International Tax for the Growing Business

PATRICK J. MCCORMICK, J.D., LL.M.

INTRODUCTION

Businesses of all sizes and types engage in transactions with foreign connections, with the number of such transactions growing exponentially in an increasingly global marketplace. "International business" in the tax realm is no longer exclusively concerned with multinational conglomerates engaged in complex planning through tax havens; rather, the focus now is more commonly on emerging businesses first encountering international issues as their businesses expand. This article focuses on these types of businesses – both foreign-domiciled businesses entering the United States market (coined "inbound" transactions) and United States-domiciled businesses engaging in transactions with foreign components ("outbound" transactions). As this area is filled with intricacies which can arise based on the specific facts involved, this introductory overview is not intended to detail every consideration which could potentially have relevance in the international spectrum. Rather, the goal is to provide a primer on a number of the more common considerations in this context.

FOREIGN ENTITIES ENTERING THE UNITED STATES MARKET

As background, foreign entities with United States connections are generally subject to tax on two primary classes of income by the United States. First, a foreign entity carrying on a trade or business in the United States is taxed on all income effectively connected with that trade or business; credits and deductions are available where returns are timely filed. Where no trade or business is found, the entity instead is subject to tax on United States-sourced fixed or determinable annual or periodic income (such as dividends sourced from the United States); deductions typically are not permitted for this income. The latter category of income is generally subject to withholding requirements by payors. Importantly, income tax treaties (discussed later) can modify default rules.

ENTITY CLASSIFICATION

A threshold consideration is classification of the foreign-domiciled entity for United States purposes; as one may expect, foreign jurisdictions typically do not maintain identical rules to the United States regarding entity types. Entity classification in the United States thus does not hinge on classification of the entity in the country of its formation.

Default rules for classification are applicable to entities which are not "per se" corporations (with those entities automatically classified as corporations in the United States).[1] Under the default rules, a foreign entity is an association taxable as a corporation if its owner or owners have limited liability; if it has one owner who does not have limited liability it is treated as a disregarded entity, and it is treated as a partnership if it has multiple members at least one of whom does not have limited liability.[2] However, foreign entities are generally permitted to elect their classification for United States tax purposes. Elections out of the default rules are made by use of Form 8832; however, an initial election is required within 75 days of the entity becoming "relevant".

A foreign entity becomes "relevant" when its classification affects the liability of any person for federal tax or information purposes.[3] The Regulations state: "The date that the classification of a foreign eligible entity is relevant is the date an event occurs that creates an obligation to file a federal tax return, information return, or statement for which the classification of the entity must be determined. Thus, the classification of a foreign entity is relevant, for example, on the date that an interest in the entity is acquired which will require a U.S. person to file an information return on Form 5471."[4] Cognizance of the entity's date of relevance is thus vital to maximize United States flexibility.

Effectively Connected Income

Generally, a foreign corporation engaged in trade or business within the United States during the taxable year is taxable on income effectively connected with the conduct of that trade or business.[5] Neither the Code nor the Regulations specifically define what is considered a United States trade or business; the Service ordinarily does not rule on whether a taxpayer is engaged in a trade or business.[6] However, case law dictates that, where profit-oriented activities are carried on in the United States which are regular, substantial, and continuous, these activities are properly classified as a United States trade or business, whether carried on directly by the taxpayer or through its agent/agents.[7] Foreign corporations have been held to have carried on a United States trade or business through a single person acting as a United States agent, even where (as one example) the agent for

---

1 Treas. Reg. § 301.7701-2(b)(8).

2 Treas. Reg. § 301.7701-3(b)(2).

3 Treas. Reg. § 301.7701-3(d)(1)(i).

4 *Id.*

5 I.R.C. Section 882(a).

6 *See* Rev. Proc. 2014-7, 2014-1 I.R.B. 238.

7 *U.S. v. Balanovski*, 236 F.2d 298 (2d Cir. 1956); *U.S. v. Northumberland Insurance Company*, 521 F.Supp. 70 (DNJ 1981).

a sales company assumed full responsibility for sales under the relevant contracts.[8] As one may suspect from the above, the standard for a United States trade or business is low, resulting in most types of involved activities being classified as a trade or business.

BRANCH PROFITS TAX

In addition to the corporate tax imposed under Section 882, the branch profits tax levies a second tax on foreign corporations engaged in a United States trade or business; this tax is equal to 30% (subject to treaty modification) of the foreign corporation's "dividend equivalent amount" for the taxable year.[9] A foreign corporation's "dividend equivalent amount" is its effectively connected earnings and profits for the taxable year adjusted based on United States net equity.[10] The term "effectively connected earnings and profits" means earnings and profits attributable to effectively connected income without reduction for distributions made by the foreign corporation during any taxable year or by the amount of branch profits tax or tax on excess interest paid by the foreign corporation.[11] Earnings and profits attributable to certain specified items (such as gain on the disposition of a United States real property interest) are excluded.[12]

Under the branch profits rules, United States assets are assets (aside from interests in partnerships, trusts, or estates) held by the foreign corporation as of the determination date (typically the close of the foreign corporation's taxable year) if all income produced by the asset (as of the determination date) is effectively connected income (or would be if the asset produced income) and all gain from the asset's disposition would be effectively connected income.[13] U.S. liabilities are the amount of Unites States-connected liabilities of the foreign corporation, which normally equals the total value of U.S. assets for the taxable year multiplied by the total amount of worldwide liabilities divided by the total value of worldwide assets for the year.[14]

Expansion on the rationale behind the branch profits tax is of benefit in understanding its operation. For foreign corporations conducting business through a United States subsidiary, two levels of tax are incurred – one at the corporate level when income is earned, and the second when that earned income is distributed to its parent (which is then taxed as a dividend). The branch profits tax attempts to place a foreign corporation with branch

---

8 Rev. Rul. 70-424, 1970-2 C.B. 150.

9 I.R.C. Section 884(a).

10 I.R.C. Section 884(b).

11 Treas. Reg. § 1.884-1(f)(1).

12 *See* I.R.C. Section 884(f)(2).

13 Treas. Reg. § 1.884-1(d)(1)(i).

14 Treas. Reg. § 1.882-5(c)(2).

operations in a similar position by both taxing at the corporate level when income is earned and imposing a second tax on transmittal of funds (at the same rate as a dividend).

FDAP INCOME

United States-sourced fixed or determinable annual or periodic income of a foreign corporation which is not effectively connected with the conduct of a United States trade or business is normally subject to a 30% gross-based tax, with tax generally required to be withheld by the payor.[15] FDAP income can include interest (subject to expansive exceptions), dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodic gains, profits and income.[16] Importantly, income that is or is deemed to be effectively connected income is not subject to the FDAP rules (and the withholding requirements associated therewith) if it is included in the gross income of the recipient for the taxable year.[17] Taxpayers who receive income solely subject to withholding are relieved of the obligation to file a United States tax return if all United States tax liability is covered by withheld amounts.[18] Withholding obligations by payors are detailed later in this article.

Sourcing of FDAP items carries understandable importance in this context (as, where items are not sourced from the United States, no U.S. tax jurisdiction exists for non-United States persons). Both interest income and dividend income are normally sourced to the residence of the payor.[19] Rents and royalties are sourced to the location or place of use of the property.[20] Source of income for personal services is ordinarily the place where services are performed.[21]

NONRESIDENT ALIEN EMPLOYEES

Nonresident aliens (i.e. those who are neither United States citizens nor residents) are taxed in the United States on income effectively connected with a United States trade or business (and are taxed at regular United States rates for the same).[22] The tax is determined on a net basis, with deductions permitted.[23] Where nonresident alien employees perform

---

15 I.R.C. Section 881(a)(1).

16 I.R.C. Section 1441(b).

17 I.R.C. Section 1441(c)(1).

18 Treas. Reg. § 1.6012-1(g)(2)(i).

19 I.R.C. Section 861(a)(1); I.R.C. Section 861(a)(2).

20 I.R.C. Section 861(a)(4).

21 I.R.C. Section 861(a)(3).

22 I.R.C. Section 871.

23 *Id.*

services in the United States, this work is generally classified as a trade or business (subject to certain limited exceptions).[24] Since a nonresident alien individual is considered to be engaged in a United States trade or business if s/he performs personal services in the United States as an employee, wages, salaries, compensation and other remuneration received for these personal services are income effectively connected with a United States trade or business.[25]

In general, foreign employers who pay compensation for services performed in the United States by either residents or nonresident aliens must withhold United States income taxes on such compensation to the extent the compensation is properly classified as wages.[26] "Wages" generally are defined as all remuneration for services performed by an employee for her/his employer.[27] A nonresident alien who performs services in the United States as an employee is subject to withholding at the regular rates for employees.[28]

UNITED STATES PARTNERS OF A FOREIGN PARTNERSHIP

United States persons who own interests in foreign partnerships are required to report their share of the partnership's distributive items; a foreign partnership is defined simply as a partnership which is not domestic.[29] Foreign partnerships can be required to file Form 1065 where the partnership has gross income derived from sources within the United States or gross income which is effectively connected with the conduct of a trade or business in the United States.[30]

FILING REQUIREMENTS

Every corporation subject to the federal income tax must annually file a return.[31] Taxpayers engaged in a United States trade or business must file a return even if there is no income or if income is exempted by a statute or treaty.[32] A foreign corporation must file a return on Form 1120-F.[33] Effectively connected income usually is not subject to withholding;

---

24 I.R.C. Section 864(b).

25 *See* Rev. Rul. 92-106, 1992-2 C.B. 258.

26 I.R.C. Section 3402.

27 I.R.C. Section 3401(a).

28 Treas. Reg. § 31.3401(a)(6)-1.

29 I.R.C. Section 7701.

30 I.R.C. Section 6031.

31 I.R.C. Section 6012(a)(2).

32 Treas. Reg. § 1.6012-2(g)(1)(i).

33 Treas. Reg. § 1.6012-2(g)(1)(i).

rather, the foreign corporation engaged in a United States trade or business is required to file a return and pay tax under the same rules as for domestic corporations.[34]

Foreign corporations engaged in a United States trade or business (or who have received income treated as effectively connected with such a business) are allowed the deductions which are properly allocated and apportioned to the foreign corporation's gross income which is effectively connected, or treated as effectively connected, with its conduct of a trade or business within the United States.[35] However, this benefit is available only if the foreign corporation timely files a true and accurate return.[36] An 18-month grace period is applicable for these purposes, generally requiring the return to be filed within 18 months of the due date.[37]

Nonresident aliens who receive wages must file income tax returns on or before the 15th day of the fourth month following the end of the tax year.[38] Nonresident aliens are generally permitted only one exemption amount.[39]

A multitude of tax information reporting requirements exist for taxpayers; however, most of these requirements (i.e., the FBAR, Form 8938, Form 3520, Form 8621, Form 5471, etc.) exist primarily for United States persons (and do not extend to foreign individuals or corporations). However, an important note relates to a foreign entity's underlying owners and employees; if a principal of an entity or an associated party has spent sufficient time within the United States, this person can be classified as a United States resident. United States residents are taxable on their worldwide income (from sources both inside and outside the United States).[40] An individual is classified as a resident of the United States for a given year if they (i) are lawfully admitted for permanent residence, (ii) meet substantial presence requirements, or (iii) make an election to be treated as a citizen.[41] An individual meets substantial presence requirements in a given year (subject to an exception if the individual has a "closer connection" to another country) if they were present in the United States for at least 31 days during the current year and the sum of days spent over the last three years (after use of applicable multipliers) is 183.[42] The applicable multiplier

---

34 *See* I.R.C. Section 1441(c)(1).

35 Treas. Reg. § 1.882-4(a)(1).

36 Treas. Reg. § 1.882-4(a)(2).

37 Treas. Reg. § 1.882-4(a)(3).

38 Treas. Reg. § 1.6072-1(c).

39 I.R.C. Section 873(b)(3).

40 I.R.C. Section 1.

41 I.R.C. Section 7701(b).

42 I.R.C. Section 7701(b)(3).

for the current year is 1, the applicable multiplier for the first preceding year is 1/3, and the applicable multiplier for the second preceding year in 1/6.[43] Where a nonresident alien becomes a United States resident, they become subject to United States tax on worldwide income and are generally subject to all United States information reporting requirements as residents.

UNITED STATES ENTITIES WITH FOREIGN CONNECTIONS

Moving to the outbound realm, United States-based businesses will encounter international issues under a growing multitude of circumstances; understanding United States requirements in the context of such transactions is thus increasingly vital. United States tax treatment of outbound transactions was altered significantly by the Tax Cuts and Jobs Act; an overview of the existing rules is provided first, with details on the modifications under the Act immediately following. As this article focuses on United States tax implications, the tax rules and regimes of foreign jurisdictions are not covered (as one should suspect, foreign advisors licensed in relevant countries are the only appropriate parties to advise on these issues).

UNITED STATES TAXATION OF FOREIGN TRANSACTIONS BY U.S TAXPAYERS

Activities of United States corporations in foreign jurisdictions can be structured in a number of ways. Where activities are undertaken through a branch or a flow-through entity, income from the activities goes directly to the parent entity for United States tax purposes. Conversely, where income is earned by a foreign subsidiary, a United States shareholder traditionally has not been subject to tax on the amounts earned until those amounts were repatriated (i.e. through a dividend to the shareholder).[44]

The default rule of tax deferral for income earned by a foreign subsidiary is modified under certain circumstances. Specifically, special rules exist for Subpart F income, passive foreign investment companies, and Section 367(a) transactions.

SUBPART F INCOME

Subpart F of the Internal Revenue Code imposes a direct tax on a "U.S. shareholder" of a controlled foreign corporation ("CFC") as to certain earnings of the CFC. The overarching goal of Subpart F is to limit availability of income shifting techniques (resulting in United States recognition deferral) which otherwise would be available to United States parties earning certain classes of income through foreign corporations. Subpart F essentially treats a U.S. shareholder of a controlled foreign corporation as if s/he actually received the pro rata share of specified income items,

---

43 *Id.*

44 I.R.C. Section 11.

regardless of whether receipt occurred. As application of Subpart F is often complex, a general overview of the concepts involved is provided for familiarity.

For Subpart F purposes, the term U.S. shareholder includes United States persons (a United States citizen, resident, domestic partnership, domestic corporation, or any non-foreign estate or trust) owning at least 10% of the foreign corporation's voting stock or value.[45] Such a foreign corporation is a CFC for a particular year if on any day during such year U.S. shareholders own more than 50% of total combined stock (measured either by voting power or value).[46] This ownership/interest requirement can be juxtaposed with the lack of a similar prerequisite in the context of passive foreign investment companies (discussed below). The amount included in a U.S. shareholder's taxable income is limited to the corporation's undistributed earnings and profits.[47]

Subpart F income has multiple prongs, and generally consists of what can be classified as "movable income". A primary component of Subpart F is foreign base company income, which is the sum of items including foreign personal holding company income (income from interest, dividends, rents, royalties, annuities, and dispositions of property including those types of income), foreign base company sales income (income from transactions in personal property where a related person is a buyer or seller), and foreign base company services income (income from services transactions involving related persons).[48]

Current reporting of Subpart F income is required by U.S. shareholders to the extent of their pro rata share of such income (even if, as mentioned, the corporation makes no distributions).[49] Subpart F inclusion normally creates an indirect foreign tax credit.[50]

PASSIVE FOREIGN INVESTMENT COMPANIES

A passive foreign investment company ("PFIC") is defined as a foreign corporation where either (1) 75% or more of the gross income of the corporation for the taxable year is passive income, or (2) the average percentage of assets held by the corporation during the taxable year which produce passive income or which are held

---

45 I.R.C. Section 957(c).

46 I.R.C. Section 957(a).

47 I.R.C. Section 952(c)(1)(A).

48 I.R.C. Section 954.

49 I.R.C. Section 951.

50 I.R.C. Section 960.

for the production of passive income is at least 50%.[51] For these purposes, passive income is defined as any income which is of a kind which would be foreign personal holding company income (including dividends, royalties, rents, annuities, etc.).[52] Obligations generally arise where a United States person owns interests in a foreign corporation which primarily makes passive investments. Rules in the PFIC realm are, like with Subpart F, intended to limit the ability of United States persons to defer tax on covered foreign corporate earnings. Unlike with Subpart F, no minimum interest requirements exist for PFIC rules to apply (i.e. there is no 50% ownership requirement).

Separate regimes can be applicable to PFICs. Under default rules, punitive tax consequences apply where a shareholder either receives an excess distribution in relation to PFIC stock or disposes of the stock (essentially subjecting PFIC holders to tax at top applicable rates and interest amounts based on the holding period for interests). Elections are available to opt-out of the default PFIC regime and mitigate the tax effects associated with the holding of PFICs. The first option available is the qualified electing fund (QEF) election. Under QEF rules, a taxpayer who owns stock in a QEF includes in gross income: (1) as ordinary income, such shareholder's pro rata share of the ordinary earnings of such fund for such year, and (2) as long-term capital gain, such shareholder's pro rata share of the net capital gain of such fund for the year.[53]

A second option available for a PFIC holder is to make a mark-to-market election. Such an election is available only for "marketable stock" (generally defined as PFIC stock regularly traded on a securities exchange). When the mark-to-market election is made, the taxpayer essentially recognizes gain or loss on the shares on an annual basis (based on the shares' fair market value).[54] Of note is that mark-to-market gains are treated as ordinary income; losses can be recognized, but only to the extent of prior gains.

Transfers to Foreign Corporations – I.R.C. Section 367(a)

Section 367(a)(1) alters the application of the normal nonrecognition rules when certain transfers of property are made by United States persons to foreign corporations. Section 367(a)(1) provides that if, in connection with any exchange described in Sections 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes

---

[51] I.R.C. Section 1297(a).

[52] I.R.C. Section 1297(b)(1).

[53] I.R.C. Section 1293.

[54] I.R.C. Section 1296.

of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.[55] Section 367(a) applies where the transferor is a United States person and the transferee is a foreign corporation, as its intention is to curb tax avoidance which could come from permitting tax-free transfers of appreciated assets out of the United States' jurisdiction.

Modifications Under the Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act made significant alterations to the default rules for outbound transactions. The modifications provided will have a major prospective impact on how foreign activities are conducted.

Section 245A – Deduction for Foreign-Sourced Dividends

New Section 245A(a) provides that, in the case of any dividend received from a specified 10-percent owned foreign corporation by a domestic corporation which is a United States shareholder with respect to such foreign corporation, there shall be allowed as a deduction an amount equal to the foreign-source portion of such dividend. A "specified 10-percent owned foreign corporation" is any foreign corporation with respect to which any domestic corporation is a United States shareholder (other than a PFIC which is not also a CFC). In accordance with the Committee Report to the Act, the dividend received concept is to be interpreted broadly. No foreign tax credit or deduction is permitted for dividends to which Sec. 245A is applicable.

Importantly, the Section 245A deduction is available only to C-corporations which are not registered investment companies or real estate investment trusts. Thus, non-corporate shareholder (i.e. individuals or other non-corporate entities) will not be eligible to use the deduction.

Additional limitations also exist; one is that Sec. 245A is inapplicable to "hybrid dividends". "Hybrid dividends" are dividends for which the foreign subsidiary received a tax benefit from a foreign country; the goal is to limit disparate treatment between United States and foreign tax laws. A holding period also applies to the Sec. 245A deduction: it is available only for United States shareholders who have held shares of the foreign corporation for more than 365 days during a specified 731-day period. Additionally, the Sec. 245A exclusion does not apply where a shareholder of a PFIC makes a qualified electing fund election and treats amounts as a deemed dividend.

---

55 I.R.C. Section 367(a)(1).

Special rules have been implemented in association with Section 245A. For sales of a foreign subsidiary, where such a sale occurs after 2017 and stock was held for one year or more, any amount received which is treated as a dividend for purposes of Sec. 1248 is also treated as a dividend for purposes of Sec. 245A. Additionally, where a United States corporation transfers substantially all assets from a foreign branch to a foreign corporation, the United States parent must include a "transferred loss amount" in its gross income (essentially requiring recapture of post-2017 losses of the branch).

Deemed Repatriation of Prior Earnings

Based in part on the ramifications of Sec. 245A, new rules are also provided for foreign earnings on which Untied States tax has been deferred. Under modified Sec. 965, Subpart F income is increased in the last year of a deferred foreign income corporation beginning before January 1, 2018 by accumulated post-1986 deferred foreign income of the corporation determined as of either November 2, 2017 or December 31, 2017 (whichever is greater). The rate of inclusion is 15.5% for cash and cash equivalents and 8% for other assets.

Importantly, this provision can apply to U.S. shareholders who are not corporations where statutory requirements are met. A deferred foreign income corporation is defined as any specified foreign corporation of a U.S. shareholder which has accumulated post-1986 deferred foreign income greater than zero; a specified foreign corporation is either a CFC or any foreign corporation as to which one or more domestic corporations is a U.S. shareholder. Accumulated post-1986 deferred foreign income is generally the post-1986 earnings and profits of the foreign corporation (with certain exceptions).

U.S. shareholders are permitted (by election) to pay the net tax liability over eight years, with 8% of the net tax paid in each of the first five years, 15% in the sixth year, 20% in the seventh year, and 25% in the final year. Termination of the business can create an acceleration of amounts due. For S corporations which are U.S. shareholders, each shareholder of the S corporation can elect to defer payment of their liability until a triggering event occurs for the liability (with triggering events including cessation of S corporation status, cessation of the S corporation's activities, or a transfer of stock by the shareholder). A six-year statute of limitations is applicable to assessment of this tax.

Global Intangible Low-Taxed Income and Foreign Derived Intangible Income

Each U.S. shareholder of any CFC must now include in gross income what is termed the shareholder's global intangible low-taxed income ("GILTI") for the tax year. GILTI is defined as the excess of the shareholder's net CFC tested income for the tax year over the shareholder's net deemed tangible income return for the tax year. The net deemed tangible income return is the excess of 10% of the aggregate of the shareholder's pro rata share of the qualified business asset investment of each controlled foreign corporation for the tax year over an interest expense calculation. Functionally, GILTI essentially places tax on the excess of an assumed 10% rate of return on tangible business assets (imposing tax on foreign earnings which exceed a standard rate of return amount). GILTI is taxed at a 10.5% effective rate for domestic corporations, with foreign tax credits available up to 80% of the amount of the income.

As to foreign-derived intangible income, FDII is the amount which bears the same ratio to the corporation's deemed intangible income as its foreign-derived deduction eligible income bears to its deduction eligible income. Essentially, FDII is the portion of intangible income derived from serving foreign markets; like GILTI, it assumes a 10% rate of return on tangible assets. The FDII concept offers a special reduced effective tax rate on income from US-held intangibles; like with GILTI, FDII does not explicitly look at intangibles but assumes a fixed rate of return on business assets (with the balance of income being attributed to intangibles). FDII is taxed at an effective rate of 13.125% for US corporations. The GILTI and FDII rules are designed to stop the practice of U.S. companies moving their intangibles offshore to remove income generated by it outside the United States' tax scope.

WITHHOLDING REQUIREMENTS FOR PAYMENTS TO FOREIGN PERSONS

For United States taxpayers engaged in foreign transactions, one area where cognizance of requirements is critical is on withholding obligations for payments made to foreign parties. Under United States rules, persons having control, receipt, custody, disposal, or payment of certain items of income from sources within the United States of any nonresident alien normally are required to deduct and withhold from such income a tax equal to 30%.[56] As indicated above, income that is or is deemed to be effectively connected income is not subject to withholding if it is included in the gross income of the recipient for the taxable year.[57] Absent actual knowledge or reason to know otherwise, a withholding agent may rely on a claim of exemption from withholding for income effectively connected with a United States trade or business if, before the payment to the foreign person, the

---

56 I.R.C. Section 1441(a).

57 I.R.C. Section 1441(c)(1).

withholding agent can reliably associate the payment with a Form W-8 upon which it can rely to treat the payment as made to a foreign beneficial owner.[58]

Persons obligated to withhold are designated as "withholding agents"; the withholding agent is normally the last party in the United States handling funds. A withholding agent must withhold 30% of any payment of an amount subject to withholding made to a payee that is a foreign person unless it can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a payee that is a United States person or as made to a beneficial owner that is a foreign person entitled to a reduced rate of withholding.[59] The term "foreign person" includes foreign corporations.[60] Withholding must occur when an item subject to withholding is paid; items are deemed paid when they are includable in gross income.[61]

A withholding agent generally is personally liable for any amount required to be withheld, whether or not tax is actually withheld.[62] Where the actual tax owed is paid by the beneficial owner of income, the withholding agent is relieved of liability for tax, but still can be liable for interest and penalties.[63]

Where a withholding agent fails to withhold and pays the withholding tax from its own funds, the tax payment is either additional income to the beneficial owner or an advance of funds.[64] If additional income, the total amount subject to withholding is the amount of the payment before withholding divided by the excess of one over the tax rate.[65]

Foreign Partners of a United States Partnership

A nonresident alien individual partner or foreign corporate partner is considered to be engaged in any United States trade or business in which the partnership is engaged.[66] To this end, a foreign partner's distributive share of partnership net income effectively connected with a United States trade or business of the partnership is taxed under general Code provisions, and the partnership must withhold tax at the maximum applicable rate for the income. Foreign partners are taxed at a flat 30% rate on their distributive share of

---

58 Treas. Reg. § 1.1441-4(a)(2)(i).

59 Treas. Reg. § 1.1441-1(b)(1).

60 Treas. Reg. § 1.1441-1(c)(2).

61 Treas. Reg. § 1.1441-2(e)(1).

62 I.R.C. Section 1461.

63 I.R.C. Section 1463.

64 Treas. Reg. § 1.1441-2(d)(3).

65 Treas. Reg. § 1.1441-3(f)(1).

66 I.R.C. Section 875(1).

items that are not effectively connected with the conduct of a United States trade or business of the partnership or the partner; the partnership must withhold the tax due with respect to these items whether or not any distributions are made to foreign partners.

Tax Relief Options

Inherent within the concept of multijurisdictional business is the potential for taxation of the same income by multiple jurisdictions. The main options available for relief from a United States perspective come from use of the foreign tax credit (for outbound transactions) and income tax treaties (for inbound transactions). United States individuals working overseas also may pursue the foreign earned income exclusion.

Foreign Tax Credits

The foreign tax credit is generally available to citizens and residents of the United States for taxes paid to foreign jurisdictions.[67] The credit is designed and intended to alleviate the burdens of double taxation. In most instances, foreign tax credits are not permitted for either nonresident aliens or foreign corporations.[68] A nonresident alien or foreign corporation may be permitted to take a foreign tax credit against effectively connected income if either (1) income effectively connected with the trade or business includes income from foreign sources or (2) the country imposing the tax is not the taxpayer's country of incorporation/domicile or the tax would have been imposed even if the country was not the country of incorporation/domicile.[69]

A foreign levy is considered a tax if "it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes."[70] Payments made in lieu of a tax on income imposed by a foreign country are considered to be taxes for foreign tax credit purposes.[71] Taxes also must be validly owed for a foreign tax credit to be taken. Where a taxpayer claims a foreign tax credit for taxes paid, then subsequently receives a refund for all or part of those taxes, the taxpayer is required to file an amended return in the United States reducing the foreign tax credit taken.

Generally, the credit for foreign income taxes is limited to an amount equal to the pre-credit United States tax on foreign-source income.[72] Foreign taxes available for credit but

---

67 I.R.C. Section 901(a).

68 I.R.C. Section 26(b)(2)(K).

69 I.R.C. Section 906.

70 Treas. Reg. § 1.901-2(a)(2).

71 I.R.C. Section 903.

72 I.R.C. Section 904.

not able to be used because of the foreign tax credit limit can be carried back to the previous year or carried forward for up to ten years.

TAX TREATIES

An alternate option to alleviate double taxation is the use of tax treaties. The Internal Revenue Service currently lists income tax treaties with over sixty (60) countries in its database. Tax treaties act to reduce the scope of a country's taxing authority in situations covered by treaty terms. Where treaty terms do not cover a type of transaction (or where no treaty exists between the United States and a relevant country), the United States taxes in accordance with its standard rules.

Benefits available depend on the specific treaty at issue; however, a number of concepts are commonly utilized. Treaties often provide that business profits of a resident of one treaty party country may be taxed by the other treaty party country only where a "permanent establishment" is maintained in the non-residence country.[73] The term "permanent establishment" is typically defined as a fixed place of business through which the business of an enterprise is wholly or partly carried on, and normally will include a place of management, a branch, an office, or a factory; a building site or construction project usually will constitute a permanent establishment if it lasts more than twelve months.

Branch profits tax can also be impacted by tax treaties. Where a foreign corporation is a qualified resident of a country with which the United States has an income tax treaty, the rate of tax is the rate specified by the treaty for branch profits or, if no rate is provided, the rate on dividends paid by a domestic wholly-owned subsidiary to its foreign parent.[74] The regulations list twenty-eight countries for which the branch profits tax is eliminated for qualified residents (including, among others, the United Kingdom, Germany, and Japan).[75]

As to wages, salaries, and other remuneration derived by a resident of a treaty party country, these amounts generally are taxable only in that country unless employment is exercised in the other country.[76] Additional limitations often apply if insufficient time was spent by the recipient in the non-residence country (usually 183 days) and the remuneration is not borne by a permanent establishment in that other country.

---

73 *See* U.S.-Germany Treaty, Article 7(1).

74 I.R.C. Section 884(e)(2).

75 Treas. Reg. § 1.884-1(g)(3).

76 *See* Canada-United States Tax Treaty, Article XV(1).

Information Forms for International Transactions

As one would expect, numerous information reporting forms are relevant in this context. A brief overview of some of the most relevant forms, focusing on their applicability to foreign business transactions, is provided below. As with the above, the intention is to provide an overarching introduction to items of relevance, with determinations as to whether forms are required always being fact-specific.

FBAR

United States persons with financial interests in or signature authority over foreign financial accounts must disclose their foreign holdings on FinCEN Report 114 (the "FBAR") if the aggregate value of such accounts exceeds $10,000 during the calendar year. Reporting requirements exist for United States citizens, residents, entities (corporations, partnerships, and limited liability companies), trusts and estates.[77] United States persons are considered to have a "financial interest" in an account where the owner of record or holder of legal title is (1) a corporation in which the United States person owns (directly or indirectly) more than 50% of the voting power or the total value of the shares or (2) a partnership where a United States person owns directly or indirectly more than 50% of the interest in profits or capital.[78] Reporting requirements exist both where a United States person has a financial interest in an account or signature authority over the same, meaning that, for example, corporate officers with signature authority can maintain filing requirements individually.

Form 8938

Form 8938 is used to report specified foreign financial assets where the total value of all specified foreign assets in which the taxpayer has an interest is more than the appropriate reporting threshold. Form 8938's instructions indicate that "specified individuals" and "specified domestic entities" maintain a reporting requirement; the definition of "specified individual" includes United States residents and citizens, and the definition of "specified domestic entity" includes closely held domestic corporations that have at least 50% of gross income from passive income, closely held domestic corporations if at least 50% of assets produce or are held for the production of passive income, closely held domestic partnerships that have at least 50% of income from passive income, and closely held domestic partnerships if at least 50% of assets produce or are held for the production of passive income.

---

77 31 Regs. § 1010.350(b).

78 31 Regs. § 1010.350(e)(2).

Specified foreign assets include financial accounts maintained by a foreign financial institution. They also include stock or securities issued by someone that is not a United States person, any interest in a foreign entity, and any financial instrument or contract that has an issuer or counterparty that is not a United States person (if any of these assets are held for investment and not held in an account maintained by a financial institution).

An "interest" in specified foreign financial assets exists if any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the asset are or would be required to be reported, included, or otherwise reflected on the taxpayer's tax return. An individual who owns a disregarded entity, for example, is classified as the owner of any foreign financial assets held by the entity. The instructions state that, in most cases, a taxpayer is not classified as owning an interest held by another type of entity (such as a corporation or partnership).

Form 5471

Form 5471 is required to be filed for United States persons who are officers and directors in a corporation in which a United States person has acquired either 10% of the stock of the company (including at the company's formation) or an additional 10% of the stock of the company (measured in value or voting power). A United States person must also file Form 5471 when disposing of sufficient stock in the foreign corporation to reduce their interest to less than that stock ownership requirement. Persons classified as in "control" of a foreign corporation (owning 50% or more of the stock of a foreign corporation) for 30 days or more and owners of stock in a controlled foreign corporation for 30 days or more (who also own such stock on the last day of the year) must also file.

Form 5472

Form 5472 is filed by a reporting corporation which had a reportable transaction with a foreign or domestic related party. A reporting corporation is either (1) a 25% foreign-owned United States corporation or (2) a foreign corporation engaged in a trade or business in the United States. A reportable transaction includes certain transactions (listed on the form) for which monetary consideration was the sole consideration paid or received during the reporting corporation's tax year, or certain transactions (also listed) where either any part of the consideration paid or received was not monetary consideration or less than full consideration was paid or received.

Form 8865

Form 8865 imposes similar requirements to Form 5471 for United States persons with interests in foreign partnerships. Filing requirements exist for individuals who controlled a foreign partnership at any time during the year, owned 10% or greater interests in a foreign partnership controlled by United States persons, contributed property to a foreign partnership in exchange for an interest in the partnership, or had "reportable events" (generally acquisitions, dispositions, and changes in proportional interests) during their tax year.

FORM 8858

Form 8858 is used by United States persons who own a foreign disregarded entity to satisfy specified reporting requirements. United States persons (including domestic corporations) who are tax owners of a foreign disregarded entity are required to file the Form. Form 8858 is due on the same date as the taxpayer's tax return, including extensions. Summary filing procedures are available for dormant foreign disregarded entities, which are foreign disregarded entities which (for the year at issue) meet eight specified requirements.

FORM 8621

Investments in passive foreign investment companies are reported on Form 8621; the form must be filed by U.S. persons who are direct or indirect shareholders in PFICs. A taxpayer is required to file Form 8621 when the taxpayer: (1) receives certain direct or indirect distributions from the PFIC; (2) recognizes gain on a direct or indirect disposition of PFIC stock; (3) is reporting information with respect to a QEF or mark-to-market election; (4) is making an election reportable on Form 8621; or (5) is required to file an annual report.

FORM 8832

Form 8832 is used by an eligible entity to elect how it will be classified for federal tax purposes (as outlined above). It may elect treatment as a corporation, partnership, or an entity disregarded as separate from its owner. Information contained on Form 8832 is used by the Service to establish the entity's filing and reporting requirements for federal tax purposes.

FORM 8833

Form 8833 is used by taxpayers to make treaty-based return position disclosures, which are required for many treaty benefits. A separate form is required annually for each treaty-based return position taken by a taxpayer, although a taxpayer can treat payments or income items of the same type received from the same payor as a single item for reporting purposes. A treaty-based position is taken where a taxpayer maintains that a treaty of the United States overrules or modifies a provision of the Internal Revenue Code and thereby causes (or potentially causes) a reduction of tax on the individual's tax return. Certain positions are not required to be reported, as delineated in the Form's instructions.

FORM 1042

Form 1042 is used to report (1) the tax withheld under chapter 3 (applying to payments made to foreign persons) on certain income of foreign persons, including nonresident aliens, foreign partnerships, foreign corporations, foreign estates, and foreign trusts, (2) tax withheld under chapter 4 (generally applicable to withholdable payments made to an entity payee that is a foreign financial institution) on withholdable payments, and (3) payments reported on Form 1042-S under chapters 3 or 4. Withholding agents or intermediaries who receive, control, have custody of, dispose of, or pay a withholdable payment or an amount subject to withholding must file an annual return for the preceding calendar year unless an exception to filing applies.

Form 1042-S

Form 1042-S is filed by withholding agents to report amounts paid during the preceding calendar year that are subject to reporting. Amounts subject to reporting on Form 1042-S are amounts from United States sources paid to foreign persons (including persons presumed to be foreign) or included in a U.S. payee pool that are reportable under chapters 3 and 4, even if no amount is deducted and withheld from the payment because of a treaty or Code exception to taxation or if any amount withheld was repaid to the payee. However, withholding agents who are individuals are not required to report a payment on Form 1042-S if they are not making the payment as part of their trade or business and no withholding is required to be made on the payment.

Form W-8ECI

Form W-8ECI is supplied by foreign persons to prevent withholding on United States-sourced income which is effectively connected with the conduct of a trade or business. Parties receiving effectively connected income from sources in the United States supply Form W-8ECI to (1) establish they are not a United States person, (2) claim that they are the beneficial owner of the income for which the Form is being provided or are an entity engaged in a United States trade or business submitting Form W-8ECI on behalf of their owners, partners, or beneficiaries, and (3) claim that the income is effectively connected with the conduct of a United States trade or business.

Forms W-8BEN/W-8BEN-E

Form W-8BEN is provided to withholding agents or payors by nonresident aliens who are the beneficial owners of an amount subject to withholding. Form W-8BEN is provided by taxpayers to (1) establish they are not a United States person, (2) claim that they are the beneficial owner of the income for which Form W-8BEN is being provided, and (3) if applicable, claim a reduced rate of, or exemption from, withholding as a resident of a foreign country with which the United States has an income tax treaty and who is eligible for treaty benefits. Form W-8BEN-E is used by foreign entities to document their status.

Form 926

Form 926 is used by United States citizens, residents, corporations, estates, or trusts to report certain transfers (or deemed transfers) of property to a foreign corporation. Contributions by a United States partnership to a foreign corporation are treated as contributions from each partner rather than the partnership itself; therefore, each partner is obligated to file Form 926 individually when a partnership makes a reportable transfer (the partnership itself is not required to file).

Forms 1116/1118

Form 1116 is generally required to be filed to claim a foreign tax credit where an individual, estate or trust paid or accrued certain foreign taxes to a foreign country or United States possession (an election is also available). A corporation electing the benefits of the foreign tax credit under Section 901 must file Form 1118.