International Tax for the Growing Business

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As the global marketplace has expanded, emerging businesses have started to focus on international tax issues.

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 activities expand. This article focuses on these types of businesses—both foreign-domiciled businesses entering the U.S. market (inbound transactions) and U.S.-domiciled businesses engaging in transactions with foreign components (outbound transactions). As this area is filled with intricacies that can arise based on the specific facts involved, this overview is not intended to detail every consideration that could potentially have relevance in the international spectrum. Rather, the goal is to provide a primer on several of the more common considerations in this context.

Foreign Entities Entering the U.S. Market

As background, foreign entities with U.S. connections are generally subject to tax on two primary classes of income by the country. First, a foreign entity carrying on a trade or business in the U.S. 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 U.S.-sourced

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fixed or determinable annual or periodic income (such as dividends sourced from the U.S.); 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 below) can modify default rules in the outbound context.

Entity Classification

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

Default rules for classification are applicable to entities that are not per se corporations (with those entities automatically classified as corporations in the U.S.).[1.1] 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; it is treated as a partnership if it has multiple members at least one of whom does not have limited liability.[1.2] However, foreign entities are generally permitted to elect their classification for U.S. tax purposes. Elections out of the default rules are made by use of Form 8832, Entity Classification Election; 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.[1.3] 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."[1.4] Cognizance of the entity's date of relevance is thus vital to maximize U.S. flexibility.

Effectively Connected Income

Generally, a foreign corporation engaged in trade or business within the U.S. during the tax year is taxable on income effectively connected with the conduct of that trade or business.[1.5] Neither the Code nor the Regulations specifically define what is considered a U.S. trade or business; the Service ordinarily does not rule on whether a taxpayer is engaged in a trade or business.[1.6] However, case law dictates that, where profit-oriented activities are carried on in the U.S. that are regular, substantial, and continuous, these activities are properly classified as a U.S. trade or business, whether carried on directly by the taxpayer or through its agents.[1.7] Foreign corporations have been held to have carried on a U.S. trade or business through a single person acting as a U.S. agent, even where, for example, an agent for a sales company assumed full responsibility for sales under the relevant contracts.[1] As one may suspect from the above, the standard for a U.S. trade or business is low, resulting in most types of involved activities being classified as a trade or business for these purposes.

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 U.S. trade or business; this tax is equal to 30% (subject to treaty modification) of the foreign corporation's "dividend equivalent amount" for the tax year.[2] A foreign corporation's "dividend equivalent amount" is its effectively connected earnings and profits for the tax year adjusted based on U.S. net equity.[3] 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 tax year or by the amount of branch profits tax or tax on excess interest paid by the foreign corporation.[4] Earnings and profits attributable to certain specified items (such as gain on the disposition of a U.S. real property interest) are excluded.[5]

Under the branch profits rules, U.S. 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 tax 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.[6] U.S. liabilities are the amount of U.S.-connected liabilities of the foreign corporation, which normally equals the total value of U.S. assets for the tax year multiplied by the total amount of worldwide liabilities divided by the total value of worldwide assets for the year.[7]

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

FDAP Income

U.S.-sourced fixed or determinable annual or periodic income of a foreign

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1 Rev. Rul. 70-424, 1970-2 CB 150.

1.1 Reg. 301.77-2(b)(8).

1.2 Reg. 301.7701-3(b)(2).

1.3 Reg. 301.7701–3(d)(1)(i).

1.4 *Id.*

1.5 Section 882(a).

1.6 See Rev. Proc. 2014-7, 2014-1 IRB 238.

1.7 *Balanovski*, 236 F.2d 298 (CA-2, 1956); *Northumberland Insurance Company,* 521 F.Supp. 70 (DC NJ, 1981).

2 Section 884(a).

3 Section 884(b).

4 Reg. 1.884-1(f)(1).

5 See Section 884(f)(2).

6 Reg. 1.884-1(d)(1)(i).

7 Reg. 1.882-5(c)(2).

corporation that is not effectively connected with the conduct of a U.S. trade or business is normally subject to a 30% gross-based tax, with tax generally required to be withheld by the payor.[8] 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.[9] 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 recipient's gross income for the tax year.[10] Taxpayers who receive income solely subject to withholding are relieved of the obligation to file a U.S. tax return if all U.S. tax liability is covered by withheld amounts.[11] Withholding obligations by payors are detailed below.

Sourcing of FDAP items carries understandable importance in this context as, where items are not sourced from the U.S., no U.S. tax jurisdiction exists for non-U.S. persons. Both interest income and dividend income are normally sourced to the residence of the payor.[12] Rents and royalties are sourced to the location or place of use of the property.[13] Source of income for personal services is ordinarily the place where services are performed.[14]

A foreign entity becomes "relevant" when its classification affects the liability of any person for federal tax or information purposes.

Nonresident Alien Employees

Nonresident aliens (i.e., those who are neither U.S. citizens nor residents) are taxed in the U.S. on income effectively connected with a U.S. trade or business (and are taxed at regular U.S. rates for the same).[15] The tax is determined on a net basis, with deductions permitted.[16] When nonresident alien employees perform services in the U.S., their work is generally classified as a trade or business (subject to certain limited exceptions).[17] Since a nonresident alien individual is considered to be engaged in a U.S. trade or business if he performs personal services in the U.S. as an employee, wages, salaries, compensation, and other remuneration received for these personal services is income effectively connected with a U.S. trade or business.[18]

In general, foreign employers who pay compensation for services performed in the U.S. by either residents or nonresident aliens must withhold U.S. income taxes on such compensation to the extent the compensation is properly classified as wages.[19] "Wages" generally are defined as all remuneration for services performed by an employee for an employer.[20] A nonresident alien who performs services in the U.S. as an employee is subject to withholding at the regular rates for employees.[21]

U.S. Partners of a Foreign Partnership

U.S. 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 that is not domestic.[22] Foreign partnerships can be required to file Form 1065, U.S. Return of Partnership Income, where the partnership has gross income derived from sources within the U.S. or gross income that is effectively connected with the conduct of a trade or business in the U.S.[23]

Filing Requirements

Every corporation subject to the federal income tax must file a return annually.[24] Taxpayers engaged in a U.S. trade or business must file a return even if there is no income or if income is exempted by a statute or treaty.[25] A foreign corporation must file a return on Form 1120-F, U.S. Income Tax Return of a Foreign Corporation.[26] Effectively connected income normally is not subject to withholding; rather, the foreign corporation engaged in a U.S. trade or business is required to file a return and pay tax under the same rules as for domestic corporations.[27]

Foreign corporations engaged in a U.S. trade or business (or who have received income treated as effectively connected with such a business) are allowed the deductions that 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 U.S.[28] However, this benefit is available only if the foreign corporation timely files a true and accurate return.[29] An 18-month grace period is applicable for these purposes, generally requiring the return to be filed within 18 months of the due date.[30]

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.[31] Nonresident aliens are generally permitted only one exemption amount.[32]

A multitude of tax information reporting requirements exist for taxpayers; however, most of these requirements (i.e., the FBAR, Form 8938, Statement of Foreign Financial Assets; Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts; Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund; Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, etc.) exist primarily for U.S. 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 a party associated with the entity has spent sufficient time within the U.S., this person can be classified as a U.S. resident. U.S. residents are taxable on their worldwide income (from sources both inside and outside the U.S.).[33] An individual is classified as a resident of the U.S. for a given year if he: (1) is a lawfully admitted for permanent residence; (2) meets substantial presence requirements; or (3) makes an election to be treated as a citizen.[34] 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 he was present in the U.S. 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.[35] The applicable multiplier 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.[36] Where a nonresident alien becomes a U.S. resident, he becomes subject to U.S. tax on worldwide income and is generally subject to all of the same U.S. information reporting requirements as residents.

U.S. Entities With Foreign Connections

Moving to the outbound realm, U.S.-based businesses encounter international issues under a growing multitude of circumstances; understanding U.S. requirements in the context of such transactions is thus increasingly vital. U.S. tax treatment of outbound transactions was altered significantly by the Tax Cuts and Jobs Act (TCJA);[37] an overview of the rules predating the TCJA is provided first, with details on the modifications under the TCJA provided thereafter. As this article focuses on U.S. 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).

U.S. Taxation of Foreign Transactions by U.S. Taxpayers

U.S. corporations' activities in foreign jurisdictions can be structured in several ways. Where activities are undertaken through a branch or a pass-through entity, income from the activities goes directly to the parent entity for U.S. tax purposes. Conversely, where income is earned by a foreign subsidiary, the parent traditionally has not been subject to tax on the amounts earned until those amounts were repatriated (i.e., through a dividend to the shareholder).[38]

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 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 U.S. recognition deferral) which otherwise would be available to U.S. parties earning certain classes of income through foreign corporations. Subpart F essentially treats a U.S. shareholder of a CFC as if he actually received the pro rata share of specified income items, regardless of whether receipt occurred.

For Subpart F purposes, the term U.S. shareholder includes U.S. persons (a U.S. citizen, resident, domestic partnership, domestic corporation, or any nonforeign estate or trust) owning at least 10% of the foreign corporation's voting stock or value.[39] Such foreign corporation is a CFC for a particular year if on any day during that year U.S. shareholders own more than 50% of total combined stock (measured either by voting power or value).[40] 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.[41]

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).[42]

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).[43] Subpart F inclusion normally creates an indirect foreign tax credit.[44]

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 tax year is passive income, or (2) the average percentage of assets held by the corporation during the tax year which produce passive income or which are held for the production of passive income is at least 50%.[45] 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,

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8 Section 881(a)(1).
9 Section 1441(b).
10 Section 1441(c)(1).
11 Reg. 1.6012-1(g)(2)(i).
12 Section 861(a)(1); Section 861(a)(2).
13 Section 861(a)(4).
14 Section 861(a)(3).
15 Section 871.
16 *Id*.
17 Section 864(b).
18 See Rev. Rul. 92-106, 1992-2 CB 258.
19 Section 3402.
20 Section 3401(a).
21 Reg. 31.3401(a)(6)-1.
22 Section 7701.
23 Section 6031.
24 Section 6012(a)(2).
25 Reg. 1.6012-2(g)(1)(i).
26 *Id*.
27 See Section 1441(c)(1).
28 Reg. 1.882-4(a)(1).
29 Reg. 1.882-4(a)(2).
30 Reg. 1.882-4(a)(3).
31 Reg. 1.6072-1(c).
32 Section 873(b)(3).
33 Section 1.
34 Section 7701(b).
35 Section 7701(b)(3).
36 *Id*.
37 P.L. 115-97, 12/22/17.
38 Section 11.
39 Section 957(c).
40 Section 957(a).
41 Section 952(c)(1)(A).
42 Section 954.
43 Section 951.
44 Section 960.
45 Section 1297(a).

rents, annuities, etc.).[46] PFIC requirements are generally triggered if a U.S. person owns interests in a foreign corporation that primarily makes passive investments. Rules in the PFIC realm are, like with Subpart F, intended to limit the ability of U.S. 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 when 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 relevant holding period).

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.[47]

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 recognizes gain or loss on the shares on an annual basis (based on the shares' fair market value).[48] 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.

Transers to Foreign Corporations-Section 367(a). Section 367(a)(1) alters the application of the normal nonrecognition rules when certain transfers of property are made by U.S. 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 U.S. person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.[49] Section 367(a) applies when the transferor is a U.S. person and the transferee is a foreign corporation, as its intention is to curb tax avoidance that could come from permitting tax-free transfers of appreciated assets out of the U.S.' jurisdiction.

Modifications Under the TCJA. The TCJA made significant alterations to the default rules for outbound transactions. The modifications provided can be expected to 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% owned foreign corporation by a domestic corporation that is a U.S. shareholder with respect to such foreign corporation, there will 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 U.S. shareholder (other than a PFIC that is not also a CFC). No foreign tax credit or deduction is permitted for dividends to which Section 245A is applicable.

Importantly, the Section 245A deduction is available only to C corporations that are not registered investment companies or real estate investment trusts. Noncorporate shareholders (i.e., individuals or other noncorporate entities) thus will not be eligible to use the deduction.

Additional limitations also exist; one is that Section 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 of this limitation is to limit disparate treatment between U.S. and foreign tax laws. A holding period also applies to the Section 245A deduction: it is available only for U.S. shareholders who have held shares of the foreign corporation for more than 365 days during a specified 731-day period. Additionally, the Section 245A exclusion does not apply when a shareholder of a PFIC makes a qualified electing fund election and treats amounts as a deemed dividend.

Certain 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 that is treated as a dividend for purposes of Section 1248 is also treated as a dividend for purposes of Section 245A. Additionally, when a U.S. corporation transfers substantially all assets from a foreign branch to a foreign corporation, the U.S. 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 Section 245A, new rules have also been included for foreign earnings on which U.S. tax has been previously deferred. Under modified Section 965, Subpart F income is increased in the last year of a deferred foreign income corporation beginning before 1/1/18 by accumulated post-1986 deferred foreign income of the corporation determined as of either 11/2/17 or 12/31/17 (whichever is greater). The rate of inclusion is 15.5% for cash and cash equivalents and 8% for other assets.

Importantly, (and in contrast with Section 245A) this provision can apply to U.S. shareholders who are not cor-

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46 Section 1297(b)(1).
47 Section 1293.
48 Section 1296.
49 Section 367(a)(1).
50 Section 1441(a).
51 Section 1441(c)(1).
52 Reg. 1.1441-4(a)(2)(i).
53 Reg. 1.1441-1(b)(1).
54 Reg. 1.1441-1(c)(2).
55 Reg. 1.1441-2(e)(1).
56 Section 1461.
57 Section 1463.
58 Reg. 1.1441-2(d)(3).
59 Reg. 1.1441-3(f)(1).
60 Section 875(1).

porations if statutory requirements are met. A deferred foreign income corporation is defined as any specified foreign corporation of a U.S. shareholder that 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.

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 that are U.S. shareholders, each of the S corporation's shareholders 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 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 income.

Foreign-derived intangible income, (FDII) is the amount that 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 U.S.-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 U.S. 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 them outside the U.S.' tax scope. Business impacted should factor in the ramifications of GILTI and FDII in making decisions affected by the rules (e.g., in how to structure entities).

Both interest income and dividend income are normally sourced to the residence of the payor.

Withholding Requirements for Payments to Foreign Persons

For U.S. taxpayers engaged in foreign transactions, one area where cognizance of requirements is critical is on withholding obligations for payments made to foreign parties. Under U.S. rules, persons having control, receipt, custody, disposal, or payment of certain items of income from sources within the U.S. of any nonresident alien normally are required to deduct and withhold from such income a tax equal to 30%.[50] 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 tax year.[51] 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 U.S. trade or business if, before the payment to the foreign person, the withholding agent can reliably associate the payment with a Form W-8 on which it can rely to treat the payment as made to a foreign beneficial owner.[52]

Persons obligated to withhold are designated as "withholding agents;" the withholding agent is normally the last party in the U.S. 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 on which it can rely to treat the payment as made to a payee that is a U.S. person or as made to a beneficial owner that is a foreign person entitled to a reduced rate of withholding.[53] The term "foreign person" includes foreign corporations.[54] Withholding must occur when an item subject to withholding is paid; items are deemed paid when they are includable in gross income.[55]

A withholding agent generally is personally liable for any amount required to be withheld, regardless of whether tax is actually withheld.[56] When 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.[57] 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.[58] 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.[59]

Foreign Partners of a U.S. Partnership

A nonresident alien individual partner or foreign corporate partner is considered to be engaged in any U.S. trade or business in which the partnership is engaged.[60] To this end, a foreign partner's distributive share of partnership net income effectively connected with a U.S.

trade or business of the partnership is taxed under general Code provisions. Here a withholding requirement is important on the partnerships. 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 items that are not effectively connected with the conduct of a U.S. trade or business of the partnership or the partner; the partnership must withhold the tax due with respect to these items regardless of whether any distributions are made to foreign partners.

A nonresident alien who performs services in the U.S. as an employee is subject to withholding at the regular rates for employees.

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 U.S. perspective come from use of the foreign tax credit (for outbound transactions) and income tax treaties (for inbound transactions). U.S. individuals working overseas also may pursue the foreign earned income exclusion.

Tax Treaties

The IRS currently lists income tax treaties with over 60 countries in its database. Tax treaties act to reduce the scope of a country's taxing authority in situations covered by treaty terms. When treaty terms do not cover a type of transaction (or where no treaty exists between the U.S. and a relevant country), the U.S. taxes in accordance with its standard rules.

Benefits available depend on the specific treaty at issue; however, a number of concepts are commonly used. 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.[61] 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.

Branch profits tax can also be affected by tax treaties. When a foreign corporation is a qualified resident of a country with which the U.S. 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.[62] The regulations list 28 countries for which the branch profits tax is eliminated for qualified residents (including, the U.K., Germany, and Japan).[63]

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.[64] 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.

Foreign Tax Credits

The foreign tax credit is generally available to citizens and residents of the U.S. for taxes paid to foreign jurisdictions.[65] The credit is intended to alleviate the burdens of double taxation. In most instances, foreign tax credits are not permitted for either nonresident aliens or foreign corporations.[66] A nonresident alien or foreign corporation may be allowed 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.[67]

A foreign levy is considered a tax if "it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes."[68] Payments made in lieu of a tax on income imposed by a foreign country are considered to be taxes for foreign tax credit purposes.[69] Taxes also must be validly owed for a foreign tax credit to be taken. When 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 U.S. reducing the foreign tax credit amount.

Generally, the credit for foreign income taxes is limited to an amount equal to the pre-credit U.S. tax on foreign-source income.[70] Foreign taxes available for credit but 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.

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. Determinations as to whether forms are required is always fact-specific in this realm.

FBAR

U.S. 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 U.S. citizens, residents, entities (corporations, partnerships, and limited liability companies), trusts, and estates.[71] U.S. 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 U.S. 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 U.S. person owns directly or indirectly more than 50% of the interest in profits or capital.[72] Reporting requirements exist both where a U.S. person has a financial interest in an account or signature authority over the account, meaning that, as an 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 U.S. residents and citizens. 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.

Specified foreign assets include financial accounts maintained by a foreign financial institution. They also include stock or securities issued by someone who is not a U.S. person, any interest in a foreign entity, and any financial instrument or contract that has an issuer or counterparty that is not a U.S. 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 in a multitude of arrangements in relation to foreign corporations. The form must be filed for U.S. persons who are officers and directors in a corporation in which a U.S. 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 U.S. 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 that had a reportable transaction with a foreign or domestic related party. A reporting corporation is either: (1) a 25% foreign-owned U.S. corporation, or (2) a foreign corporation engaged in a trade or business in the U.S. 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, Return of U.S. Persons With Respect to Certain Foreign Partnerships, imposes similar requirements to Form 5471 for U.S. 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 U.S. 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, Information Return of U.S. Persons With Respect To Foreign Disregarded Entities, is used by U.S. persons who control a foreign disregarded entity to satisfy specified reporting requirements. U.S. 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 that (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.

NOTES

61 See U.S.-Germany Treaty, Article 7(1).
62 Section 884(e)(2).
63 Reg. 1.884-1(g)(3).
64 See Canada-U.S. Tax Treaty, Article XV(1).
65 Section 901(a).
66 Section 26(b)(2)(L).
67 Section 906.
68 Reg. 1.901-2(a)(2).
69 Section 903.
70 Section 904.
71 31 Reg. 1010.350(b).
72 31 Reg. 1010.350(e)(2).

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, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b), 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 when a taxpayer maintains that a treaty of the U.S. overrules or modifies a provision of the 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, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, 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, Foreign Person's U.S. Source Income Subject to Withholding, 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 U.S. 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.

Form W-8ECI

Form W-8ECI, Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States, is supplied by foreign persons to prevent withholding on U.S.-sourced income which is effectively connected with the conduct of a trade or business. Parties receiving effectively connected income from sources in the U.S. supply Form W-8ECI to: (1) establish they are not a U.S. 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 U.S. 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 U.S. trade or business.

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

Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals), 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 U.S. 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 U.S. has an income tax treaty and who is eligible for treaty benefits. Form W-8BEN-E, Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities) is used by foreign entities to document their status.

Form 926

Form 926, Filing Requirement for U.S. Transferors of Property to a Foreign Corporation, is used by U.S. citizens, residents, corporations, estates, or trusts to report certain transfers (or deemed transfers) of property to a foreign corporation. Contributions by a U.S. 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 and 1118

Form 1116, Foreign Tax Credit, 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 U.S. possession (an election is also available). A corporation electing the benefits of the foreign tax credit under Section 901 must file Form 1118, Foreign Tax Credit—Corporations.

Conclusion

Emerging businesses face challenging and often unanticipated issues in the international tax realm. Cognizance of the issues present is of enormous benefit in advising clients on how to proceed; without this awareness, seemingly innocuous transactions or activities can create significant ramifications for a business. When issues are properly evaluated, however, businesses can properly take advantage of the opportunities provided by the global market. ●