Basics of US International Tax

Chapter 136

Karthik Ranganathan, Advocate

Karthik Ranganathan, Senior Associate with Nishith Desai Associates is a Company Secretary and Post Graduate in Law from New York University School of Law. He initially practiced in the Madras High Court in the Civil, Writ, Arbitration and Indirect tax jurisdictions where he had the occasion to appear on behalf the Ministry of Finance, Corporate Affairs and Railways – Government of India. He has also worked with Big Four Accounting Firms like Ernst & Young and KPMG in their Chennai offices in the corporate tax, international tax and indirect tax practices.

Synopsis

I. Introduction to US international tax system

US taxes its residents both the individuals and the corporations on worldwide income basis. On US source income, US taxes have to be paid in any case and there would be no credits available even if any foreign country taxes are paid on US source income. However, in case of foreign source income, since US follows worldwide income taxation and in order not to discourage its domestic players from making outbound investments, US grants credits on the foreign taxes paid against the US tax liability. However, there are certain limitations on such credits which are discussed later in this article.

The highest tax bracket for individuals in the US is 35% (it ranges from 10% to 35%) and for corporations the tax rate is 35%. The tax rates for the individuals in the US underwent a significant change in the famously called 'Bush tax cuts' in 2002. Of many changes, the tax rates for individuals were gradually lowered from 39.6% to 38.6% and then to the current rate of 35%. The Bush tax cuts were for 10 years and would automatically lapse in December 2012 unless extended by Obama administration.

For corporations, entity classification is an important aspect since US taxes both domestic and foreign corporations at the same rates. There are certain foreign entities which are by default considered to be a corporation by the US which are listed in the Treasury Regulations. Other entities, especially domestically organised entities have to option to be elected either as corporations or as transparent (look thru) entities by 'checking-the-box' regime. The effect in simple is that if an entity is classified as a corporation, such entity *per se* is taxed and not its members (depends on corporate or non-corporate shareholders and the nature of dividends) and in case of look thru entity, the entity is not taxed but its members are.

As we may know, US tax system is one of the most complex tax systems in the world and its international tax system is arguably the hardest part of it. Given that, we would be analysing the basics of US international tax system in this article.

To get introduced to the devil i.e., the details of US international tax, to be taxed in the US, 'taxpayer connection' is the basis for taxing US citizens, residents and domestic corporations. This is commonly known as residence based taxation. Therefore, regardless the source of income i.e. within or without US, if there is a US connection to a taxpayer then such taxpayer is subject to US taxes. All other taxpayers are taxed based on 'income connection' which is commonly known as source based taxation i.e. a non-resident alien[1] (neither a resident nor not a US citizen) or a foreign

1 'Alien' under US immigration laws means a person who is neither a US citizen nor a US national. US national include US citizen and is wider in its meaning. A 'resident' is one who fulfills the conditions to be a US tax resident. Therefore, a nonresident alien is one who is not a US citizen and does not fulfill the test of US tax residency. Also, a 'resident alien' is one who is not a US citizen but fulfills US tax residency tests.

corporation pays US taxes only on certain US source income and on effectively connected income (ECI).

II. Residence of individuals and entities

As per section 7701 of the Internal Revenue Code (the Code or IRC) the definition of person; partnership and partner; and corporation for the purpose of residence is as follows:

(a) Person

The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.

(b) Partnership and partner

The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organisation, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organisation.

(c) Corporation

The term "corporation" includes associations, joint-stock companies, and insurance companies.

1. Person (Individuals)

As mentioned above, it is important to determine the status of an individual either as resident alien or non-resident alien for establishing the appropriate tax regime since resident aliens are taxed on their worldwide income and non-resident aliens only on certain US source income.

The determination of status as resident or non-resident is under section 7701(b) of the Code, an individual is a US resident if he is a:

— US citizen,

— Green card holder or permanent resident, or

— Maintains a 'substantial presence' in the US.

In all other circumstances, he/she will be treated as non-resident.

US citizens

Even if US citizens are not physically present in the US for the tax year in question, they would still be treated as residents of the US and would be subject tax on their worldwide income. In other words, US citizens are always liable to US taxes on their worldwide income regardless whether they are physically present in the US or not[2].

That said US citizens would be eligible to claim foreign tax credits on the taxes paid in the foreign country on foreign source income against their US tax liabilities. However, no credit will be available against the taxes to be paid in the US on the US source income. In the sense, US does not allow credits against its own source of income. Foreign tax credits are discussed in detail later in this article.

Permanent residents

Permanent residents i.e. green card holders (though now white in colour) is defined in section 7701(b)(6) which provides that an individual is a lawful permanent resident of the United States at any time if:

(A) Such individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, and

(B) Such status has not been revoked (and has not been administratively or judicially determined to have been abandoned).

An individual shall cease to be treated as a lawful permanent resident of the United States if such individual commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country, does not waive the benefits of such treaty applicable to residents of the foreign country, and notifies the Secretary of the commencement of such treatment. Therefore, for green card holders to avoid US taxes, such person should become a resident of a foreign country

2 Arguably, US is the only country in the world which has citizenship based taxation. Eritrea, though, has citizenship based taxation but otherwise called 'diaspora' tax which means by its term that those who have fled Eritrea. The basis for citizenship based taxation in the US is upon the belief that US citizenship confers benefits independently of its residence. Well, if one feels proud to be a US citizen then it would cost him dearly!

by applying the tie-breaker rule of the relevant treaty. Failing which, such person would be liable to US taxes even if he is not physically present in the US. However, the Internal Revenue Service website mentions that green card holders would be treated as US tax residents under the condition that they spend at least one day in the United States.

Substantial presence test

For the purpose of the third type, substantial presence means:

— The individual was present 31 days in the US in the year in question; **and**

— The weighted average is 183 days over the current year and the two preceding years i.e. (current year: 1; preceding year: 1/3 and second preceding year: 1/6).

This means that all the number of day's stay of the current year and one-third of the number of day's stay of the first preceding year and one-sixth of the number of day's stay of the second preceding year would be counted. And the weighted average for these three years should exceed 183 days. Therefore, ideally, if a person stays 122 days every year in the US he can avoid substantial presence test residence.

Exceptions to the substantial presence rule – Time spent as employee of foreign government, as a student or teacher (students up to five years and teachers up to two years), or when alien is in the US for medical reasons.

In case if the individual maintains dual residency i.e., is a tax resident of two countries (which is very common with US citizens staying significantly in foreign country), then tie-breaker rule would apply as per the respective tax treaty. Dual residence is resolved by tie-breakers i.e., where the permanent home of the resident is situated; or his closest personal and economic relations; or his habitual abode; or his citizenship.

2. Entities

As per section 7701(a)(4), a corporation is domestic if organised (incorporated) in the US. A partnership is domestic if it is created in the US.

If a company is a resident of two countries (if organised in the US and if wholly controlled and managed from a foreign country) then as per tax treaty, the place of organising would apply for US tax purposes. However, most treaties look at place of effective management and control.

In case of a limited liability partnership (LLP) or a limited liability company (LLC), they are by default treated as flow thru entities i.e., the partners/members are taxed and not the entity as such unless such entities 'check-the-box' to be treated as corporation.

The taxable year in the US is usually the calendar year for individuals (i.e., Jan to Dec) and for corporations, they can choose their tax year which must be 12 months.

III. Taxation of Inbound and Outbound investments

1. Inbound investments

Sections 861 to 865 of the Code and the Regulations issued thereunder deal with sourcing of income for US tax purposes. The rules that apply with regard to sourcing of income is the same for both foreign persons and US persons. However, non-resident aliens and foreign corporations are liable to tax only on US source income and for US persons including corporations sourcing are important to determine the availability of foreign tax credits on foreign source income to offset against US tax liability.

Sections 861 and 862 of the Code deal with determining the source of certain types of income within and without the United States. The various types of income dealt under sections 861 and 862 are passive in nature such as interest income, dividends, personal services, rent and royalties, disposition of United States real property interest, sale or exchange of inventory property, etc.

If income is not effectively connected with a trade or business in the US then it is exempt from US tax unless it is from sources within the US and falls within certain designated classes which include dividends, interest, rents and royalties, etc., but generally does not include capital gains and other income realised on sales of property. These incomes are called fixed or determinate and annual or periodic (FDAP) also called as passive income.

When passive/FDAP income is subject to US tax, the tax rate is a flat 30% by way of withholding (except as reduced by tax treaty) and applies to the gross amount of the income without any deductions. FDAP does not include gain from sale of property i.e. capital gains on sale of property are not subject to withholding tax

(WHT) under the Code. As per section 865(a) trading gains by a foreign person (including trading in shares and securities) are foreign source and not subject to US tax as FDAP.

1.1 FDAP

The tax liability of each of the above incomes in detail is as follows:

A. Interest income

Interest income is from US sources if it is paid or accrues on an obligation of a domestic corporation, a non-corporate resident of the US (individuals), the federal government or an agency or instrumentality of the federal government. Therefore, if a US person makes an interest payment to a non-US person, then such payment becomes US source income and thereby subject to US WHT. However, depending on the nature of the business of the obliger i.e. US borrower the interest payment though made by a US person would be treated as foreign source income. If 90% of the income of the obliger is from an active foreign business in the testing period then any interest paid by such US person would be deemed to be foreign source income and no WHT would apply.

For partnership, it will be US source only if the partnership is engaged in trade or business (ETB) in the US at any time during taxable year. For corporations, all interest paid by a domestic corporation is deemed to be US-sourced income.

Tax treaty effect

As per US Model tax treaty, "interest derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State". In practice, it means interest is thus exempt in the country of its source if the recipient of such interest income is a resident of the other treaty country.

Permanent Establishment

The exemption for interest does not apply to interest attributable to a permanent establishment or fixed base in a country where a person carries on business. The interest received by a branch of a foreign bank, for example, is not exempt under the general rule, but rather treated as a business profit attributable to the branch business. Also, interest received from a foreign branch of a US bank is treated as foreign source income. However, interest received from a US branch of a foreign bank would be treated as US source income.

B. Dividends

Dividends paid by a US corporation are generally US source income and dividends paid by foreign corporations are generally foreign source. However, if at least 25% of the foreign corporation's gross income is connected to a US business, dividends are deemed to be proportionately US source.

Tax treaty effect

Income tax treaties generally reduce, rather than eliminate, the tax imposed by the country of source on dividends received by residents of the other treaty country. In the U.S. Model Treaty, the tax imposed on dividends by the country of source is reduced to 15% for most dividends and to 5% if the recipient is a corporation owning at least 10% of the voting stock of the corporation paying the dividend.

C. Services

Source rules

As a general rule, service income is usually sourced where the services are performed. In particular, services performed in the US will be sourced in the US unless all of the following requisites (*de minimis* threshold) are met:

- Services performed by non-resident alien in the US less than 90 days;
- Compensation for services rendered does not exceed $3,000; and
- Compensation is for services as an employee (or under contract) of:
  - A non-resident alien or foreign corporation or partnership that is not engaged in a trade or business in the US; or
  - A US citizen or resident, if services are performed for an office maintained in a foreign country by such US resident.

Tax treaty effect

In general, residents of one country may derive income from personal services in the other country without taxation in the source country.

Most US treaties divide services into two classes:

(i) Independent services – Services performed as an independent contractor or in self-employment.

(ii) Dependent services – Services performed as an employee under the close direction of another person. In addition, many treaties contain a special provision for the compensation of corporate directors, performing artists and athletes, as well as the incomes of students, teachers and scholars.

Independent Personal Services article in US tax treaties is similar to the business profits article i.e., the source state may not tax the personal unless he has an office or fixed place of business in the state and the services are attributable to that office or fixed place of business.

Dependent Personal Services is where the employee would typically be taxed at residence country unless he works abroad. In which case, he would be taxed by the source country. However, he won't be taxed by source country if:

i. He is less than 183 days in the source country;

ii. Compensation is actually paid by home country employer;

iii. The employer is not a resident of the source country; and

iv. The salary is not borne by a PE that the employer has in the source country.

In summary, an employee of an employer in one treaty country can spend up to 183 days annually in the other treaty country without being taxed there. In these situations, employees would remain subject to income tax only in their country of residence.

D. Rents and Royalties

Rental income from property located in US or from any interest in such property is US source income. Gains from sale or exchange of personal property are not FDAP and are sourced in the country of residence of seller. They are not subject to WHT.

Source rules

The general rule for sourcing rents and royalties is where the property is located (rents from lessees of tangible property) or used (rents from licensees of intangible property).

License/sale of intellectual property

— For licensing, source will be the place of use of IP.

— For sale of IP (when a contingent price is determined by production, use), then source will be where the IP is located/used.

— For sale of IP at a certain price, then gain is sourced in the country of residence of the seller, as long as it is not contingent on productivity, use, etc.

Tax treaty effect

Under the US Treaty Model, royalties received by a resident of a treaty country are usually taxable only in that country (exemption in the source country) or a reduction of WHT rates would apply on the taxes imposed by the source country.

Services vs. Royalties in an IP context

Services when the performer is not the owner of an IP

In the below two case laws, there was no US tax liability either under services income or income from royalties by applying different yardsticks even when the types of income was more or less the similar.

In *Karrer case*, a Swiss national, Paul Karrer was a resident in Switzerland and a scientist who developed scientific formulas. Karrer entered into an agreement with a Swiss company to get certain percentage of sales of vitamins in Europe based on his scientific formulas. Karrer was hired by the Swiss company to perform services and he did not own the intellectual property. Later the Swiss company entered into contract with US company to sell vitamins in US. The US company made payments directly to Karrer under the arrangement.

The issue was whether the payments were for compensation for services or royalty payment to Karrer. If it were services then there would be no US taxes because services were not performed in the US. However, if it were royalty payments then there would be

US taxes because IP was used in the US. However, the US Court of Claims held that the payments were for performance of services and therefore, not liable to US taxes.

In *Boulez case*, a US company named CBS hired a German artist who was a resident of Germany to record performances in the US. The issue was whether the payments made by the US company to the German artist was for performance of services or for royalty.

Under the Code, there would be tax in both situations i.e., either performance of services in the US or royalty which is US sourced income. However, under the US–German tax treaty, if the payments were treated as royalty then only the country of residence of the performer had the right to tax such income and the source country did not have the right to tax.

The US Tax Court held that the payments were actually for performance of services since Boulez did not have any IP rights over the recordings as per the contract. Therefore, Boulez was taxed in the US as the services were performed in the US. Interestingly, Germany treated the income as royalties as per the German tax law and therefore, taxed such income in Germany as well.

E. Real Estate dispositions

There are three possible ways of disposing of a US real estate:

— Foreign taxpayer owns US property directly

— Foreign taxpayer owns US property through a domestic corporation

— Foreign taxpayer owns US property through a foreign corporation

Under the first two situations there would be US taxes i.e., gains, profits and income from the sale of a US real estate property or US real property interest is US source income. US real property interest means interest in real property located in the US (interest including shares of company owning real property, leaseholds, fee ownership and options).

However, under the third situation i.e., holding US real property through a foreign corporation and the sale of shares of such corporation is not deemed to be US source income.

Unidentifiable income

If there is no specific source under which a particular type of income would fit in like services, royalties, interest, etc., then the closest source will have to be chosen and tax such income under that category.

In *Bank of America* case, BofA was engaged in transactions whereby it would act as intermediary between US seller and a foreign purchaser. Since the seller and the purchaser did not know each other, the usual method of payment was by issuing letter of credit by a foreign bank (where the purchaser was resident) to the US seller. Under this arrangement, the foreign bank would issue letter of credit to the US seller. The seller would take it to his banker in US i.e., BofA for encashment once the sale is completed. BofA had commercial relationship with such foreign banks. Under this method, the seller would have comfort of the local bank (BofA) that would back up promise of payment by the foreign bank. For the support provided by BofA, the foreign bank would compensate it for its 'services'.

The issue involved in this case was the source and the type of income that was earned by BofA. A part of the fees was characterised as a reward taken by BofA in taking the credit risk and therefore, was sourced as interest income to it.

Certain other part of the fees was treated as compensation for services rendered by BofA to the foreign bank. On the facts, the borrower was a foreign bank and the services were performed in the US by BofA. Therefore, the US Court of Claims sourced the fees for services as US source income and taxed it accordingly and the fees paid for taking the credit risk was treated as foreign source interest income and therefore, not taxable in the US.

1.2 Engaged in trade or business in the US

We had discussed in the previous paragraphs about the taxation of passive investment income in the US which had a flat WHT implication usually at the rate of 30% or at lower rates as prescribed in the relevant tax treaties. If however, such investment income is effectively connected with a US trade or business then such income would be taxed at net basis at regular individual or corporate rates.

As per the current US international taxation system, there three kinds of taxing US source income earned by foreign persons.

The first being, flat WHT on passive investment income as discussed above. The second, taxing such investment income at regular rates on the net income post deductions if such incomes are effectively connected with a US trade or business. The third, even though a foreign person is engaged in US trade or business, any other unrelated passive investment income if not effectively connected with a US trade or business would still be taxed as passive income. The force of attraction rule which was prevalent previously in the US would attract even unrelated passive investment income if the foreign person is engaged in any trade or business and would be taxed at regular rates. However, now the force of attraction rule has been limited and any unrelated passive income would not automatically be attracted to US trade or business.

There is no definition in the Code or Regulations for the terms 'trade or business in the US'. However, according to case laws, a foreign corporation is engaged in a US trade when it is engaged in activities in the US which are 'considerable, continuous and regular'. Further, 'engaged in trade or business' is broader than permanent establishment (PE) concept. So, even when a foreign corporation does not have a PE in the US, it could still be engaged in trade or business.

Taxation of foreign corporations

A foreign corporation engaged in trade or business in the US shall be taxable on its effectively connected income (ECI). The gross income of foreign corporation includes ECI and other income from US sources. However, the corporation would be in a position to claim deductions from its gross income. The foreign corporation may take deductions to the extent income is allocated/connected to ECI like the business expenses incurred while earning ECI.

Taxation of partnerships

A non-resident alien or foreign corporation shall be engaged in a trade or business if the partnership of which such person is a partner is engaged in a trade or business in the US. If a person is acting as an agent for a foreign partnership and is engaged in trade or business, then the foreign partnership will be deemed to be ETB.

If a partnership has ECI and a portion of ECI is allocable to a foreign partner, then such partnership must withhold US taxes on the foreign partner's portion.

Sale of a partnership interest generates ECI to the same extent that the sales of assets would have generated.

1.3 Effectively connected income

If the income is effectively connected with a trade or business in the US then the taxable income is computed by the same rules that apply to US persons, except that gross income not effectively connected with the US trade or business is excluded and deductions are limited to those connected with ECI. If a foreign corporation or a non-resident alien is not engaged in a US trade or business, no ECI will arise.

However, sections 871(d) & 882(d) enable a non-resident alien & a corporation respectively who/which has income from real property held for production of income to elect to treat the income as ECI.

The two tests used to determine whether any income is ECI in the US are (i) asset use test and (ii) business activities test.

Under the asset use test if the non-resident alien or the foreign corporation uses any properties in the US like plant and machinery, office premises, etc. would be treated as effectively connected. Under the business activities test, it depends on the nature of activities of the foreign person like dealers in stock and securities for the purpose of earning interest income or dividends or capital gains on sale of such stocks, etc. Also, licensing of IPRs or service fees by firms would be treated as ECI.

Income effectively connected to a pre-existing business

Deferred payments on sales or services – If the foreign resident is no longer in the business and receives payments in respect of past business services or property sales, the income are still US business. If the income would have been ECI when the US business was conducted, the income will be deemed ECI.

Business property that ceases to be used or held by a US trade or business and sold within 10 years – If the foreign resident is no longer in the business and sells property used in the US trade or business and if the gains would have been ECI when the US business was conducted, the gain will be deemed ECI.

FDAP vs. ECI

The effective connection of a foreign person's income from US sources is tested by segregating these items into two categories viz. FDAP income which means passive income that would be subject to WHT (as discussed above). ECI is connected with a US trade or business only if an actual connection exists.

To determine whether a US source income will be ECI, it has to satisfy the 'assets use test' or 'activities test' i.e. material fact test. An income is derived from assets used in the business or the business activities were a material factor in realising the income or it comes under the force of attraction rule.

Tax treaty effect

If income is not ECI under the Code, the foreign person will not have a permanent establishment (PE). Under treaties, to be subject to taxation in the US on business income, the taxpayer must have (a) a PE and (b) have income attributable to the PE.

Therefore, income will not be attributable to a PE unless the income is generated by the assets of the business; or the activities of the business are a material factor in the realisation of income.

The requirement that income be attributable to a PE to be taxable on a net basis is a higher threshold than the requirement that it be ECI. In order for income to be attributable to a PE, there must both be a PE and income must be attributable to it.

2. Outbound investments

2.1 Foreign tax credit

Overview of FTC

The policy behind the FTC is to alleviate the double taxation that results when income earned in a foreign country is taxed both by the U.S. and in the country of source. The foreign tax credit is the home-country relief provided by the U.S. Generally, FTC is only allowed to citizens and residents of the U.S. or domestic corporations. It will be attributable to foreign corporations with U.S. ECI if the residence country tax the ECI derived in the U.S.

The Code authorises the taxpayer to take a credit on the amount of its foreign taxes paid, to be offset against US taxes due on foreign source income subject to the limitations imposed. Taxpayers may deduct or credit foreign taxes in a particular year, provided the choice is applied consistently to all foreign taxes incurred in the year (i.e., taxpayer cannot credit in some cases and deduct in other cases). In general, opting for FTC is always better than deducting foreign taxes from gross income as FTC works on *tax vs. tax* basis. If foreign taxes are not creditable, then the deduction becomes a good alternative.

Without the FTC, the US taxpayers with foreign source income would be at a higher burden than the US taxpayers who have only US source income. This would deter US taxpayers from making foreign investments and US taxes would be a major factor on foreign investment decisions.

Capital Export Neutrality (FTC system) versus Capital Import Neutrality (Exemption system)

Under the CEN, the home country does not exempt from its domestic taxes rather provides tax credits against its tax liability. This is precisely what the US international tax system does. In an ideal CEN system, the excess taxes paid by a domestic investor abroad should be refunded by the home country. In the US, though foreign tax credits are granted against US tax liability, it does not follow pure CEN i.e. it does not refund on excess foreign taxes paid thereby, making less favourable to US taxpayers. However, with the carryback and carry forward rules to some extent there is tax neutrality in the US on foreign taxes paid.

Under the CIN, the domestic country of the taxpayer exempts the foreign income from its taxes which is typically followed in the European countries. In this system, the foreign income is not liable to domestic taxation of the taxpayer and works really well if the investments are made in low taxed jurisdictions as there would not be any additional domestic taxation unlike in the CEN system.

However, if the foreign taxes are higher than the domestic taxation then the net effect under both the systems i.e. CEN and CIN would be the same as additional taxes paid abroad would be a cost for foreign investments.

Carry overs

As discussed above, credits not used in the year to which they relate (excess credit year) may be carried back one year and forward 10 years. In general, foreign tax credit planning involves attempts to generate low-taxed foreign income (for taxpayers with excess credit), or generate high taxed foreign income (for taxpayers with excess limitation).

Direct Credit [Section 901(a)]

A U.S. person who has foreign source income burdened by tax is eligible to take foreign tax credit. US persons mean US citizens and domestic corporations and it includes alien residents. US persons may credit income taxes paid to any foreign country. Non-resident alien individuals and foreign corporations can also claim credit for taxes paid to any foreign country with respect to income that is effectively connected with the US trade or business.

Only foreign 'income taxes' are eligible for credit against US taxes. For this, creditability would be determined as per US standards. Therefore, though a foreign country may term it income taxes, if as per the Code it is not deemed to be income taxes then such taxes are not creditable. Treasury Regulations (Regs.) 1-901-2 determine the creditability of foreign taxes. However, this position could be changed by a tax treaty which means, there could be an agreement between the US and the treaty partner obliging the IRS to provide credit on certain taxes levied in the foreign country though may not be treated as income taxes in the US. In *Exxon Corp. vs. Commissioner*, the Tax Court allowed credit on the UK petroleum revenue tax since Article 2 of the US-UK tax treaty provided tax credit for the UK PRT.

Taxpayers in an excess credit position may elect to deduct foreign taxes for a given year. However, a taxpayer must deduct or credit all foreign taxes for a given year and cannot cherry pick in the same year.

Indirect Credit [Section 902(a)]

Section 902 treats foreign income taxes paid by subsidiaries of the US parent corporations as deemed paid by the parent. As a result, the US corporation becomes entitled to the credit under section 901 for the taxes deemed paid by it. This is commonly known as 'indirect credit'.

As explained, the credit of taxes which are borne at the entity-level (i.e., corporate taxes of the subsidiary) is eligible for the US company but is deferred until actual repatriation of the income which suffers such taxes i.e. until payment of dividend. However, there are certain requirements to be eligible for indirect tax credit. Such as:

Stock Ownership Requirement – The US parent should own 10% or more of the vote of the foreign subsidiary. In such circumstances, the US parent corporation is deemed to have paid foreign tax in the same proportion of its participation in such foreign corporation. Such proportion can be applied to the dividends received and to undistributed earnings.

Technical Taxpayer Rule – To be eligible to claim foreign tax credit, a tax is deemed paid only by the person on whom the foreign law imposes legal liability for such tax even if another person such as a withholding agent remits the tax. In other words, it is the technical taxpayer under foreign tax law who is deemed to have paid the tax and not the person who bears the economic burden of foreign tax that can take the FTC. Therefore, the US person should be eligible to claim FTC even if the tax is actually borne by any other person other than the foreign subsidiary.

2.2 Entities that typically generate FTC

Controlled Foreign Corporation (CFC)

A CFC is a foreign corporation over half of whose voting power or total stock value is owned by one or more U.S. persons, each of whom owns at least 10 per cent of the voting stock. A CFC's passive and other tax-haven type income is imputed (attributed) to such share holders as their ordinary income. If a share holder is a corporation owning at least 10 per cent of the voting stock, it can claim an indirect credit for foreign tax imposed on the CFC's profits. With regard to an individual, he is not eligible to claim indirect foreign tax credit on the taxes paid by the foreign subsidiary as individuals are entitled to claim only direct FTC under section 901. However, the individual can check the box of the foreign corporation to be treated as a look thru entity (like a partnership) and thereby becoming eligible to claim credit as and when the taxes are paid by the foreign entity. However, by this the individual would be deemed to have earned the foreign income directly and a tax deferral will not be possible.

Passive Foreign Investment Company (PFIC)

A PFIC is a foreign corporation heavily involved in passive investment (75% of its income or 50% of its assets are passive). A U.S. share holder of a PFIC, no matter how small percentage must either elect to be taxed on the PFIC's income on a simplified flow-through basis (flow-through of ordinary income and long-term capital gain), or report disposition of the stock as ordinary income with an interest charge approximately designed to negate the benefit of deferral. However, indirect foreign credits on PFIC income are available only to 10-per cent corporate shareholders.

FTC limitations [Section 904(a)]

The need to have limitation on the FTC is, without which, the foreign governments would raise their tax rate to higher level which would reduce U.S. tax revenue on foreign source income as US taxes on worldwide income.

The formula which limits the FTC for US tax purposes is:

$$\textit{Tentative US taxes} \times \frac{\textit{Foreign taxable income}}{\textit{Worldwide taxable income}}$$

This however, can be simplified to: *US tax rate x foreign taxable income*

Basket limitation

Income and foreign taxes must both be allocated to baskets i.e. same type of income. Initially there were nine baskets i.e. nine types of incomes and the foreign incomes were allocated to each basket depending on its nature. The limitation applies separately to each basket (as per the formula above). However, due to the extreme complexity involved in maintain records and to allocate FTC to each type of income the IRS reduced the baskets and as of now there are only two baskets such as passive income basket and all other income basket.

IV. Treaty override, treaty shopping, anti-conduit rules and hybrid entities in the US

The benefits of a US tax treaty like lower withholding rates on FDAP, exemptions, non-discrimination protections, permanent establishment provisions, etc. may not be available to the taxpayer of the other contracting country by applying the Limitation of Benefits (LOB) clause in the treaty, if the Congress, Courts or the Executive branch perceives as abusive situations or circumstances that circumvent the premise on which a treaty was negotiated.

A. Treaty override

Under Supremacy Clause of the US Constitution both treaties & statutes are treated as equal. Further, section 894(a) provides that the Code would be applied without due regard to treaty obligations and section 7852(d) of the Code provides that neither treaties nor the Code have preferential status over the other. In the event of a conflict, a statute can override a treaty under the 'later in time' rule. It has generally been understood that amendments to the Code could override the treaty where the intent to do so was clear in legislative history. However, the Code provision should be clear of such intent.

B. Treaty shopping

Limitation on Benefits

Treaties generally define a resident corporation in accordance with the place of incorporation, place of management or similar criteria. However, the LOB clause imposes more obligations to be eligible to tax treaties benefits to avoid frauds. As a matter of fact, every US treaty has an LOB article but for two treaties i.e. with Hungary and Poland.

An LOB provision has the following characteristics:

— LOB provision in the treaties is a mechanism aimed at preventing treaty benefits to a corporation that has no significant economic contact with a treaty partner or does not pay taxes in a treaty country.

— LOB provision in the US Model Treaty denies benefits to corporation unless it satisfies at least one of the following tests:

i. **Ownership test** — More than 50% of the corporation's or its parent corporation's voting rights are publicly traded. The stocks must be publicly traded in the country where it alleges to be resident;

ii. **Base erosion test** — At least 50% of its shares are owned by residents of a treaty country who qualify for benefits and less than 50% of its gross income is repaid to non-residents of either the US or the other treaty country. In other words, the company should have local ownership (be controlled by its residents) and local tax base (not eroded by payments to residents of third countries);

iii. **Active business test** — With respect to treaty benefits relating to income earned in the US, the US income must be connected to a business in the treaty country and the business in the treaty country should not be unsubstantial in relation to the US activity generating the income; or

iv. Competent authorities should determine for other reasons that treaty benefits are available.

C. Anti-conduit rules

If an intermediate company is interposed in a low tax jurisdiction with which US has a tax treaty between the US company and the other related company with the only intention to be entitled to treaty benefits then such structure will most likely not be accepted.

In the famous *Aikens* case, a US subsidiary was paying interest on loan to a Bahamian company. There was no treaty between the US and Bahamas. So, the Bahamian company swapped the US subsidiary's note with Honduras company so that loan was going through Honduras. US has tax treaty with Honduras. The US court said that Honduras wasn't 'actually receiving' the interest for every dollar coming in that dollar had to go out. Although the treaty exempted interest received by a treaty partner resident in Honduras, the court interpreted 'received' to require dominion and control over the funds and concluded that the intermediary had no such control but instead functioned as a collection agent. So, the payments made by the US subsidiary were liable for withholding tax. The basis of such a rationale was that the Honduras company was not really free to spend the dollars it received but was simply a conduit or agent for this transaction.

In 1991, the anti-conduit Regulations were introduced in Regs. 1.881-3 which empowers the Revenue Service to ignore the existence of a conduit entity in a conduit financing arrangement and to obligate taxpayers to discharge withholding obligations as if it dealt directly with the financing entity.

D. Hybrid entities

There are two types of hybrid entities in general such as:

Regular hybrid entity

This entity is transparent for US tax purposes but a separate entity for other country. Examples are partnership under U.S. tax law but as a taxable entity in the other country like the Limited Liability Companies (LLCs) in the US.

The effective cross border tax arbitrage involved under these circumstances when any payments are made by a US hybrid entity to its foreign parent would be that the U.S. would not tax such payments under the impression that the payments are made within the same entity (i.e., the flow thru US entity would be treated as a branch of the foreign company). On the other hand, the foreign country would also not tax it since much of the US tax treaties are residence based taxation i.e. only the payer country, the US, would have the right to tax because as per the foreign country the payments are made between two related entities and the US entity will be looked at as a separate entity.

Reverse hybrid

Under this an entity is treated as a separate entity in the US but a look thru entity in the other country. This is done by having a partnership in the US 'check-the-box' to be treated as a corporation and the other country would treat the partnership as a flow thru entity.

Measures to prevent misuse hybrid entities

The general understanding of treaty partners is that a treaty reflects a source country's agreement to relieve taxation with the expectation that the residence country will exercise its right to tax the income at home. Where hybrid entities frustrate that expectation, US takes measures to deny treaty reduced withholding taxes. Section 894(c) denies treaty reduced withholding rates with respect to payments of US source income to an entity treated as transparent under US tax law where:

- the treaty is silent on treatment of income earned by a partnership, and
- the home country doesn't tax its entity upon distribution of any income.

V. Check-the-box Regulations (CTB)

Before the CTB regime, an entity was classified as a corporation or as partnership based on the following requisites:

(i) continuity of life,

(ii) limited liability,

(iii) centralised management, and

(iv) free transferability of interest.

If the answer to all the above requirements is positive then such an entity was regarded as a corporation.

In 1996, the CTB regulations were adopted in order to simplify the issue of entity classification. In short, a CTB election is an entity classification election that is made on I.R.S. Form 8832, *Entity Classification Election*. One has to check the appropriate box, specify the date that the election is to be effective, sign and file the form. The choice is effective on the date indicated in the form, but no more than 75 days before or five years after filing. Usually, there are three possible classifications of business entities for US tax purposes such as, corporation, partnership, or disregarded entity. Apart from corporation and partnership, a disregarded entity means, if there is only one US owner of a foreign partnership and if the US owner checks the box to treat the foreign partnership as a corporation then such entity is treated as a disregarded entity.

Effect of checking the box of a foreign entity

The main benefit of the CTB is to avoid the application CFC rules on US persons. CFC rules apply only on a foreign 'corporation' which is controlled by US persons. Under CTB, a foreign corporation can be treated as transparent entity i.e. partnership or vice versa. So, by checking the box, the foreign corporation is treated as a partnership and thereby CFC implications would be avoided.

If a foreign entity is treated as a partnership by CTB, then its controllers are deemed to be owners of the assets and not the stocks. However, *per se* entities (entities which are public limited companies) are not eligible for CTB and cannot be treated as partnership.

If any of the owners do not have limited liability in a foreign entity, the entity would fall under the default partnership status. By CTB, such entity can be treated as a corporation. If there is only one US owner to the foreign partnership then by CTB such entity becomes a disregarded entity (as mentioned above) and the effect being, the income of such disregarded entity is not included to the income of the sole US owner. This helps deferral of US taxes on foreign income.

CTB can also be applied to domestic entities where a domestic partnership is deemed to be a corporation. For example, a Delaware LLC or a partnership may elect to be treated as a corporation for US tax purposes and through such a corporation, investment in foreign companies could be made. However, once an entity elects to change its status then it must wait for five years before it may reverse. However, if it does within five years then such change (i.e., unchecking the box) would be deemed to be liquidation of the foreign entity and US tax consequences on liquidation as mentioned under sections 331 and 332 of the Code would apply to US share holders.

For individuals, who owns all the stocks of a foreign company which pays tax in that foreign country no foreign tax credit would be available to such individual upon dividend distribution on the underlying taxes paid by the foreign company (i.e., on the corporate taxes) as no indirect tax credit is available to non-corporate share holders. Therefore, classical double taxation would apply on the same income i.e. at the corporate level and the individual share holder level. By checking the box, the underlying taxes become eligible for direct tax credit i.e. the foreign entity is deemed to be transparent and therefore, the US share holder is deemed to be a partner of such entity and would be eligible on the taxes paid by the partnership as his own taxes. However, by checking the box it will make the entity transparent and there would be no deferral of the income earned by the foreign entity and would be subject to tax in the hands of the individual as and when it is earned.