price	$ 737.80	$ 751.70

Thus, the 23% method would be selected because it results in a greater amount of income attributable to the FSC. The exempt income then is $21 ($32.20 *x* 15/23). The remaining amount $11.20 ($32.20 - $21) is taxable to the FSC. The U.S. supplier/shareholder is taxed on $107.80 ($140 - 32.20).

Assuming a 34% corporate tax rate, the tax savings from utilizing the FSC is $7.14 ($140. *x* .34) -[($11.20 *x* .34) + ($107.80 *x* .34)].

b. *The Possessions Corporation*

The possessions corporation (PC) is a tax-advantaged U.S. corporation generally intended to encourage U.S. organizations to establish active business operations in U.S. possessions, most notably in Puerto Rico. If the PC qualifies, it receives a special tax credit equal to the U.S. tax attributable to its possession source income.[80] Because of this tax credit and other special tax exemptions granted by the Puerto Rican government, PC's have extremely low effective tax rates (generally less than ten percent).

A U.S. corporation may elect to be taxed as a PC if, during the three preceding years, it earned at least 80 percent of its gross income

80. *Id.* § 936(a)(1).

in a U.S. possession and at least 75 percent of its gross income is from active business operations conducted in a U.S. possession.[81] An election cannot be revoked for at least ten years without permission from the IRS, usually granted only for hardship reasons where tax avoidance is not a factor.[82]

In the past, U.S. corporations abused this incentive for doing business in Puerto Rico by transferring their intangible property (patents, copyrights, etc.) to a PC after deducting all research and development expenses attributable to the intangible property on its U.S. tax return. By then transferring the intangible to the PC, the U.S. corporation attempted to shelter future earnings. The law now provides that the PC's income from such intangibles is treated as U.S. source income to the corporation's shareholders rather than possession source income, thereby eliminating the tax credit on such income.[83] There is an exception for income from intangibles held by a PC with a significant business presence (generally measured in terms of local employment) in the possession whereby the U.S. parent and its PC share in intangible income received by the PC based upon a cost sharing or profit splitting formula.[84]

3. *Controlled Foreign Corporations*

U.S. multinational corporations may defer indefinitely (postpone payment of) U.S. tax on income earned outside the United States by their foreign subsidiaries. To prevent U.S. corporations from artificially shifting profits from international operations to their foreign subsidiaries via "transfer pricing,"[85] the United States has created the concept of the "controlled foreign corporation" (CFC). The objective of the CFC rules is to prevent corporations from establishing subsidiaries in tax haven countries for the sole purpose of tax avoidance. The law provides that U.S. stockholders are taxed on their pro rata share of certain types of income earned by a CFC (called "Subpart F" income) regardless of when the U.S. shareholder of the CFC receives the income.[86] Thus, tax deferral privileges ordinarily granted to foreign corporations are eliminated when CFC

81. *Id.* § 936(a)(2).
82. *Id.* § 936(e)(2).
83. I.R.C. § 936(h)(l)(A) (1986).
84. *Id.* § 936(h)(5).
85. For a discussion of the allocation of income and deductions among affiliated companies pursuant to I.R.C. § 482, *see infra* notes 105-113 and accompanying text.
86. I.R.C. § 951(a)(1)(A)(iii) (1986).

requirements are met. The shareholders, however, are not taxed again on that income when it is actually distributed to them.[87]

A foreign corporation constitutes a CFC and its U.S. shareholders currently must pay tax on its "Subpart F income" if more than 50 percent of its voting power or value is controlled directly or indirectly at any time during the year by U.S. shareholders.[88] U.S. shareholders, for this purpose, are U.S. persons who own at least ten percent of the foreign corporation's voting power.[89] Thus, if 46 percent of a foreign corporation's stock is owned by one U.S. shareholder and the remaining 54 percent is owned equally by six unrelated U.S. persons (nine percent each), it cannot be a CFC. If any one of the six U.S. persons, however, acquires an additional one percent, directly or indirectly, the foreign corporation becomes a CFC. This change in status occurs because the 46 percent shareholder and the ten percent shareholder together meet the 50 percent and ten percent requirement.

Subpart F income includes those types of income that had been frequently shielded from U.S. taxation through artificial arrangements with subsidiaries in tax haven countries. The major types include: (1) income earned from providing insurance protection for U.S. property of residents;[90] (2) passive income, such as dividends, interests, rents, royalties, and gains from sale of stock;[91] (3) sales commissions, fees, and profits earned as a result of buying and selling goods which are neither produced nor used in the CFC's country when one of the parties involved in the transaction is related to the CFC;[92] and (4) income for management, maintenance, and other services performed outside the CFC's country of incorporation for the benefit of a related party.[93]

Generally, if Subpart F income constitutes less than the lesser of five percent of gross income or one million dollars, none of the income is taxed to the U.S. shareholders.[94] On the other hand, if Subpart F income exceeds 70 percent of the CFC's total income, 100 percent of the CFC's income is treated as Subpart F income.[95] In

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87. *Id.* § 959(a).
88. *Id.* § 957(a).
89. *Id.* § 951(b).
90. *Id.* §§ 952(a)(1), 953.
91. I.R.C. §§ 952(a)(2), 954(a)(1), 954(c) (1986).
92. *Id.* §§ 954(a)(2), (d).
93. *Id.* §§ 954(a)(3), (e).
94. *Id.* § 954(b)(3)(A).
95. *Id.* § 954(b)(3)(B).

addition, if a CFC's Subpart F income cannot be repatriated to the United States because of currency restrictions, it is not taxable to the U.S. shareholders until the restrictions are removed.[96]

4. *Foreign Personal Holding Company*

U.S. shareholders of a foreign corporation may avoid taxation on all or part of the corporation's undistributed income under the CFC rules, yet still be taxed under the "foreign personal holding company" (FPHC) rules. A foreign corporation is an FPHC if at least 50 percent of its gross income (or 60 percent if it was not an FPHC in the previous year) is FPHC income and more than 50 percent of the voting power or value of its outstanding stock was owned at any time during the taxable year directly or indirectly by no more than five U.S. citizens or residents.[97]

FPHC income consists of passive income (*e.g.*, dividends, interest, royalties, annuities, net gains from assets which generate passive income, passive leasing and licensing income, and rents) that does not constitute at least 50 percent of the gross income of the corporation. FPHC income also includes income from personal service contracts and payments for the use of its property by a shareholder who owns directly or indirectly at least 25 percent in value of the FPHC's outstanding stock.[98]

FPHC shareholders, like CFC shareholders, are deemed to have received constructive dividends equal to their interest in undistributed FPHC income. When these dividends are distributed, they are not taxed again and the shareholders simply decrease their basis in the stock.[99]

5. *Passive Foreign Investment Companies*

The Tax Reform Act of 1986 added the passive foreign investment company (PFIC) to the panoply of specially defined foreign corporations that receive special U.S. income tax treatment. The objective is to deprive U.S. taxpayers of the economic benefit of deferral of U.S. tax on a U.S. taxpayer's share of the undistributed income of a foreign investment company which has predominantly passive income—no matter how small that interest might be.

96. I.R.C. § 964(b) (1986).
97. *Id.* § 552(a).
98. *Id.* § 553(a).
99. *Id.* § 959(a).

A foreign corporation is a "passive foreign investment company" (PFIC) if 75 percent or more of its gross income for the tax year is passive income, or at least 50 percent of the average value of its assets during the tax year produce, or are held for the production of, passive income.[100] The advantage of deferral is negated by requiring U.S. taxpayers owning shares in a PFIC to pay tax plus an interest charge based on the value of tax deferred at the time the shareholder disposes of his or her PFIC investment, or on receipt of an "excess distribution."[101] An excess distribution for a year is any distribution in respect of stock to the extent that it represents a ratable portion of the total distributions on the stock during the year that exceeds 125 percent of the average distributions during the three prior years.[102] In lieu of this treatment, shareholders of a PFIC individually may elect qualified electing fund[103] status for the PFIC in which the electing U.S. shareholders include in gross income their shares of the PFIC's earnings and profits each year.[104]

C. *Allocating Income and Deductions Among Affiliated Companies*

1. *Section 482*

Few business decisions have greater impact on the operations of multinational organizations than those involving pricing policies between affiliated companies located in different countries. Transfer prices between units of the same organization will be respected for U.S. tax purposes only if such prices are at "arm's length" (*i.e.*, prices that are based on market values between unrelated businesses).[105] Because many multinationals often do not operate in this manner, the Internal Revenue Service (IRS) may reallocate income and deductions between affiliated companies as empowered by Section 482. Specifically, this Section and its regulations deal with five

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100. *Id.* § 1296(a).
101. I.R.C. § 1291(a) (1986).
102. *Id.* § 1291(b)(2)(A).
103. *Id.* § 1295.
104. *Id.* § 1293(a).
105. *See* Levy & Rachelman, *Section 482 - The Super Royalty Provisions Adopt the Commensurate Standard*, 41 TAX LAW. 611 (1988) (an excellent article which explains the arm's length standard in the context of intangible pricing). Also, in October 1988, the Treasury Department released a comprehensive "White Paper" study of intercompany pricing for intangibles transferred to overseas subsidiaries. *Id.*

types of transactions: (1) interest on inter-company loans;[106] (2) services performed for a related party;[107] (3) use of tangible property by a related party;[108] (4) inter-company transfers of intangible property;[109] and (5) inter-company sales of tangible property.[110] The law also prohibits importers from using a transfer price for federal income taxation which exceeds the comparable U.S. customs value assigned to that property.[111]

As might be expected, the law in this area is vague, and allows the IRS and the courts considerable interpretative latitude. It is the responsibility of the taxpayer, however, to convince the IRS and, if necessary, a court, that its pricing policies with its foreign affiliates are the same as those with unaffiliated companies. Simply showing that the company's pricing method is based on sound business reasons will not prevent the IRS and the courts from adjusting income between related parties.[112] Where such an adjustment results in double taxation of the same income by the United States and another country, taxpayers may seek relief if the United States has an income tax treaty with that other nation which provides for the competent authority of each treaty country to pursue an equitable solution to the double taxation problem.[113]

2. *Allocation of Deductions*

In the United States, the authority governing the allocation of deductions between U.S. companies and their foreign affiliates is provided by regulations which allocate business deductions first on the basis of the class of gross income to which that deduction is attributable.[114] The law lists fifteen different classes of income that are applicable, including business income, rents, interest, and dividends.[115] The deductions, once allocated to a class of income, are

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106. Treas. Reg. § 1.482-2(a) (as amended in 1988).
107. *Id.* § 1.482-2(b).
108. *Id.* § 1.482-2(c).
109. *Id.* § 1.482-2(d).
110. *Id.* § 1.482-2(e).
111. I.R.C. §§ 1059A - 1(b)(4) (1986).
112. 58 T.C. 10 (1972), *aff'd*, 489 F.2d 957 (2nd Cir. 1973), *cert. denied*, 419 U.S. 829 (1974).
113. For a complete discussion of the competent authority mechanism in U.S. income tax treaties, *see Income Tax Treaties - Administrative and Competent Authority Aspects*, Tax Mgmt. (BNA) 402-2nd, at A-2 (Jan. 1, 1988).
114. Treas. Reg. § 1.861-8(a)(2) (as amended in 1984).
115. *Id.* § 1.861-8(a)(3).

then apportioned between U.S. source and foreign source income.[116]

Even though a multinational's taxable income from all sources usually remains unchanged regardless of whether deductions are allocated to foreign or U.S. sources, many pay higher taxes as a result of an allocation of deductions to foreign source income because of the effect the reallocation has on the multinational's foreign tax credit limitation.

In general, Section 904(a) limits foreign income taxes that may be used to offset U.S. income tax to the amount of U.S. income tax as the taxpayer's foreign source income. This limitation is expressed as follows:

$$\left[\frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}}\right]\text{U.S. Tax Before Credit}$$

Consequently, any reduction in foreign source taxable income by allocating additional expenses to it effectively reduces a taxpayer's maximum foreign tax credit dollar for dollar.

A shift in deductions from U.S. source income to foreign source income lowers the foreign tax credit limitation. This issue is complicated even further if, after a tax audit, the IRS reallocates income under Section 482, which results in a change of gross income relationships to the extent that deductions must be reallocated and reapportioned between U.S. and foreign sources.

> *EXAMPLE*: During 1988, U.S. corporation *A* reports $10,000 of foreign source taxable income and accrues $3,200 of foreign taxes. *A's* worldwide taxable income is $20,000. Upon audit, the IRS allocates $1,000 of expenses from the U.S. to *A's* foreign activities. Although the adjustment does not change *A's* $6,800 (20,000 x 34%) gross U.S. income tax liability, it does reduce *A's* foreign tax credit limitation as follows:
>
> $$\text{Pre-audit limitation} \quad \$6{,}800 \left[\frac{\$10{,}000}{\$20{,}000}\right] = \$3{,}400$$
>
> $$\text{Post-audit limitation} \quad \$6{,}800 \left[\frac{\$\ 9{,}000}{\$20{,}000}\right] = \$3{,}060$$

This changes net U.S. tax liability and results in an excess foreign tax credit which can be carried back or forward. If the corporation

116. *Id.* § 1.861-8(a)(2).

continues to operate in a foreign country whose rates exceed those of the United States, the excess credits may never be used.

D. *Foreign Currency Gains And Losses*

U.S. individuals or corporations may transact international business in many currencies. In most instances, however, they must report U.S. taxable income in dollars.[117] Because the exchange rate from a particular foreign currency to dollars may change over time, these fluctuations produce taxable gains or losses attributable to the price fluctuations. Whether these foreign currency exchange gains and losses are ordinary or capital depends upon the nature of each transaction (*i.e.*, gains and losses that arise in the normal course of business are ordinary, while those that arise from investment or personal transactions produce capital gains or losses).

With certain exceptions that are beyond the scope of this article, U.S. taxpayers must use the U.S. dollar for recording international transactions.[118] Where the taxpayer has no physical location in a foreign country, exchange gains or losses in that country are determined on a transaction by transaction basis. Gain or loss for each transaction is determined in the foreign currency and then translated into U.S. dollars at the exchange rate in effect on that date, or, if more than one rate is in use, the one that properly reflects income.[119] The difference between this amount and the actual amount received is the exchange gain or loss. This gain or loss is reported when collection (or payment) is made, regardless of whether the accrual or cash method of accounting is used.

In the case of a United States corporation with a foreign branch, the profit or loss of the branch for the year is computed in the foreign branch's currency and then translated into U.S. dollars at the weighted average exchange rate for the taxable year.[120] When distributions are made from this income, any exchange gain or loss (*i.e.*, the difference between the exchange rate at the date of distribution and the weighted average rate used to report the income) is recognized as ordinary income or loss.[121] Branch losses resulting from

117. Treas. Reg. § 1.964-1(d)(7)(i) (as amended in 1983; Treas. Reg. § 1.902-1(g) (as amended in 1977).
118. Where the taxpayer maintains a "qualified business unit," it may keep its books and records for U.S. income tax purposes in a foreign currency. *See* I.R.C. §§ 985-989 (1986).
119. Treas. Reg. §§ 1.964-1(d)(7), (8) (as amended in 1983).
120. I.R.C. § 989(b)(4) (1986).
121. *Id.* § 987(3)(B).

translation of foreign currency into U.S. dollars are deductible by the U.S. taxpayer only to the extent of the U.S. taxpayer's dollar basis in the branch.[122]

Generally, dividend income paid in a foreign currency by a foreign corporation to a U.S. taxpayer is translated based on exchange rates in effect when the dividends are received.[123] Subpart F income and FPHC income are translated in the same manner as income from a branch.[124] When distributions are made from this income, any exchange gain or loss (*i.e.*, the difference between the exchange rate at the date of distribution and the weighted average rate used to report the income) is recognized as foreign source ordinary income or loss.[125]

When taxpayers are unable to convert foreign currencies into U.S. dollars because of exchange restrictions imposed by the host government, they may elect to defer the U.S. taxation on such income until the blockage restrictions are removed. The deferral elections for blocked currency generally are not available for income that is includable, regardless of whether distributed to the taxpayers (*e.g.*, FPHC income or income from a foreign partnership). The deferral is also unavailable when the taxpayer is able to use the funds in the foreign country.[126]

II. U.S. Taxation of Nonresident Aliens, Partnerships with Nonresident Alien Partners, and Foreign Corporations

Following the 1986 Tax Reform Act, foreign investment in the United States, already an attractive proposition because of the stability of the American economy, became far more attractive due to an across-the-board reduction of tax rates on many types of transactions.[127] As a result, foreign persons investing in the United States and their tax advisors need to have an awareness of the issues which

122. H.R. Rep. No. 841, 99th Cong., 2d Sess. at II-677 (1986).
123. I.R.C. §§ 986(c), 989(B) (1986).
124. *Id.* § 989(b)(3).
125. *Id.* § 988(a)(1)(A).
126. Rev. Rul. 74-351, 1974-2 C.B. 144.
127. The advantage provided by the Tax Reform Act of 1986 may be only temporary in that the Act has provided the impetus for almost all other developed nations to remain competitive through revision of their tax codes. (For example, the Act reduced the highest individual marginal rate from 50 percent to 28 percent and the highest corporate marginal rate from 46 percent to 34 percent. *See* I.R.C. §§ 1, 11 (1986).) Indeed, when the dust settles, the post-reform rate differentials among the codes of the nations with market economies may be relatively unchanged. Nevertheless, the absolute reduction in rates is remarkable. *See Japanese House Approves Overhaul in Tax Laws*, Wash. Post, Nov. 17, 1988, at A35.

arise in tax planning for investment in the United States by nonresident aliens and foreign corporations.[128]

A. *U.S. Tax Jurisdiction*

Federal income tax law determines the U.S. taxation, if any, of nonresident aliens and foreign corporations in the United States based upon the type of income earned and the location where that income is earned. In general, if nonresident aliens and foreign corporations conduct a trade or business in the United States at some time during the year, all income that is "effectively connected" with that U.S. trade or business will be taxed in the same manner and at the same rates as U.S. citizens and domestic corporations.[129] On the other hand, if no such trade or business is conducted in the U.S., nonresident aliens and foreign corporations are taxed only on their investment income derived in the United States.[130]

1. *Nonresident Alien Defined*

As previously indicated, U.S. citizens are taxed on their worldwide income while nonresident alien individuals are only subject to U.S. tax on their U.S. source income and income effectively connected with a U.S. trade or business. For this purpose, a nonresident alien is defined as any individual who is neither a citizen of the United States nor a resident of the United States.[131] The term "resident" includes an individual lawfully admitted for permanent residency (*i.e.*, who holds a green card) or who meets a "substantial presence" test.[132] The substantial presence test requires that the individual be present in the United States on at least 31 days during the current year, and that the sum of the number of days on which the individual was present in the United States in the current and the two preceding calendar years as adjusted by a fraction (one third in the case of the

128. Sections 7701(a)(4) and (5) define a foreign corporation as any corporation not created or organized under federal law or the laws of one of the 50 states or the District of Columbia. The "United States" includes the sea bed and subsoil of marine areas adjacent to the territorial waters of the United States. *See* I.R.C. § 638 (1986); Treas. Reg. § 1.638-1(a)(1) (1973). The meaning of United States generally does not include United States possessions. I.R.C. § 7701(a)(9) (1986).

129. I.R.C. § 871(b)(1) (1986) (individuals); I.R.C. § 882(a)(1) (1986) (foreign corporations).

130. *Id.* § 871(a) (individuals); § 881(a) (foreign corporations).

131. *Id.* § 7701(b)(1)(B).

132. *Id.* § 7701(b)(1)(A).

first preceding year and one sixth for the second preceding year) equals or exceeds 183 days.[133]

> *EXAMPLE: T* is a citizen of Country *X*. *T* is present in the United States for 60 days in 1988, 123 days in 1989, and 140 days in 1990. For purposes of the physical presence test, *T* is considered in the United States for a total of 191 days during the 3-year period, (140 x l) + (123 x .333) + (60 x .167). Consequently, *T* is a resident alien of the United States taxable on his worldwide income for 1990 because he was in the U.S. for at least 31 days in 1990 and at least 183 days for the 3-year period ending in 1990.

An individual does not meet the substantial presence test with respect to any one year if the individual is present in the United States on fewer than 183 days in that year and the individual can establish that, for that year, he or she has a tax home in a foreign country and has a closer connection to that foreign country than to the United States.[134] There are certain exemptions from these residency rules for diplomats, students, and individuals in the U.S. for medical treatment.[135]

2. *Gross Income Defined*

The general definition of gross income for purposes of taxing nonresident aliens and foreign corporations requires that such income be sufficiently connected with the American economy.[136] This is in contrast to the definition of gross income for purposes of taxing U.S. citizens and domestic corporations which includes all income from whatever source derived.[137] Thus, in the case of nonresident aliens and foreign corporations, whether an amount of income constitutes gross income taxable by the United States depends upon the source of that income[138] and whether that income is effectively connected with a "U.S. trade or business."[139] As discussed below, the income of a

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133. *Id.* § 7701(b)(3).
134. I.R.C. §§ 7701(b)(3)(B)(i)-(ii) (1986).
135. *Id.* §§ 7701(b)(3)(D), 7701(b)(5).
136. *Id.* § 872(a).
137. *Id.* § 61(a). *See also* Treas. Reg. §§ 1.61-1 to 1.61-15 (1986).
138. *See* I.R.C. §§ 861-864 (1986) (source of income rules as to nonresident alien individuals and foreign corporations).
139. The notion of what constitutes a "trade or business" is not defined either in the law or regulations but is referred to in I.R.C. §§ 62(a)(1) and 162(a). The entire issue of what constitutes a "trade or business" has been opened up to some conjecture by the decision of the Supreme Court of the United States in *Comm'r. v. Groetzinger*, 480 U.S. 23 (1987), *aff'g*

nonresident alien or foreign corporation from the disposition of U.S. real estate may be deemed effectively connected with the conduct of U.S. trade or business.[140]

3. *Sourcing of Income*

Whether income is from sources within the United States depends upon the type of income received by the nonresident alien or foreign corporation. In general, the following constitute U.S. source income subject to U.S. taxation when paid by a U.S. person to a foreign person:

— Interest paid by U.S. obligors;[141]

— Dividends paid by U.S. corporations or by foreign corporations to the extent that at least 25 percent of the foreign corporation's gross income over the three prior years is effectively connected with a U.S. trade or business;[142]

— Compensation for personal services performed in the United States;[143]

— Rentals and royalties from property located in the United States;[144]

— Dispositions of "United States real property interests;"[145] and

— Sales or exchanges of personal property within the United States.[146]

Expenses, losses, and other deductions are apportioned or allocated to such income in arriving at taxable income from sources within the United States.[147]

Gross income from sources *without* the United States includes interest, other than that derived from sources within the United States;

771 F.2d 269 (7th Cir. 1985), *aff'g* 82 T.C. 793 (1984). Although the discussion of what constitutes a trade or business is too detailed for discussion herein, the general tenor of the *Groetzinger* decision implies that the taxpayer's involvement in an economic activity must be continuous and regular and have as a primary purpose the production of income or profit to constitute a "trade or business."

140. I.R.C. §§ 871(d), 882(d), 897 (1986).

141. *Id.* § 861(a)(1). If 80 percent of the U.S. obligor's gross income over the three prior years is from sources outside the United States, however, the interest paid by that obligor is considered foreign source income to the recipient. *Id.* § 861(a)(1)(A), (c)(1).

142. *Id.* § 861(a)(2).

143. Compensation for services performed in the U.S. is not U.S. source income if: (a) the services are performed by a nonresident alien individual present in the United States for periods not exceeding a total of 90 days during the taxable year; (b) such compensation does not exceed $3,000; and (c) the compensation is for services performed as an employee of, or under a contract with, a foreign partnership or foreign corporation not engaged in a trade or business in the United States. *Id.* § 861(a)(3).

144. I.R.C. § 861(a)(4) (1986).

145. *Id.* § 861(a)(5).

146. *Id.* § 861(a)(6).

147. *Id.* § 861(b).

dividends, other than those derived from sources within the United States; compensation for personal services performed without the United States; rentals and royalties from property located without the United States; gains from the sale or exchange of real property located without the United States; and gains derived from the purchase of personal property within the United States followed by its sale or exchange without the United States.[148] In short, income which is not U.S. source income is defined to be foreign source income.

4. *Effectively Connected with a U.S. Trade or Business*

As well as being subject to tax on certain forms of U.S. source income, nonresident individual aliens and foreign corporations are also taxable on their income which is effectively connected with a U.S. trade or business. Section 864 provides definitions indispensable to the determination of whether income is "effectively connected" with a trade or business within the United States.[149] For example, an item is considered "produced" in the U.S. if it is "created, fabricated, manufactured, extracted, processed, cured or aged" in the United States. Similarly, the phrase "trade or business within the United States" generally includes the performance of personal services within the United States at any time within the taxable year.[150]

In the case of a nonresident alien individual or a foreign corporation, income "effectively connected with a U.S. trade or business" is taxable at the same rates as those that apply to citizens, residents, and domestic corporations on their worldwide income.[151] In determining whether U.S. source income from interest, dividends, and other fixed or determinable annual or periodical gains, otherwise subject to withholding tax, is effectively connected with the conduct of trade or business within the United States and taxable at the rates applicable to citizens and residents, factors required to be taken into account include: (1) whether the income was derived from assets *used in* or held for *use in* the conduct of U.S. trade or business; or (2) whether the activities of such business were a *material* factor in the realization of the income.[152] All other income, gain, or loss from sources within

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148. *Id.* § 861(a).
149. *See* I.R.C. § 864 (1986).
150. *Id.* § 864(b)(1). A limited exception applies to a nonresident alien receiving not more than $3,000 for services in the U.S. for a period not exceeding 90 days from either a foreign person or a foreign office of a U.S. person.
151. *Id.* § 864(c)(1)(B).
152. *Id.* § 864(c)(2).

the United States is treated as effectively connected with the conduct of a trade or business within the United States.[153]

> *EXAMPLE*: Foreign corporation *N* is engaged in the business of purchasing and selling household equipment. *N* is engaged in business in the United States by reason of the sales activities it carries on in the U.S. In 1967, *N* receives installment payments of $800,000 on U.S. sales which results in $200,000 of income. The $200,000 is effectively connected with the conduct of a trade or business in the United States for 1967.

> *EXAMPLE*: In December 1967, *N* ceases to conduct a trade or business in the United States, but in 1968, *N* receives installment payments of $500,000 on sales it made in the U.S. in 1967 which results in $125,000 of income. The $125,000 is not effectively connected with the conduct of a trade or business for 1968 in the United States by *N*.

> *EXAMPLE: M* is a foreign corporation engaged in the business of manufacturing machine tools in a foreign country. It establishes a branch office in the United States during 1968 from which it solicits and negotiates orders from customers in the United States. Because these activities constitute the conduct of a U.S. trade or business, income from such sales during 1968 is effectively connected with the conduct of a U.S. trade or business for that year. In 1968, some customers directly placed orders with *M*'s home office which sold the customers goods without contacting the U.S. branch. Nevertheless, the income resulting from these direct sales is also treated as effectively connected with the conduct of a U.S. trade or business.

Income from sources *without* the United States is effectively connected with a U.S. trade or business if the nonresident alien individual or a foreign corporation receiving the income has an office or other fixed place of business within the United States to which the income is attributable and the income arises from certain rents, royalties, dividends, interest, or gain from the sale of stocks, notes, bonds, or inventory.[154]

> *EXAMPLE*: A foreign corporation, *M*, not a controlled foreign corporation under I.R.C. Section 957, manufactures and sells ma-

153. *Id.* § 864(c)(3); Treas. Reg. § 1.864-4(b), (Example 1) (as amended in 1984).
154. I.R.C. § 864(c)(4)(B) (1986); Treas. Reg. § 1.864-6(c)(3), (Example 1) (1972).

chinery in a foreign country through its sales office in the United States for use in foreign countries. Title to the property sold is transferred to the foreign purchaser outside the United States although no office of *M* in a foreign country participates materially in the sale. During the taxable year, *M* derives taxable income (determined as though *M* were a domestic corporation) of $250,000 from the sales. If the sales made through the U.S. office for the taxable year had been made in the United States and the property had been sold for use in the United States, the taxable income from sources within the United States from such sales would have been $100,000. Therefore, *M* has $100,000 of income which is effectively connected with the conduct of a U.S. trade or business.

A nonresident alien individual or foreign corporation is deemed to have an office or other fixed place of business in the U.S. if the foreign person, corporation, or its agent has the authority to negotiate and conclude contracts in the name of the nonresident person or corporation within the United States and regularly exercises that authority.[155] Income, gain, or loss is not attributable to an office or other fixed place of business within the United States unless the office or fixed place of business is a material factor in the production of the income, gain, or loss and engages in such activities on a continuing basis.[156] Furthermore, there must be an allocation of income, gain, or loss attributable to such an office or other fixed place of business where the activities of such office or fixed place of business constitute a material factor in the production of the income, gain, or loss.[157]

5. *Allocable Expenses*

Items of gross income, expenses, losses, and deductions which are not specifically allocated pursuant to the rules described above, are to be allocated or apportioned to sources within or without the United States pursuant to treasury regulations.[158]

EXAMPLE: X is a domestic corporation which purchases and sells consumer items in the United States and foreign markets. Sales in foreign markets are generally made to related foreign subsidiaries. In a given taxable year *X* reported sales of $1,500,000 (one-third of

155. I.R.C. § 864(c)(5)(A) (1986).
156. *Id.* § 864(c)(5)(B).
157. *Id.* § 864(c)(5)(C).
158. *Id.* § 863; Treas. Reg. § 1.863-1 (as amended in 1958) and Treas. Reg. § 1.863-3 (as amended in 1988).

which were in foreign markets). *X* incurred $150,000 of deductible marketing expenses allocable to domestic and foreign sales. The allocation and apportionment of the marketing department expenses are determined as follows:

To gross income from domestic sales:

$$\$150{,}000 \left[\frac{1{,}000{,}000}{1{,}500{,}000}\right] = \$100{,}000$$

To gross income from foreign sales:

$$\$150{,}000 \left[\frac{500{,}000}{1{,}500{,}000}\right] = \$50{,}000$$

On audit of *X's* return the IRS, pursuant to I.R.C. Section 482, adjusted *X's* sales to its foreign subsidiaries by increasing the sales price by $100,000. As a result of the reallocation of income, the apportionment of the deduction for the marketing expenses is redetermined in the following manner:

To gross income from domestic sales:

$$\$150{,}000 \left[\frac{1{,}000{,}000}{1{,}600{,}000}\right] = \$93{,}750$$

To gross income from foreign sales:

$$\$150{,}000 \left[\frac{600{,}000}{1{,}600{,}000}\right] = \$56{,}250$$

B. *Taxation of Nonresident Alien Individuals*

As previously stated, gross income of a nonresident alien individual includes only income from U.S. sources or income effectively connected with a U.S. trade or business.[159] In the case of U.S. source income not connected with a U.S. trade or business, payments of such income to a nonresident alien is subject to a 30 percent withholding tax,[160] subject to reduction by treaty between the United

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159. I.R.C. § 872(a) (1986). Section 872(b) however, provides exemptions for earnings derived from the operation of a ship or aircraft documented or registered under the laws of a foreign country where such foreign country provides a reciprocal exemption. I.R.C. § 872(b) (1986).

160. While I.R.C. § 871 (1986) imposes tax on non-resident alien individuals, I.R.C. § 1441 (1986) insures collection of the taxes due, requiring the withholding of a flat 30 percent on income paid to nonresident aliens, foreign partnerships and foreign corporations where such income is derived from U.S. sources.

Persons charged with responsibility for withholding include lessees and/or mortgagors of real or personal property, fiduciaries, employers, officers and employees of the United States and others acting in a capacity such that they have the control, receipt, custody, disposal or payment of the income. *See* I.R.C. § 1441(a) (1986). No withholding is required where an item of income (other than compensation for personal services) is effectively connected with

States and the foreign investor's jurisdiction.[161] Included in such income is U.S. source interest,[162] dividends, rents, compensation, annuities, and other fixed or determinable annual or periodical income. A tax of 30 percent is also imposed on the net capital gain of a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year.[163]

Income effectively connected with a U.S. trade or business of a nonresident alien individual during the taxable year is taxed at the same graduated rates under Section 1, Section 55, or Section 402(e)(1) as apply to citizens and residents of the United States.[164] Again, gross income employed in arriving at taxable income for this purpose includes only gross income which is effectively connected with the conduct of a trade or business within the United States.[165]

For purposes of effectively computing connected taxable income, deductions are allowable to the extent that they are connected with such income through an apportionment and allocation procedure set out in treasury regulations.[166] Certain deductions, however, are permitted without allocation, the most important of which is casualty losses under Section 165(c)(3) so long as the loss is on property located within the United States.[167] To be entitled to any deductions or credits, the nonresident alien must file a true and accurate income tax return.[168]

Where a nonresident alien individual derives income during the taxable year from an interest in U.S. real property held for the

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the conduct of a "trade or business" within the United States. *See* I.R.C. § 1441(c) (1986). The filing of Form 4224 is required to state applicable exemptions, although the withholding agent charged with payment of compensation for a nonresident alien individual paid for independent personal services and exempt from withholding by treaty files Form 8233.

161. Currently, the United States has income tax treaties with almost 40 nations that in many cases provide for substantial reductions in the withholding tax for certain kinds of income, most commonly interest or dividends.

162. Interest for this purpose does not include original issue discount under I.R.C. § 1273 (1986) but withholding is imposed on original issue discount, if any, when the obligation is paid. I.R.C. § 871(a)(1)(C)(ii) (1986).

163. *Id.* § 871(a)(2).

164. *Id.* § 871(b).

165. *Id.* § 871(b)(1), (2). If, under the laws of any foreign country, U.S. citizens or foreign corporations are subject to discriminatory or extraterritorial taxes, the President can double U.S. tax rates upon corporations and citizens of that jurisdiction doing business within the United States. *Id.* § 891. Although never used, this power ensures that foreign governments will not impose tax regimes against Americans that are more severe than those imposed upon other foreign nationals.

166. I.R.C. § 873(a) (1986); Treas. Reg. 1.861-8 (as amended in 1984).

167. I.R.C. § 873(b) (1986).

168. *Id.* § 874.

production of income, the nonresident alien may elect to treat all such income as effectively connected with the conduct of a trade or business within the United States even though the taxpayer's activities with respect to the property are so passive that no U.S. trade or business actually exists.[169] Although such an election is generally irrevocable,[170] nonresident aliens should consider this option to offset income derived from other U.S. trades or businesses of the taxpayer where the property is operating at a loss.

The law also imposes the 30 percent withholding tax on amounts received from sources within the United States by a nonresident alien from gains on the sale or exchange of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, and franchises—to the extent such gains are from payments which are contingent upon the productivity, use, or disposition of the property; from interests sold or exchanged; or from payments which are treated as contingent—but only to the extent the amount received is not effectively connected with the conduct of a trade or business within the United States.[171] Formerly, if more than 50 percent of the gain in a taxable year was from the sale or exchange of property described above, all of the gain for the taxable year from the sale or exchange of such property was treated as being from payments contingent on the productivity, use, or disposition of the property.[172]

An exception from the withholding tax applies to interest received by foreign persons where such interest is paid on certain portfolio debt investments.[173] This exception is intended to permit U.S. multinational corporations and the U.S. government to issue debt instruments on the Eurobond market at interest rates less than would be required if the interest were subject to withholding tax.[174]

169. *Id.* § 871(d).
170. *Id.* § 871(d)(1).
171. *Id.* § 871(a)(1)(D). The 30 percent withholding tax is imposed only if the income is not connected effectively with a United States trade or business. *Id.* § 871(a). Income effectively connected with a United States trade or business is taxed in the same manner and at the same rates as income earned by U.S. citizens and residents. *Id.* § 871(b).
172. Former I.R.C. § 871(e), *repealed by* Tax Reform Act of 1986, § 1211(b)(5), Pub. L. No. 99-514, 100 Stat. 2085 (1986), codified at 26 U.S.C. 1.
173. *Id.* §§ 871(h), 881(c).
174. The purpose for this exception to the withholding tax is indicated by the following text of the Senate Finance Committee Report to the Tax Reform Act of 1984:

> . . .[T]o avoid the withholding tax, U.S. corporations seeking access to the Eurobond market generally establish international finance subsidiaries that issue Eurobonds, almost all of which are incorporated in the Netherlands Antilles. Exemption from the withholding tax is claimed under the U.S. income tax treaty with the Netherlands,

C. *Conduit Treatment Required of Partnerships*

Nonresident alien individuals or foreign corporations are considered engaged in a trade or business within the United States if any partnership of which such individual or corporation is a partner is so engaged.[175] Thus, membership by a nonresident alien individual or foreign corporation in a partnership which has income effectively connected with a trade or business within the United States is taxed *pro tanto*, notwithstanding the fact that the nonresident alien individual or foreign corporation may have no direct income effectively connected with a trade or business within the United States. This, of course, follows the standard approach of U.S. tax law treating the partnership as a conduit and imposing tax not on the partnership but on the partners individually. Where a U.S. partnership has any income effectively connected with the conduct of a U.S. trade or business, the partnership or other withholding agent is required to withhold 28 percent of each non-corporate foreign partner's share of the effectively connected income and 34 percent of each corporate foreign partner's share of the effectively connected income.[176]

D. *Taxation of U.S. Source Income Paid to Foreign Corporations*

Subject to certain exceptions, a foreign corporation is subject to the same 30 percent withholding tax as nonresident alien individuals on U.S. source interest, dividends, rents, compensation, and other fixed or determinable annual or periodical income, as well as on

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as extended to the Netherlands Antilles.

> The committee believes that if tax-free access to the Eurobond market is important, such access should be direct. . . the current practice by U.S. corporations of issuing Eurobonds through finance subsidiaries located in the Netherlands Antilles, rather than directly from the United States, is neither economical nor indicative of sound tax policy.

S. REP. No. 169 (Vol. I), 98th Cong., 2d Sess. 420 (1984).

175. I.R.C. § 875 (1986).

176. *Id.* § 1446. Related to these rules for partnerships, the American Bar Association has called for repeal of the rule that prohibits a nonresident alien from being a shareholder of an S corporation. Like a partnership, an S corporation is not subject to tax at the corporate level, but merely passes its income through to its shareholders pro rata, thereby subjecting that income to one level of taxation. Currently, a corporation with a nonresident alien as a shareholder cannot elect to be treated as an S corporation. *Id.* § 1361(b)(1)(C). Were the American Bar Association's position to be adopted, the S corporation would probably become subject to the same rules as partnerships for purposes of withholding tax on the nonresident alien shareholder's portion of the S company's effectively connected income. *See Legislative Recommendations No. 1988-18*, ABA COMMITTEE ON U.S. ACTIVITIES OF FOREIGNERS AND TAX TREATIES.

gains from the sale of intangible property to the extent such gains are from payments which are contingent upon the productivity, use, or disposition of the property sold.[177] The 30 percent tax only applies to these items to the extent that they are not effectively connected with the conduct of a trade or business within the United States. If the income is effectively connected with the conduct of a trade or business within the United States, then the income is taxed at ordinary prevailing U.S. corporate rates.[178]

Gross income of a foreign corporation subject to U.S. taxation includes income which is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States.[179] Like nonresident alien individuals, a foreign corporation is allowed deductions only to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States under an apportionment and allocation procedure set out in treasury regulations.[180] A foreign corporation can receive the benefit of deductions or credits only upon the filing of a true and accurate return.[181]

A foreign corporation may elect to treat income derived from U.S. real property as income effectively connected with a U.S. trade or business even though it would not otherwise be eligible for such treatment.[182] Such an election may be advantageous if the foreign corporation has other income effectively connected with the United States against which operating losses from the real estate could be offset. The election is revocable in a subsequent year only with the consent of the Secretary of the Treasury.[183]

E. *Branch Profits Tax*

For a foreign corporation operating in the United States through a branch, Section 884 adds a new tax upon the foreign corporation's U.S. earnings termed the "branch profits tax." In adding the branch profits tax, Congress attempted to equalize the treatment of U.S.

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177. I.R.C. § 881(a) (1986).
178. *Id.* § 882(a). I.R.C. § 1442 requires the 30 percent tax to be withheld in the same manner and on the same items of income as that provided in § 1441. *Id.*
179. *Id.* § 882(b).
180. *Id.* § 882(c)(1)(A); Treas. Reg. 1.861-8 (as amended in 1984).
181. I.R.C. § 882(c)(2) (1986).
182. *Id.* § 882(d)(1).
183. *Id.*

branches of foreign corporations with the treatment already imposed upon U.S. subsidiaries of foreign corporations.[184] The tax is a 30 percent withholding tax upon the post-1986 U.S. effectively connected earnings and profits of the foreign corporation's U.S. branch. As an incentive to induce foreign corporations not to repatriate U.S. earnings, the tax is not imposed if the branch profits are reinvested in a U.S. business.[185] The withholding tax is in addition to the regular corporate income tax of Section 11, the alternative minimum tax of Section 55, and the alternative capital gains tax of Section 1201(a). The branch profits tax may be reduced or eliminated if the United States has a treaty with the foreign corporation's domicile and the foreign domicile permits a withholding tax on the dividends paid by the foreign corporation.[186]

Notwithstanding the branch profits tax, foreign corporations should consider branch operations in the United States where the U.S. operations will initially have start-up losses such that there will be no earnings and profits attributable to income effectively connected with the conduct of a U.S. trade or business.

F. *Taxation of U.S. Real Property Dispositions by Foreign Sellers: Foreign Investments in Real Property Tax Act (FIRPTA)*

As previously noted, capital gains realized by foreign corporations not engaged in a U.S. trade or business are exempt from U.S. tax. Similarly, capital gains of a nonresident alien individual not engaged in a U.S. trade or business and present in the U.S. for less than 183 days in the taxable year are exempt from U.S. tax.[187] These exemptions have one major exception where the foreign person disposes of a "United States real property interest" (USRPI), in which case the disposition is treated as effectively connected with a U.S. trade or business and consequently taxable at the same rates applicable to U.S. persons.[188] If a nonresident alien individual is subject to the alternative minimum tax of Section 55, Section 897 imposes a tax of 21 percent on the lesser of the individual's alternative minimum

184. *See Joint Explanatory Statement of the Committee of Conference*, H.R. CONF. REP. No. 841, 99th Cong., 2d Sess., at 4075, 4735 (1986).
185. I.R.C. § 884(b) (1986).
186. *Id.* § 884(e); Temp. Treas. Reg. §§ 1.884-1T(h), 1.884-5(T) (1988).
187. *See* I.R.C. § 871(a)(2) (1986) (individuals); I.R.C. § 882(a)(3) (1986) (corporations).
188. *Id.* § 897(a), (b).

taxable income or the individual's "net U.S. real property gain" for the taxable year. The net United States real property gain is the excess of gains over losses from dispositions of USRPI's for the taxable year.[189] For this purpose, losses are permitted to offset gains only to the extent the losses arose from a trade or business, a transaction entered into for profit, or were personal casualty losses under Section 165(c)(3).[190]

Generally, a USRPI is an interest in real property[191] located in the United States or the Virgin Islands, and any interest (other than that as a creditor) in any domestic corporation unless the taxpayer establishes that the corporation was not a "United States real property holding corporation" (USRPHC), at any time over the five year period ending on the date of the disposition of such interest.[192] A USRPI does not include any interest in a corporation if, as of the date of disposition, the corporation did not hold any USRPI and any USRPI's held during the five year period prior to disposition of the stock were disposed of in transactions in which the full amount of the gain, if any, was recognized.[193]

A USRPHC is any U.S. corporation in which the fair market value of its USRPI's exceeds 50 percent of the fair market value of its interest in real property located within and without the United States plus any other assets held by it for use in a trade or business.[194] Assets held by a partnership are attributed to its corporate partners for purposes of measuring if a corporate partner is a USRPHC.[195] Additionally, where a corporation holds a controlling interest in a second corporation, the first corporation is treated as holding a portion of each asset of the second corporation equal to the pro rata amount of the fair market value of the stock held in the second corporation by the first corporation.[196]

Any gain recognized by a foreign corporation on distribution of a USRPI is equal to the excess of the fair market value of the USRPI

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189. *Id.* § 897(a)(2)(B).
190. *Id.* § 897(b).
191. Real property for this purpose includes any interest in a mine, well or other mineral deposit and covers such diverse interests in real estate as leaseholds, options and options on leaseholds. *Id.* § 897(c)(1)(A)(i), (c)(6)(A). Real property also includes associated personal property (*e.g.*, movable walls, furnishings, etc.) *Id.* § 897(c)(6)(B).
192. I.R.C. § 897(c)(1)(A) (1986).
193. *Id.* § 897(c)(1)(B).
194. *Id.* § 897(c)(2). An exception to USRPHC exists for certain publicly traded corporations. *Id.* § 897(c)(3).
195. *Id.* § 897(c)(4)(B).
196. *Id.* § 897(c)(5)(A). "Controlling interest" for this purpose is 50% or more of the fair market value of all classes of stock of a corporation. *Id.* § 897(c)(5)(B).

over the foreign corporation's adjusted basis in the USRPI.[197] Similarly, with respect to distributions to the partners of a partnership, the amount of money or the fair market value of any property received by a nonresident alien individual or foreign corporation in exchange for all or part of its interest in a partnership, is treated to the extent attributable to a USRPI as a taxable sale or exchange in the United States of such property.[198]

A foreign corporation may avoid Section 897 by electing to be treated as a domestic corporation where such foreign corporation holds a USRPI and where, under any treaty obligation of the United States, the foreign corporation is entitled to nondiscriminatory treatment with respect to that interest.[199] The election is effective for purposes of Section 897 and for certain reporting purposes.[200] The election can be revoked only with the consent of the Secretary of the Treasury.[201]

Where a transfer of a USRPI to a foreign corporation is made as paid in surplus or as a contribution to capital in the foreign corporation, the excess of the fair market value of the property transferred over the sum of the adjusted basis of the property in the hands of the transferror, plus the amount of gain recognized to the transferror, is recognized by the transferring nonresident alien individual or foreign corporation.[202]

Where a USRPI is acquired by a U.S. person from a foreign person, the law requires the U.S. *transferee* to withhold the lesser of ten percent of the amount realized or an amount equal to the transferror's maximum tax liability, plus any unsatisfied prior withholding tax liability which may exist as to the interest transferred.[203] The transferee obligated to withhold is liable for the tax if not

197. I.R.C. § 897(d) (1986).
198. *Id.* § 897(g).
199. In general, a nondiscrimination clause in a tax treaty provides that the national of a contracting state shall not be subject to any taxation which is more burdensome than the taxation to which nationals of the other contracting state are subject under the same circumstances. *See* 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, *reprinted in* Taxation of Transnational Transactions (CCH) §§ 212-13, art. 24 (1987-88).
200. Foreign investors with USRPIs valued at $50,000 or more and who do not engage in a U.S. trade or business must provide certain information to the IRS pursuant to as yet published regulations. *See* I.R.C. § 6039C (1986).
201. *Id.* § 897(i)(2).
202. *Id.* § 897(j).
203. *Id.* § 1445(a), (c); Treas. Reg. §§ 1.1445-1, 1.1445-7 (1986).

withheld and is also potentially subject to criminal penalties under Section 7202 for failure to withhold.[204]

G. *Transportation Provisions*[205]

A four percent tax is imposed on a foreign corporation's U.S. source gross transportation income which is not effectively connected with a U.S. trade or business.[206] U.S. source gross transportation income means any U.S. source income[207] derived from or connected with the use or leasing for use of a ship or aircraft.[208] If the income is subject to the four percent tax, it is not subject to the 30 percent withholding tax.[209] Finally, Section 883 provides an exclusion from gross income for the income of foreign corporations received from the operation of ships under a foreign flag, where the foreign country grants an equivalent exemption to citizens of the United States and to U.S. corporations. Similarly, there is an exclusion for aircraft of foreign registry.[210]

CONCLUSION

Tax planning remains essential for most individuals and for all businesses. Because of the variety of available options and interrelationships for businesses involved in transnational activities, tax planning in the transnational area is of even greater importance. The primary difficulty in transnational tax planning, however, lies in the problem associated with accumulating and evaluating all information relevant to making decisions in a transnational context.

This article has set forth the basic international tax rules from the United States perspective. Of equal, or perhaps even greater importance, are the tax rules of other nations where U.S. multinationals do business and which may be as complex as those of the United

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204. I.R.C. § 1461 (1986); Treas. Reg. § 1.1461-3(b) (as amended in 1984).

205. For a more detailed discussion of the taxation of international transportation income *see* Williamson, *Taxation of International Transportation Income: Source of Income, Gross Basis Tax and Reciprocal Tax Exemptions*, U.S. Taxation of International Operations, (P-H) (1988).

206. I.R.C. § 887(a) (1986).

207. For this purpose, income derived from transportation beginning and ending in the United States is deemed as income from the United States. *Id.* § 863(c)(l). If the transportation only begins or ends in the United States, 50 percent of the income derived from the transportation is United States source. *Id.* § 863(c)(2).

208. *Id.* § 863(c)(3)(A).

209. *Id.* § 887(b)(1), (c).

210. *Id.* § 883(a)(1), (2).

States. Whether or not a transnational business holds the minimization of U.S. income taxes as a primary goal of an international transaction, taxpayers conducting international business must develop a transnational tax strategy if they are to become or to remain competitive in international markets.