Chapter 24

Taxation of International Transactions

Eugene Willis, William H. Hoffman, Jr., David M. Maloney and William A. Raabe

Overview Of International Taxation (slide 1 of 2)

- The U.S. taxes U.S. taxpayers on "worldwide" income
- The U.S. allows a Foreign Tax Credit to be claimed against the U.S. tax to reduce double-taxation (U.S. and foreign) of the same income

Overview Of International Taxation (slide 2 of 2)

- The U.S. taxes non-resident aliens and non-resident entities on U.S. income
  - If a person lives in the U.S. for a long enough time, that person is a “resident” and is taxed as a U.S. citizen on world-wide income

International Tax Treaties

(slide 1 of 3)

- Tax treaties exist between the U.S. and many other countries
  - These treaties are designed to eliminate or minimize double-taxation on the same income
  - The treaties also identify which country (host or residence country) has original taxing authority over specific types of income

International Tax Treaties

(slide 2 of 3)

- Tax treaties are one reason international tax is complex
  - There are numerous treaties, each with different provisions
  - In many situations, several countries are involved in transactions, so it may be necessary for the practitioner to be aware of treaties among those other countries as well

International Tax Treaties

(slide 3 of 3)

- Many treaty provisions are standard, so it is possible to estimate the tax effect of a transaction. However, the treaty should always be consulted for a final analysis.

Sourcing of Income (slide 1 of 10)

- Interest income
  - Interest income from the U.S. government, the District of Columbia, from U.S. corporations, and from noncorporate U.S. residents is treated as U.S. source income
  - Certain exceptions apply

Sourcing of Income (slide 2 of 10)

- Dividend income
  - Dividends are generally sourced based on the country of incorporation of the payor
  - For example, a dividend paid by a U.S. corporation is U.S. source income

Sourcing of Income (slide 3 of 10)

- Dividend income (cont'd)
  - Exception-if a foreign corporation receives 25% or more of its income from a U.S. business in last three years, dividend is U.S. source to extent of percent of income effectively connected with conduct of a U.S. business
  - Dividends paid by a Foreign Sales Corporation or Domestic International Sales Corporation can be treated as U.S. source income

Sourcing of Income (slide 4 of 10)

- Personal services income
  - Sourced where the services are performed
  - An exception applies to non-resident aliens in the U.S. 90 days or less during the tax year
    - If U.S. compensation does not exceed $3,000 and the services are performed for a non-U.S. enterprise not engaged in a U.S. trade or business, the income is not U.S. source

Sourcing of Income (slide 5 of 10)

- Rents and Royalties
  - Income received for tangible property (rents) is sourced in the country in which the rental property is located
  - Income received for intangible property (royalties) is sourced where the property producing the income is used

Sourcing of Income (slide 6 of 10)

- Sale or exchange of property
  - Generally, the location of real estate determines the source of income derived from the property
  - Income from sale of non-inventory personal property is sourced based on the residence of the seller

Sourcing of Income (slide 7 of 10)

- Sale or exchange of property (cont'd)
  - Income from the sale of purchased inventory is sourced based on where the sale takes place

Sourcing of Income (slide 8 of 10)

- Sale or exchange of property (cont'd)
  - When the seller has produced the property, income must be apportioned between the country of production and the country of sale
    - 50/50 allocation is used unless taxpayer elects to use the independent factory price or the books and records method

Sourcing of Income (slide 9 of 10)

- Transportation Income
  - Income from transportation beginning and ending in U.S. is U.S.-source income
  - 50% of income from transportation beginning *or* ending in U.S. is U.S.-source income unless the U.S. point is only an intermediate stop
    - Does not apply to personal services income unless transportation is between U.S. and a possession

Sourcing of Income (slide 10 of 10)

- Income from space and ocean activities outside the jurisdiction of any country is sourced according to the residence of the person conducting the activity
- International communication income of a U.S. person is 50% U.S. sourced if transmission is between U.S. and a foreign country

Allocation And Apportionment Of Deductions (slide 1 of 4)

- Deductions and losses must be allocated and apportioned between U.S.- and foreign-source income
  - Deductions directly related to an activity or property are allocated to classes of income
  - Then, deductions are apportioned between statutory and residual groupings

Allocation And Apportionment Of Deductions (slide 2 of 4)

- Interest expense is allocated and apportioned to all activities and property regardless of the specific purpose for incurring the debt
- Allocation and apportionment is based on either FMV or tax book value of assets
  - Special rules apply in an affiliated group setting

Allocation And Apportionment Of Deductions (slide 3 of 4)

- Special rules apply to:
  - Research and development expenditures
  - Certain stewardship expenses
  - Legal and accounting fees
  - Income taxes
  - Losses
- A deduction not definitely related to any class of gross income is ratably allocated to all classes of gross income

Allocation And Apportionment Of Deductions (slide 4 of 4)

- §482 gives the IRS the power to reallocate income, deductions, credits or allowances between or among related persons when
  - Necessary to prevent the evasion of taxes, or
  - To reflect income more clearly

Foreign Currency Transactions
(slide 1 of 4)

- May be necessary to translate amounts denominated in foreign currency into U.S. dollars
- Major tax issues related to foreign currency exchange include:
  - Character of gain/loss (capital or ordinary)
  - Date of recognition of gain/loss
  - Source of foreign currency gain/loss

Foreign Currency Transactions

(slide 2 of 4)

- Important concepts related to tax treatment of foreign currency exchange transactions include:
  - Foreign currency is treated as property other than money
  - Gain/loss is considered separately from underlying transaction
  - No gain/loss is recognized until a transaction is closed

Foreign Currency Transactions
(slide 3 of 4)

- Functional currency approach under FAS 52 is used for tax purposes
  - All income tax determinations are made in taxpayer's functional currency
  - Taxpayer's default functional currency is the U.S. dollar

Foreign Currency Transactions

(slide 4 of 4)

- A qualified business unit (QBU) uses a foreign currency as its functional currency
  - QBU is a separate and clearly identified unit of a taxpayer's trade or business (e.g., a foreign branch)
  - An individual is not a QBU but a trade or business conducted by a taxpayer may be a QBU

Foreign Branch Currency Exchange Treatment (slide 1 of 2)

- When foreign branch operations use a foreign currency as functional currency
  - Compute profit/loss in foreign currency
  - Translate into U.S. dollar using average exchange rate for the year

Foreign Branch Currency Exchange Treatment (slide 2 of 2)

- Exchange gains/losses are recognized on remittances from the branch
  - Gain/loss is ordinary
  - Sourced according to income to which the remittance is attributable

Distributions From Foreign Corporations

- Included in income at exchange rate in effect on date of distribution
  - No exchange gain/loss is recognized
- Deemed dividend distributions under Subpart F are translated at average exchange rate for tax year
  - Exchange gain/loss can arise when an actual distribution of this previously taxed income is made

Foreign Taxes

- For purposes of the foreign tax credit, taxes accrued are translated at the average exchange rate for the tax year
  - An exception to this rule requires translation at the rate taxes were actually paid
    - If paid within 2 years of accrual and differ from accrued amount due to exchange rate fluctuations, no redetermination is required
    - Otherwise, where taxes paid differ from amount accrued, a redetermination is required

Export Property Tax Incentives (slide 1 of 2)

- In 2000, Congress enacted legislation that excludes extraterritorial income (ETI) from U.S. taxation
- Under the ETI exclusion, qualifying foreign trade income is exempt from U.S. taxation

Export Property Tax Incentives (slide 2 of 2)

- In general, to qualify for the ETI exclusion:
  - The property must be exported,
  - A large part of the value of the property must be due to U.S. components and labor, and
  - The taxpayer must be subject to tax in the U.S.
- In addition, the taxpayer must meet certain economic process requirements

Cross-Border Asset Transfers

- Tax consequences of transferring assets to a foreign corporation depend on
  - The nature of the exchange
  - The assets involved
  - Income potential of the property
  - Character of the property in the hands of the transferor or transferee

Outbound Transfers (slide 1 of 3)

- Similar to exchanges of assets for corporate stock of a domestic corporation, realized gain/loss may be deferred on certain outbound capital changes, moving corporate business outside the U.S.
  - Starting a new corp outside the U.S.
  - Liquidating a U.S. subsidiary into an existing non-U.S. subsidiary
  - Others

Outbound Transfers (slide 2 of 3)

- Transfer of trade or business property generally qualifies for deferral of gain or loss
- Transfer of “tainted” assets triggers immediate recognition of gain but not loss
- In addition, depreciation and other recapture potential must be recognized to the extent of gain realized

Outbound Transfers (slide 3 of 3)

- "Tainted" assets include:
  - Inventory
  - Installment obligations and accounts receivable
  - Foreign currency
  - Property leased by the transferor unless the transferee is the lessee

Inbound and Offshore Transfers

- U.S. persons that are directly or indirectly involved in an inbound or offshore transfer involving stock of a controlled foreign corporation (CFC)
  - Generally, recognize dividend income to the extent of their pro rata share of previously untaxed E & P of the foreign corporation, or
  - Income can be deferred by entering into a gain recognition agreement with the IRS

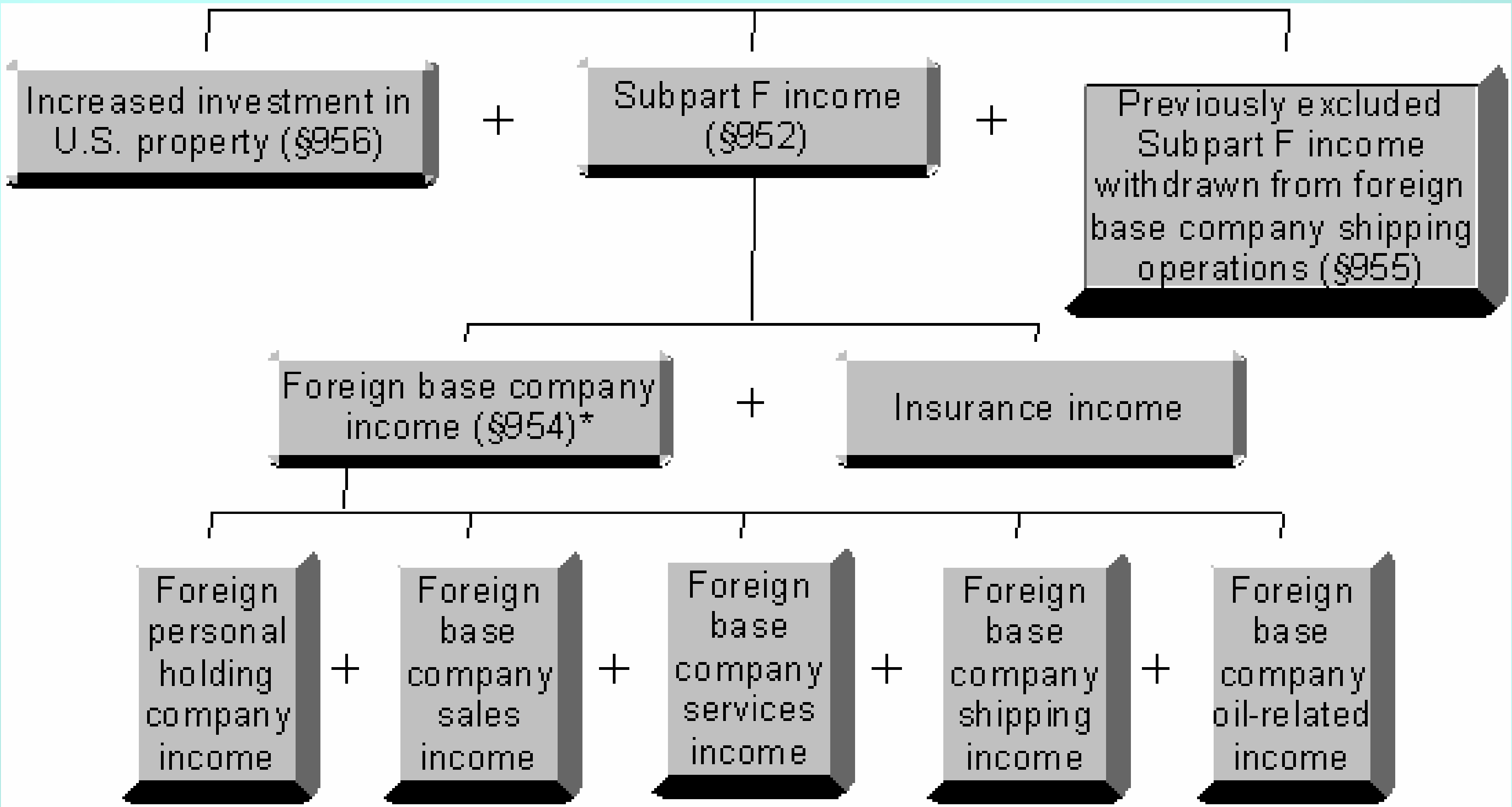
Controlled Foreign Corporations
(slide 1 of 2)

- Certain types of income generated by a controlled foreign corporation (CFC) are currently included in income by U.S. shareholders including:
  - Pro rata share of Subpart F income
  - Increase in earnings that the CFC has invested in U.S. property

Controlled Foreign Corporations
(slide 2 of 2)

- To apply, foreign corp must have been a CFC for an uninterrupted period of 30 days or more during tax year
  - A CFC is any foreign corp in which > 50% of total voting power or value is owned by U.S. shareholders on any day of tax year
  - U.S. shareholder is a U.S. person who owns (directly or indirectly) 10% or more of voting stock of the foreign corp

U.S. Shareholder's Income from CFC



*Plus all other income, when foreign base company and insurance income exceeds 70% of gross income.

Foreign Tax Credit

- Foreign tax credit (FTC) provisions are designed to reduce the possibility of double taxation
  – Allows a credit for foreign taxes paid
    - Credit is a dollar-for-dollar reduction of U.S. income tax liability
  – FTC may be “direct” or “indirect”

Direct Foreign Tax Credit

- Available to taxpayers who pay or incur a foreign income tax
  - Only person who bears the legal burden of the foreign tax is eligible for the direct credit
- Direct credit is not available to a U.S. corporation operating in a foreign country through a foreign subsidiary

Indirect Foreign Tax Credit

- The indirect credit is available to U.S. corporations for dividends received (actual or constructive) from foreign corporations
  - Foreign corp pays tax in foreign jurisdiction
  - When foreign corp remits dividends to U.S. corp, the income is subject to tax in the U.S.

Indirect Foreign Tax Credit
(slide 2 of 5)

- Foreign taxes are deemed paid by U.S. corporate shareholders in same proportion as dividends bear to the foreign corp's post-1986 undistributed E & P
- Corporations choosing the FTC for deemed-paid foreign taxes must "gross up" dividend income by the amount of deemed-paid taxes

Indirect Foreign Tax Credit
(slide 3 of 5)

- Example
  - Wren Inc, a domestic corp, receives a $120,000 dividend from Finch Inc, a foreign corp. Finch paid $500,000 of foreign taxes on post-1986 E & P totaling $1,200,000 (after taxes)

Indirect Foreign Tax Credit
(slide 4 of 5)

- Example (cont'd)-Wren's deemed-paid foreign taxes for FTC purposes are $50,000

Cash dividend from Finch	$120,000
Deemed-paid foreign taxes	
$500,000 X $\frac{\$ \quad 120,000}{\$1,200,000}$	50,000
Gross income to Wren	$170,000

Wren must include $50,000 in gross income for the gross up adjustment if FTC is elected

Indirect Foreign Tax Credit

- Only available if domestic corp owns 10% or more of voting stock of foreign corp
  - Credit is available for 2nd and 3rd tier foreign corps if 10% ownership requirement is met at the 2nd and 3rd levels
  - Credit is also available for 4th through 6th tier foreign corps if additional requirements are met

Foreign Tax Credit Limitations
(slide 1 of 4)

- Limit is designed to prevent foreign taxes from being credited against U.S. taxes on U.S.-source taxable income
  - FTC cannot exceed the lesser of:
    - Actual foreign taxes paid or accrued, or
    - U.S. taxes (before FTC) on foreign-source taxable income, calculated as follows:

$$\text{U.S. tax before FTC} \times \frac{\text{Foreign-source taxable income}}{\text{Worldwide taxable income}}$$

Foreign Tax Credit Limitations
(slide 2 of 4)

- Limitation can prevent total amount of foreign taxes paid in high-tax jurisdictions from being credited
  - Generating additional foreign-source income in low, or no, tax jurisdictions could alleviate this problem
  - However, a separate limitation must be calculated for certain categories (baskets) of foreign source income

Foreign Tax Credit Limitations
(slide 3 of 4)

- Separate limitation baskets apply to the following:
  - Passive income
  - High withholding tax interest
  - Financial services income
  - Shipping income

Foreign Tax Credit Limitations
(slide 4 of 4)

- Separate limitation baskets apply to the following: (cont'd)
  - 10/50 company dividends
  - Certain DISC dividends
  - Foreign trade income
  - Certain FSC distributions
  - All other foreign-source income is included in a general (or overall) limitation basket

Foreign Tax Credit Procedure

1. Allocate foreign income into “baskets”
2. Determine the foreign tax associated with the income in each basket
3. Determine the limitation for each basket using the following formula:

$$\text{U.S. tax before FTC} \times \frac{\text{Foreign source income in a basket}}{\text{Worldwide Taxable Income}}$$

4. Credit reduces U.S. tax liability dollar for dollar

Foreign Tax Credit Example
(slide 1 of 5)

- Bill is a U.S. citizen.
- He received $5,000 dividend income from a German corporation, on which German tax of $750 was paid.
- He lives in Nogales, Arizona, and worked part of the year in Nogales, Mexico. His income from Mexico was $30,000, and Mexican tax paid was $9,000.
- U.S. source wages were $50,000.
- Total worldwide income is $85,000 ($50,000 + $30,000 + $5,000). Assume Bill's U.S. tax before credits is $23,800.

Foreign Tax Credit Example
(slide 2 of 5)

1. The income is first divided into baskets
   – Dividend income is in the "Passive income" basket
   – Mexican income is in the "General" basket
   – Since the foreign income is in separate baskets, FTC limitations are applied separately

Foreign Tax Credit Example
(slide 3 of 5)

2. Apply FTC limitations to each basket

Passive basket:

$$\$23{,}800 \times \frac{\$\ 5{,}000}{\$85{,}000} = \$1{,}400$$

General basket:

$$\$23{,}800 \times \frac{\$30{,}000}{\$85{,}000} = \$8{,}400$$

Foreign Tax Credit Example

(slide 4 of 5)

3. Determine FTC available in each basket:
   - Passive credit is lesser of actual tax ($750) or limitation determined in 2. above ($1,400): Passive credit is $750
   - General limitation is lesser of actual tax paid ($9,000) or limitation determined in 2. above ($8,400): General limitation credit is $8,400
   - Total FTC is $750 + $8,400 = $9,150

Foreign Tax Credit Example
(slide 5 of 5)

4. Determine U.S. tax after credits:
   - U.S. tax is $23,800, less FTC of $9,150 = $14,650
5. Determine FTC carryover
   - $600 of the $9,000 tax in the General basket was not used
   - This may be carried back 2 years and forward 5 years to offset income in that same basket

Foreign Losses (slide 1 of 2)

- May be able to offset foreign losses against U.S.-source income, reducing U.S. income tax due
  - To prevent this loss of revenue, overall foreign losses must be recaptured as U.S.-source income for FTC purposes

Foreign Losses (slide 2 of 2)

- Foreign losses are recaptured by reducing the numerator of the FTC limitation formula by the lesser of:
  - The remaining unrecaptured overall foreign loss, or
  - 50% of foreign-source taxable income for the year
  - Unrecaptured losses are carried over indefinitely until recaptured

Alternative Minimum Tax FTC

- Limited to lesser of:
  - Credit for regular tax purposes, or
  - 90% of tentative minimum tax before the credit
    - Calculated on tentative minimum tax without regard to the alternative tax NOL
  - Use Foreign-source AMTI in the numerator and worldwide AMTI in the denominator
    - Taxpayer may elect to use foreign-source regular taxable income in the numerator if it does not exceed total AMTI

Residency Tests for Non Citizens
(slide 1 of 3)

- Green Card Test:
  - An individual is considered a resident of the U.S. on the first day of the tax year in which he or she is physically present in the U.S. after the card is issued
  - Residency status remains in effect until the card is revoked or the individual has abandoned permanent resident status

Residency Tests for Non Citizens
(slide 2 of 3)

- Substantial Presence Test:
  - This mathematical test applies to people in the U.S. without a green card
    - An individual in the U.S. 183 days during the year is a resident for the year for tax purposes
    - Also a taxpayer in the U.S. for 183 days in the past three years (using a specified weighting formula) is taxed as a resident

Residency Tests for Non Citizens

(slide 3 of 3)

– Exceptions apply to the substantial presence test for commuters from Mexico and Canada who work in the U.S., for certain diplomats, teachers, students and others in certain circumstances

U.S. Taxation Of Nonresident Aliens (slide 1 of 3)

- Non-resident alien income not "effectively connected" with U.S. trade or business
  - Includes dividends, interest, rents, royalties, etc
  - 30% tax must be withheld by payor of income, unless this rate is reduced by treaty with the payee's country of residence
    - No deductions can offset this income

U.S. Taxation Of Nonresident Aliens(slide 2 of 3)

- Example: German resident earns $1,000 dividend from U.S. corporation
  - Absent a U.S.-German treaty, $300 U.S. tax is withheld, and the German resident receives $700
    - Treaties frequently reduce the withholding rates on dividends and interest
  - The payor corporation remits the tax to the IRS

U.S. Taxation Of Nonresident Aliens (slide 3 of 3)

- Non-resident alien income effectively connected with U.S. trade or business
  - This income is taxed at the same rates as are applicable to U.S. citizens
  - Deductions related to the business may be claimed

U.S. Taxation Of Foreign Corps
(slide 1 of 3)

- Income not effectively connected with U.S. trade or business
  - This income is taxed at 30% as described above for individuals
  - The payor of the income must withhold and remit the tax

U.S. Taxation Of Foreign Corps
(slide 2 of 3)

- Income effectively connected with U.S. trade or business
  - This income is taxed at the same rates as are applicable to U.S. corporations
  - Deductions can offset the income

U.S. Taxation Of Foreign Corps

(slide 3 of 3)

- Branch profits tax
  - If a foreign corporation conducts business through a U.S. branch (vs. a U.S. subsidiary), any reduction in the amount of assets invested in the U.S. (as defined) is subject to a 30% additional tax
  - This tax is designed to approximate the double taxation which arises for dividends paid by a U.S. subsidiary to a foreign parent

Foreign Investment In Real Property Tax Act (slide 1 of 4)

- Gains and losses realized by NRAs and foreign corps on U.S. real property interests (USRPI) are treated as effectively connected with the conduct of a U.S. trade or business
- NRAs must pay tax equal to at least the lesser of 26% (or 28%) of AMTI or regular U.S. rates on net real property gain for the year

Foreign Investment In Real Property Tax Act (slide 2 of 4)

- USRPI is any direct interest in real property situated in U.S. and any interest in a domestic corp
  - Applies unless taxpayer can establish that domestic corp was not a U.S. real property holding corp (USRPHC) during the shorter of:
    - Period taxpayer owned interest in corp, or
    - For 5 year period ending on date interest was disposed of

Foreign Investment In Real Property Tax Act (slide 3 of 4)

- USRPHC is any corp (foreign or domestic) where FMV of corp's USRPI is 50% or more of aggregate FMV of:
  - USRPIs
  - Interests in real property located outside U.S.
  - Any other assets used in a trade or business
    - Stock regularly traded on established securities market is not a USRPI if 5% or less is owned

Foreign Investment In Real Property Tax Act (slide 4 of 4)

- Withholding provisions
  - Any purchaser or agent acquiring a USRPI from a foreign person must withhold 10% of amount realized on disposition
  - Higher withholding rates apply to certain entities

Expatriation To Avoid U.S. Taxation (slide 1 of 2)

- U.S. tax applies to U.S.-sourced income of persons who relinquished their U.S. citizenship within 10 years of deriving that income
- Only applies if person gave up citizenship to avoid U.S. tax

Expatriation To Avoid U.S. Taxation (slide 2 of 2)

- Also applies to NRAs who lost U.S. citizenship within preceding 10 year period if principal purpose was avoidance of U.S. tax
  - Tax avoidance purpose is presumed if either:
    - Average annual net income tax for five preceding taxable years > $122,000
    - Net worth is $608,000 or more

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

Dr. Donald R. Trippeer, CPA

donald.trippeer@colostate-pueblo.edu

Colorado State University-Pueblo