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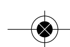

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May/June 2023

Corporate Taxation

Inbound Foreign Corporations: U.S. Effectively Connected Income

Cross-Border Mergers and Acquisitions

The Excise Tax on Stock Buybacks

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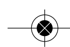

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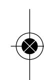

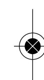

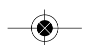

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THE INBOUND FOREIGN CORPORATION: KNOWING WHEN ITS INCOME IS U.S. EFFECTIVELY CONNECTED INCOME

JERALD DAVID AUGUST

This two-part article examines the tax rules applicable to the foreign corporation which derives income from investments or business activities conducted within the United States. The emphasis in this first part of the article is on sourcing, effectively connected income, and sales of property by foreign corporations.

This article, to be issued in two parts, describes the general rules pertaining to a foreign corporation's U.S. source income, both investment and business, as well as income, gain, or loss that is effectively connected with a U.S. trade or business or a permanent establishment for treaty purposes located in the U.S. This article, even given its length and detailed information, must be regarded as a "primer" or providing the reader with a broad overview of the subject area.[1]

Part One focuses on specific items of U.S. source income identified in the Code that will, in general, subject a foreign corporation (or other non-U.S. person) to a flat 30% tax and associated withholding subject to tax treaty modification or override. An important exception from fixed, determinable, annual, or periodical (FDAP) income applies for gains from sale or disposition of U.S. real property that is subject to U.S. income tax on a net basis under Section 897 as if such gain were "effectively connected income" (ECI) attributable to a U.S. trade or business under Section 882(a). Special sourcing rules apply with respect to sales of personal property, both tangible and intangible, as well as inventory, and there are rules applicable to allocating income and expense to sales of personal property, including inventory, partly attributable to production activities or derived from the operation of a U.S. trade or business. Coverage will extend to income sourced from licenses of personal property, including computer software and cloud computing arrangements.

Part Two (to be published in a subsequent issue of this Journal) will address the topic of when a foreign corporation will be deemed to be carrying on a U.S. trade or business, and as further applied to foreign corporations (or other non-U.S. persons) who are resident of a tax treaty country, subject to the higher threshold requirement for ECI for income attributable to a permanent establishment situated in the United States.

JERALD DAVID AUGUST is editor-in-chief of this Journal and a partner in Fox Rothschild LLP's Philadelphia office, where he heads the firm's International Tax and International Wealth Planning practice.

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Taxation of foreign corporations by the United States: effectively connected and non-effectively connected income, gain, or loss; and then there is also the branch profits tax on foreign corporations

A non-resident individual or other non-resident entity of the United States (U.S.), including a foreign corporation,[2] is subject to U.S. income tax only with respect to U.S. source income it derives from passive investments as well as income or gain effectively connected, or treated as effectively connected with the carrying on of a U.S. trade or business or through a permanent establishment. In contrast with non-U.S. persons, including a foreign corporation, a fundamental axiom of our income tax system requires a U.S. citizen or resident, as well as a U.S. (domestic) corporation or partnership, to pay U.S. income tax on his or its worldwide taxable income subject to applicable treaty provisions.[3] Double taxation is hopefully mitigated by foreign tax credit provisions as well as pertinent provisions of a bilateral tax convention between the U.S. and the jurisdiction in which the foreign corporation (or other foreign person) is resident.[4]

A U.S. person includes a domestic corporation, domestic partnership, domestic trust, or domestic estate.[5] A corporation or partnership is treated as domestic where it is created or organized in the U.S. or under the law of the U.S. or of any state unless as otherwise provided in the regulations.[6] A foreign corporation or

other non-U.S. resident carrying on a trade or business in the U.S. is taxed on a net basis, i.e., on ECI derived by such U.S. trade or business less allowable deductions.[7] The ECI rules apply U.S. trade or business characterization to income derived by indirect owners of the business through a flow-through entity, such as beneficiaries of a foreign trust or foreign partners in a partnership, for each owner's pro rata share or deemed allocation of ECI. This outcome is sourced as ECI by Sections 875(1) and 875(2),[8] which provide that a foreign corporation (or nonresident alien individual) is engaged in a U.S. trade or business where the partnership (or trust) in which such foreign corporation (or nonresident) is a member (or beneficiary) is so engaged.[9]

U.S. ECI "net-income" is subject to U.S. income tax at regular tax rates.[10] The same outcome applies to a foreign corporation that is a resident of a treaty jurisdiction to the extent its business and associated profits are attributable to a permanent establishment situated within the U.S.[11] For a foreign corporation the current tax rate of U.S. federal income tax is 21%. For many years until the 2017 Tax Cuts and Jobs Act, the rate of tax on a foreign corporation's ECI was as high as 35%. The 2024 Budget Plan announced in March 2023 by President Biden includes a proposed increase of the corporate income tax rate to 28% while increasing the overall rate of tax on foreign-derived intangible income (GILTI) under Section 951A by 100% (from 10.5% to 21%) for domestic corporations and to 28% (from 21%) for U.S. taxpayers making Section 962 elections.[12]

In addition to the regular corporate income tax, foreign corporations engaged in a domestic trade or business may become subject to three branch profits taxes on income attributable to the U.S. trade or business conducted by the foreign corporation. The main branch profits tax equals 30% (or lower tax treaty rate, if applicable) of a foreign corporation's dividend equivalent amount (DEA).[13] This tax attempts to mirror the 30% withholding tax imposed on U.S. subsidiary corporations that repatriate earnings to their foreign owners. The DEA is reduced for the annual increase in U.S. net equity of the foreign corporation.[14] DEA is increased, however, for a reduction or decrease in U.S. net equity in the current taxable year from the U.S. net equity amount as of the end of the preceding tax year.[15]

A second BPT is the branch-interest tax. The branch-interest tax imposes a withholding obligation of 30% (or lower treaty rate, if applicable) on interest paid by a foreign corporation attributable to U.S. trade or business income as if such interest were paid by a domestic corporation.[16] The branch-interest tax produces the same outcome as if a domestic corporation remitted interest payments to a foreign parent corporation or affiliate.

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[1] Readers are directed to view learned treatises in the area of international taxation, including Kuntz, Peroni, & Bogdanski, U.S. International Taxation (WG&L).

[2] A domestic corporation is a corporation created or organized in the United States or under the laws of the United States, the District of Columbia, or one of the 50 states. Sections 7701(a)(4), 7701(a)(10). A foreign corporation (or partnership) is one which is not domestic. Section 7701(a)(5). A dual-resident corporation is one that is organized in one jurisdiction but managed and controlled in a second country. When this dual-resident status exists, the presence or absence of a tax treaty is quite important. Where there is a tax treaty, the tie-breaker provision will, in general, result in the corporation's residence for tax purposes existing in the place of "effective management." Where there is no treaty involved, the dual resident corporation may be subject to tax in both jurisdictions. See Reg. 301.7701-2(b)(9) (dual chartered companies as "per se" foreign corporations). See also Section 1503(d) (prevents loss duplication to obtain double benefits of a domestic corporation that is subject to income tax in a foreign jurisdiction); Reg. 1.1503(d)-1(b)(4); PLR 9344009. See Bracuti, "OECD Hybrid Rules vs. U.S. DCL Rules: Achieving Tax Harmony," Tax Notes Int'l, 3/29/2021.

The focus of this article is on the U.S. taxation of foreign corporations and only provides limited coverage of branch or hybrid entities, reverse hybrid entities, foreign partnerships, and other nonresident persons. Unless otherwise indicated, this article assumes that share ownership of a foreign corporation will be held predominately or exclusively by non-U.S. persons, including foreign parent corporations.

[3] A "person" for purposes of the Code includes an individual, trust, estate, partnership, company, association, or corporation. Section 7701(a)(1). The term "partnership" includes a group, pool, joint venture, or other unincorporated organization by which or through any business, financial operation, or venture is carried on and is not a trust, estate, or a corporation. Section 7701(a)(2). The term "corporation" includes associations, joint-stock companies, and insurance companies.

[4] See, e.g., U.S. Model Income Tax Convention (2016), Article 23 (relief from double taxation), Article 24 (non-discrimination), Article 25 (mutual agreement procedure), and Article 26 (exchange of information and administrative assistance).

[5] Section 7701(a)(30)(D) defines a "domestic estate" as any estate other than a foreign estate defined under Section 7701(a)(31)(A). A "foreign estate" means an estate the income of which is from sources without the U.S. which is not effectively connected with the conduct of a trade or business within the U.S. In general, a foreign domicile of the estate is the general rule applied in determining whether an estate is "foreign." See Rev. Rul. 62-154, 1962-1 CB 148, and Rev. Rul. 81-112, 1981-1 CB 598. Under Section 7701(a)(3)(E), a "domestic trust" is one: (1) over which a court within the U.S. is able to exercise primary supervision over the administration of the trust; and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust. The regulations provide rules in determining resolution of the "court test" as well as the "control test," which depend on the terms of the trust document and applicable law. Regs. 301.7701-7(b), 301.7701-7(c). See also as additional background, *BW Jones Trust*, 132 F2d 914 (4th Cir. 1943); Rev. Rul. 87-61, 1987-2 CB 219 (estate of U.S. citizen who resided in foreign country for 20 years before death was nonresident alien because estate assets and administrators were located in foreign countries; that decedent was U.S. citizen and decedent's children,

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A third BPT subjects a foreign corporation to tax in an amount equal to 30% of the excess of the amount of interest deductible under Section 882 over the amount of interest treated as paid by U.S. businesses operated by the foreign corporation.[17] Such excess is viewed as if it were remitted to the foreign corporation by a wholly owned domestic subsidiary.

While this article generally assumes that the "foreign corporation" referred to herein is owned predominately or exclusively by non-U.S. persons, such will not always be the case in "real time." There are many foreign corporations engaged in business in the U.S. or in other investment activities who have shareholders or indirect owners that are U.S. citizens or residents. Therefore, even in the "real time" situation the BPT can apply to a foreign corporation which is a controlled foreign corporation under Section 957(a) based on the extent of its U.S. shareholders. This would expose such U.S. shareholders to three layers of U.S. taxation to the extent of their pro rata share ownership in the foreign corporation: (1) a tax at regular corporate tax rates under Section 882 on the foreign corporation's net taxable income that is ECI; (2) the BPT on the "DEA" under Section 884(b); and (3) dividend income under Section 301(c)(1) at the U.S. shareholder level when the U.S. source earnings, net of applicable taxes, are distributed out as dividends. A 10% or more U.S. shareholder that is a domestic corporation of the foreign corporation may qualify for dividend relief under Section 245 applied in tandem with Section 243 with respect to distributions from earnings and profits attributable to U.S. source income, including ECI.[18] As to indirect ownership by a foreign corporation in a flow through entity realizing ECI, Section 882 as well as Section 884 will have application where the domestic or foreign partnership, for example, is engaged in a U.S. trade or business or has ECI with a U.S. trade or business. The same outcome can arise where a foreign corporation owns a beneficial interest in a trust or estate that is engaged in a U.S. trade or business or has ECI.

U.S. source income: foundational rules

For a foreign corporation not engaged in a trade or business in the U.S., it is subject to a 30% flat rate (without deduction or credit) on its U.S. source income that is otherwise not ECI. Section 881(a)(1) describes this category of U.S. source income, which is generally passive in nature, as "fixed or determinable or periodical income (FDAP). FDAP U.S. source income includes dividends, interest, rents, salaries, wages, premiums, annuities, and compensations.[19] The U.S. income tax on a foreign corporation's FDAP is subject to special withholding rules.[20] The flat 30% rate of

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who were estate beneficiaries, were citizens and residents of United States "weigh against alien status for the estate [but] these factors by themselves...do not prevent the estate from being considered an alien entity"); Rev. Rul. 64-307, 1964-2 CB 163 (estate of decedent, who was citizen and resident of U.S. held to be U.S. resident, despite 80% of its assets were foreign based and foreign assets were disposed of by separate wills probated in foreign country by foreign executor; although not conclusive, "the decedent's residence is one of the most important facts"); Rev. Rul. 62-154, 1962-2 CB 148 (estate of nonresident alien may be U.S. resident).

[6] Section 7701(a)(4).

[7] Sections 882(a), 871(b). See *Maritime Grain & Trading, Ltd.*, TCM 1999-332 (negligence penalty upheld against foreign corporation organized under the laws of the United Kingdom based on failure to provide sufficient evidence that its income was not ECI with the conduct of a U.S. trade or business).

[8] *deKrause*, TCM 1974-291 (management of stock held for investment, not trade or business; nonresident alien beneficiary is taxed on flat basis without deductions).

[9] See *Unger*, TCM 1990-15, aff'd 936 F.2d 1316 (DC Cir. 1991) (Canadian corporation taxable on its pro-rata share of partnership income of a California limited partnership operating a business in California); Rev. Rul. 85-60, 1985-1 CB 187 (application of Section 875(1) to foreign beneficiary of foreign trust in limited partnership with U.S. permanent establishment); Rev. Rul. 2004-3, 2004-1 CB 486 (permanent establishment attributed to nonresident alien partner); *Vitale*, 72 TC 386 (1979). It is important to note, as discussed below, that the activities of an agent may be imputed to a foreign person in determining whether the foreign person is carrying on a U.S. trade or business or has an office or fixed place of business, i.e., a permanent establishment for tax treaty purposes, within the U.S. See, e.g., *Lewenhaupt*, 20 TC 151 (1953), aff'd per curiam, 221 F.2d 227 (9th Cir. 1955); *De Amodio*, 34 TC 894 (1960), aff'd, 299 F.2d 623 (3rd Cir., 1962); *Inverworld*, TCM 1996-301, 71 TCM (CCH) 3231 (1996). See also Regs. 1.864-7(d) (agent activity and presence of U.S. trade or business; dependent and independent agents); 1.864-7(e) (activities of employees). In an outbound context, the indirect realization of foreign source dividends may impact a U.S. taxpayer, i.e., a domestic corporation. See, e.g., Section 245A(g) (application to domestic corporate partner of a foreign partnership holding stock of a foreign corporation).

Where the taxpayer-foreign corporation (or non-citizen, non-resident of the U.S.) is "resident" in a jurisdiction which has an income tax convention with the U.S., the treaty may exempt certain business profits of the foreign corporation from U.S. taxation, unless such profits are attributable to a "permanent establishment" maintained by such corporation in the U.S. The permanent establishment threshold is narrower than the broader standard engaged in the conduct of a U.S. trade or business under Section 864(b) for non-treaty foreign corporations. See also Section 864(c) on effectively connected income which under treaty provisions is referred to in general as "business profits". The key issues for a treaty investor in attempting to avoid U.S. income tax on business profits are whether: (1) the taxpayer or an entity in which it is a member (but generally not stock ownership in an operating subsidiary located within the U.S.) is deemed to have a permanent establishment in the U.S.; and (2) the extent to which business profits are attributable to such permanent establishment. See Rev. Rul. 2004-3, 2004-1 CB 486. See also, e.g., U.S.-U.K. treaty, Article 7(1); U.S.-Japan treaty, Article 8(1); U.S.-Canada treaty, Article. 7(1); and U.S.-Netherlands treaty, Article 3(1).

tax and withholding may be modified or eliminated by applicable tax treaty.[21]

For a foreign corporation engaged in trade or business activity within the U.S. under Section 864(c), the sourcing rules, both with respect to FDAP and applied in conjunction with the ECI provisions, take on heightened significance under Section 882(a) in computing net ECI.[22] Under Section 864(c)(3), all income, gain, or loss from sources within the U.S., other than FDAP income described in Section 864(c)(2) (income from trading in stocks and securities or commodities), is treated as ECI with the conduct of a trade or business within the U.S.[23] While for many years the maximum U.S. corporate income tax rate was 35%, with the passage of the Tax Cuts and Jobs Act of 2017, the corporate tax rate became a flat 21% of taxable income.[24] In a taxable year during which a foreign corporation is deemed to be engaged in the conduct of a U.S. trade or business in a taxable year, all of its income from sources within the United States for that year (except FDAP income and certain other prescribed passive income subject to special rules) is considered to be effectively connected with the conduct of that trade or business. [25] Further, certain species of foreign source income that are attributable to a foreign corporation's office or fixed place of business in the United States may be deemed to be effectively connected with a U.S. trade or business.[26]

In addition to the regular income tax (or BEATS tax under Section 59A),[27] a foreign corporation is subject to certain "add-on" branch profits taxes, as previously discussed, under Section 884 of 30% (subject to treaty rate reduction).[28]

Income not effectively connected with a U.S. trade or business

Under Section 881(a)(1), a foreign corporation is subject to a flat 30% income tax on certain categories of U.S. source investment income, i.e., interest, dividends, rents, and other "fixed or determinable annual or periodic gains, profits, and income" (FDAP). A foreign corporation's U.S. source FDAP income is taxed on a gross basis without offsetting deductions. The flat 30% rate is subject to reduction by applicable tax treaty.[29] In contrast to a foreign corporation's U.S. source FDAP, its income which is effectively connected with the conduct, directly or indirectly, of a U.S. trade or business is subject to U.S. income tax on a net-basis.[30]

The passive income categories subject to the flat 30% tax rate (and applicable withholding) include: (1) fixed or determinable annual or periodical gains, profits, income such as interest, dividends, rents, salaries, wages, premiums, annuities, compensation, and other remunera-

[10] Sections 11, 55, 59A, 1201(a) with respect to foreign corporations; Sections 1, 55, and 402(e)(1) for non-resident aliens. The focus of this article is the U.S. income taxation of foreign corporations having U.S. source income whether or not allocable to being engaged in a U.S. trade or business.

[11] See U.S. Model Tax Treaty (2016), Article 7. A permanent establishment for purposes of the U.S. Model Tax Treaty (2016) is a fixed place of business through which the business of an enterprise is wholly or partly carried on. It includes, but is not limited to, a place of management; a branch; an office; a factory; a workshop; and a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. It further includes a building site, a construction project, an installation project, and the use of an installation or drilling rig or ship in a country to explore or exploit natural resources, provided that the enterprise lasts more than 12 months. See Article 5. There is no "force of attraction" rule under the U.S. Model Tax Treaty. Only business profits derived from the assets or activities of the permanent establishment are captured by the other contracting state. The issue of "permanent establishment" in the U.S. will be covered in further detail in Part Two of this article.

[12] The Section 962 election rate would, under the Biden proposals, increase to 28%, which may have some appeal to individuals to make a Section 962 election since the corresponding proposed increase in individual rates is 39.6% for individuals making over $400,000 per year. But consider the "off-set" under Section 962(d) (limited withdrawal opportunity with respect to previously taxed income). See *Smith*, 151 TC 41 (2018). Capital gains for individuals making over $1M per year would be taxed at 39.6%. Carried interest rules would be eliminated. The Medicare HI tax would increase to 5%. There is also a proposed "billionaires' tax" of 25% that would be applied to tax unrealized gains. Income tax on 25% of unrealized gains? What if the unrealized gain that is taxed subsequently goes South? Unlimited period to recover a tax refund when the asset(s) is sold, plus statutory interest? Doubtful.

As discussed, the Treasury's Green Book for the 2024 Budget of the Biden Administration, released on 3/9/2023, further proposes international tax changes. This most recent and updated version of the Treasury's Green Book goes beyond the repeal of the base erosion and anti-abuse tax (BEATS) and its replacement with the domestic minimum top-up tax of 15% on audited financial statement income. First, the Biden administration wants to limit the Section 245A dividends received deduction (DRD) to dividends from controlled foreign corporations or qualified foreign corporations. A U.S. shareholder, as defined, would benefit from a 65% DRD on foreign source dividends from a qualified foreign corporation provided it owns at least 20% of the stock. Shareholders with less than 20% stock ownership in qualified foreign corporations would only receive a 50% DRD. In the 2021 House Ways and Means Committee, Democrats wanted to amend Section 245A so that the 100% participation exemption would apply only to dividends from CFCs rather than specified 10% owned foreign corporations. This provision passed the House as part of the Build Back Better Act in HR 5376 in November 2021 but has not been passed by the Congress. Second, the rate of tax on GILTI would be increased to 21%. The qualified business asset investment offset in computing net tested income would be eliminated. The GILTI foreign tax credit offset will be reduced from 20% to 5%. Net operating losses will be permitted to be carried forward as well as foreign tax credits for 10 years. Among other proposed reforms stated by the Biden Administration are: (1) revising the global minimum tax; (2) further limiting expatriations of do-

tions;[31] (2) gain from the sale of timber, coal, or iron ore where the seller retains an economic interest in the property;[32] (3) payments with respect to the retirement or redemption of original issue discount obligations;[33] and (4) variable or contingent gains from the sale or exchange of intangible property such as patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other "like" property.[34] FDAP does not include, in general, capital gains. A special exclusion from U.S. source (FDAP) income is provided for "portfolio interest"[35] as well as interest on certain bank accounts.[36] Withholding also applies to gains related to the disposition of natural resources under Section 631 and gains from contingent payments received from the sale or exchange of certain intangible property.[37]

The several FDAP categories of U.S. source income must also not be effectively connected with the conduct of a trade or business within the U.S.[38] Otherwise, effectively connected FDAP income will be included in ECI of a U.S. trade or business of a foreign corporation or foreign person.[39]

Compensation including wages and salaries

Salaries and wages paid for services performed in the U.S. is FDAP. [40] Compensation paid for services rendered outside of the U.S. is foreign source income. The standard of "place where services are performed" as determining source is applied to corporations, partnerships, and other entities in addition to individuals. This principle also extends to commission income, income from advertising, and payments received under a covenant not to compete.[41] In certain instances, compensation for certain services in the U.S. performed by nonresidents temporarily present in the U.S. for 90 days or less during a tax year and as to certain nonresident alien crew members on foreign registered vessels is not U.S. source income as well. [42] Compensation for services performed within and without the U.S. is required to be allocated into foreign and U.S. source portions.[43] In Rev. Rul. 87-38, 1987-1 CB 176, the Service allocated the compensation of a nonresident alien hockey player based on services rendered within and without the U.S.[44] Where, however, the bulk of the services rendered under a contract are performed within the U.S., the entire income may lead to the conclusion that all service income will be treated as U.S. source income. [45]

A distinction has also had to be drawn in distinguishing services income and royalties. This occurred in *Boulez, 83 TC 584 (1976).* In Boulez, a French orchestra conductor, resident of Germany, was held taxable in the U.S. for payments received by the taxpayer from a U.S. corporation, CBS Records, to make recordings

mestic corporations under Section 7874; and (3) the enactment of the complex untaxed payments rule (UTPR), which is part of the Pillar Two reforms. See Kiggins, "OECD Pillar One and Pillar Two: A New Paradigm for International Taxation of International Business? Part II: Update on Pillar One and Discussion of OECD Pillar Two." Corporate Tax'n (WG&L) (Jan/Feb 2022). There also is a proposed anti-avoidance rule for eliminating subpart F or GILTI income by making large dividend distributions to non-U.S. persons after U.S. shareholders reduce or eliminate their stock positions in the CFC prior to the last day of the tax year. An example provided in the Green Book is where a U.S. shareholder owns 50% of CFC, CFC pays a dividend, and then in the 4th quarter of the same tax year, U.S. shareholder sells the stock to a U.S. shareholder buyer.

This description of the "new" proposals, that are connected with the earlier Biden tax reforms, only describes the "surface" of the proposed changes, some of which are unprecedented if enacted into law. From a quick glance, the proposed raise in U.S. corporate income tax rates by 33%, as had previously been announced by the Administration, is unattractive to domestic corporations as well as foreign corporations, including subsidiaries of multi-national enterprises (MNEs). If this escalation in corporate tax rates were enacted into law, it presumably will result in many MNEs re-configuring their supply chains away from the U.S. to other jurisdictions and would incentivize such businesses to engage in other base erosion strategies. Combined with the other proposals reflected in the Green Book, such as the repeal of the capital gains preference for high income individuals, the combined economic impacts and budget increase of up to 18 trillion over the scoring period of ten years, initial commentators from the business and professional communities generally will anticipate that Congress, with majority control of the House in the Republican Party, will not pass these reforms as presently described. Still, the dramatic changes being proposed will keep the office lights on well into the night for many days in 2023 as tax advisors and their clients attempt to model out and anticipate the added tax burdens they may face if part or all of the Biden Administration's package (and other tag-along "loophole" closers) are enacted into law.

[13] Section 884(b). A U.S. income tax treaty may reduce the rate of tax under Section 884. See fn. 18 below. The BPT is reported with the foreign corporation's tax return and is due and payable on the same date that the corporation's income tax is due and payable. Section 6151. There is no estimated tax obligation on the BPT. Reg. 1.884-1(a).

[14] Section 884(b)(1).

[15] Section 884(b)(2). Note that Section 897(i) electing corporations, for purposes of Sections 897, 1445, and 6039C, to be treated as "domestic corporations" does not apply with respect to Section 884. Electing corporations remain foreign corporations for this purpose and are subject to the BPT. No foreign tax credits may offset the BPT. As further noted, the BPT applies in addition to any income tax imposed on a foreign corporation under Section 882 on its ECI as well as in addition to income tax owed by the foreign corporation under Section 881 with respect to its U.S. source FDAP income. The rationale for the BPT is to produce the same outcome where a U.S. corporation pays a dividend to foreign shareholders. The rate of the BPT may be reduced by applicable treaty. Section 884(e)(2)(A)(i). Where the applicable treaty does not specify a BPT rate, the treaty rate provided for dividends paid to a foreign corporation resident in the foreign treaty country by its wholly owned U.S. subsidiary applies for BPT purposes. Section 884(e)(1)(A)(ii). In order to benefit from the treaty, a foreign corporation must be a "qualified resident" of such foreign

in the U.S. The contract treated the payments as compensation for services even though labeled as "royalties," which label, were it otherwise controlling, would cause the income to be exempt from U.S. tax under the U.S.-Germany tax treaty. The contract between Boulez and the U.S. corporation provided that all recordings would be the property of the U.S. corporation. The "royalties" were to be based on percentage of sales. Based on the facts set forth in the record, the Tax Court held that the petitioner was paid for services performed within the U.S. and held that under U.S. copyright law, the conductor had no copyrightable property interest in the recordings he created for the U.S. corporation, CBS Records. The income was not exempt from U.S. tax under the treaty.

Interest income as FDAP

Under Section 861(a)(1), interest paid by obligors by U.S. or District of Columbia residents, either corporation or non-corporate, including interest on bonds, notes, or other obligations of such U.S. residents, is U.S. source income.[46] Interest income remains U.S. sourced where the debtor is a U.S. resident or domestic corporation despite the fact that security pledged as collateral for the repayment of the debt is located in a foreign jurisdiction.[47] Conversely, interest is foreign source income where the debtor-payor is neither a U.S. resident nor a domestic corporation. Under Section 884(f), interest paid by a foreign corporation engaged in a U.S. trade or business or otherwise is gross income that is ECI and U.S. source income.[48] Similarly interest paid by a partnership resident in the U.S. is U.S. source income regardless of whether it has one or more foreign corporations or persons as partners.[49] An exception to the U.S. source interest income rule is interest paid by a domestic corporation where 80% or more of the corporation's receipts are derived from active foreign business income. This rule applies to existing 80/20 companies which existed on 8/10/2010 and meets the requirements of Section 861(c)(1).[50]

There are several important exceptions to U.S. source FDAP income received by a foreign corporation (or other non-U.S. person). Most notable is the bank deposit interest exemption under Section 881(d).[51] A second exception is the "portfolio interest" exemption with respect to debt obligations held for investment purposes which meet certain requirements.[52] Section 881(c)(1) generally exempts portfolio interest received by a foreign corporation from sources (U.S. resident obligors) within the U.S. from the 30% flat tax under Section 881. "Portfolio interest" is defined as interest paid on certain registered and unregistered obligations that would otherwise be subject to tax as U.S. source interest income.[53] Portfolio interest,

country. Section 884(e)(1)(B). Under Section 884(f)(1), interest paid by a U.S. trade or business conducted by a foreign corporation (or having gross income treated as ECI) is treated as if paid by a domestic corporation. The interest payment is required to be U.S. sourced and subject to the 30% flat rate tax under Section 881, e.g., the branch-level interest tax or BLIT, subject to treaty override provided the foreign corporation receiving the branch-level interest is a qualified resident. See Blessing, "The Branch Tax," 40 Tax Law. 587 (1987); Brown, "Federal Income Taxation of U.S. Branches of Foreign Corporations: Separate Entity or Separate Rules?" 49 Tax L. Rev. 133 (1993); Cummings, "Avoiding the Branch Profits Tax," 170 Tax Notes Fed. 85 (1/4/2021); Lederman & Hirsh, "Final Branch Regulations Fail to Clear the Thicket of Complexity," 78 J. Tax'n 110 (1993); Autrey, Carsalade, & Arney, "How to Avoid Triple Taxation Under the Branch Profits Tax and FIRPTA," 38 Tax Adviser 648 (2007).

[16] Sections 884(f)(1), 1441, 1442. See Reg. 1.884-0 (overview of regulations under Section 884).

[17] Note Section 861(a)(2)(B), which treats a portion of a foreign corporation's dividends as U.S. source income where 25% or more of the corporation's gross income from all sources was ECI with the conduct of a trade or business in the U.S. for the three-year period ending as of the end of the year preceding the year in which the dividends were paid. Section 861(c). See also Section 884(d)(2) (earnings and profits eliminated from the three-year test, including gain from the disposition of stock in a USRPHC.

[18] Compare Section 245A, involving the participation exemption provision for dividends from a specified 10% owned foreign corporation by a domestic corporation for the foreign-source portion of the dividend.

[19] See, e.g., Reg. 1.1441-2(b)(1)(i), 1.1441-2(b)(1)(ii).

[20] Sections 1442, 1441. See also Sections 1471(a) (FATCA withholding at 30% on "withholdable payments" to FFIs) and 1472(a) ("withholdable payments" to NFFIs).

[21] See 2016 US Model Income Tax Treaty, Article 11(1) (interest); 2017 OECD Model Treaty, Article 11(1).

[22] Sections 861, 862, 863, and 865 contain the general rules used in determining the source of income. Sections 861 and 862 identify whether certain specific forms of passive income are U.S. source or foreign source. Section 865 contains source rules for income or loss from the sale or disposition of personal property, including intangibles. Section 863(a) is a residual sourcing rule that applies to source income, expenses, losses, or deductions, other than those specified in Sections 861(a) and 862(a), and in computing income that is partly within and without the U.S. under Section 863(b). Specific coverage is provided as to shipping, aircraft or transportation income, space and certain ocean activities, and international communications income. Section 866 sets forth source rules for income, gain, or loss from the sale of personal property. Section 863 is a residual type provision which identifies the source of income items not contained in Sections 861, 862, and 865. There are other areas where the Code will vary the sourcing rule or rules for other purposes such as for foreign tax credit purposes under Section 904. Tax treaties may also change the source of income. It should be noted that in contrast to the narrower source rule under Section 881 for FDAP, a foreign corporation's U.S. ECI is far broader in scope and may include U.S. FDAP as well as income that is foreign sourced. Sections 882, 871(b). As discussed below, a U.S. tax convention may shield a foreign corporation or other person from tax on ECI if the foreign corporation does not have a U.S. permanent establishment. The permanent establishment issue will be addressed in Part Two of this article.

however, does not include interest received in certain circumstances by a bank in the ordinary course of business, by a 10% or more shareholder, or by a controlled foreign corporation (CFC) or from a related person.[54] However, interest received by a CFC from an unrelated U.S. person may qualify as portfolio interest.[55]

Portfolio interest does not include contingent interest

An important exception to the portfolio interest exemption applies with respect to "contingent interest." Section 881(c)(4) provides that portfolio interest does not include interest payable by reference to: (1) receipts, sales, or cash flow of the debtor or a related person; (2) income or profits of the debtor or a related person; (3) change in value of property of the debtor or a related person; or (4) dividend distributions, distributions from partnerships, or similar payments made by the debtor or a related person.[56] On the other hand, interest is not "contingent" solely due to: (1) the time for payment of interest or principal is subject to a contingency; (2) the underlying portfolio debt is nonrecourse; or (3) any other type of interest identified in the regulations.[57] The "contingent interest" limitation is designed to prevent disguised distributions of operational profits or similar items from masquerading as payments of portfolio interest.[58]

A related person for purposes of the portfolio debt rules is based on the related party rules in Section 267(b) or Section 707(b)(1). A related person also includes a party to any arrangement that is entered into or effectuated for the purpose of avoiding the rules preventing contingent interest from being treated as portfolio interest.[59] Finally, contingent interest may not qualify as "portfolio interest" where the interest is dividend equivalent per Section 871(m).

Original issue discount income as FDAP

With respect to original issue discount (OID) on debt obligations issued by a U.S. borrower to a non-U.S. person, including a foreign corporation, OID is excluded under Section 1441(b) from FDAP with respect to the term "interest" for purposes of Section 881(a)(1). However, amounts subject to tax under Sections 871(a)(1)(C) and 881(a)(3) to foreign persons on certain OID accrued on an OID obligation is subject to 30% withholding of the amount of U.S. source OID on a debt obligation payable more than 183 days after date of original issue.[60]

However, OID, which is otherwise not U.S. source income, is nevertheless subject to the 30% flat tax under Section 881(a)(3), which requires the inclusion in gross income of the foreign lender when: (1) the underlying OID obli-

[23] See Reg. 1.864-4(a).

[24] Section 11(d). TCJA, P.L. 115-97 (12/22/2017); H.R. Rep. No. 115-466, at 595–672, 675 (2017) . See Lowell, Thomas, and Novak, "The International Provisions of the TJCA," 45 Corp. Tax'n 18 (Mar./Apr. 2018); August, "Tax Cuts and Jobs Act of 2017 Introduces Major Reforms to the International Taxation of U.S. Corporations," Prac. Tax Law., Winter 2018; "The Maze of Tunnels and Bridges Pass-Through Entities Must Traverse in Reporting Subpart F and GILTI Income Inclusions and Previously Taxed Income Recoveries," Corporate Taxation (WG&L), Jul/Aug 2021; See August, Levitt, & Looney, "Demystifying the 20 Percent Deduction for Qualified Business Income Under Section 199A (Parts 1 and 2)," 35 Prac. Tax Law No. 3; August, "President Biden's 'Made in America' Tax Plan: Reversing the International Tax Benefits Extended to U.S. Corporations Under the TCJA," 48 Corp. Tax'n 4 (May/June 2021); Calianno and Long, "Biden Administration's Green Book Proposals Would Transform the International Tax Rules," J. Int'l Tax'n (2021). President Biden's "Made in America" tax plan, first announced in a report released by the Department of the Treasury on 4/7/2021, announced the corporate tax rate would be raised to 28%. The President is expected to again push for an increased corporate tax rate as well as a substantial increase in the excise tax on stock buybacks. The Inflation Reduction Act, P.L. 117-169, repealed the corporate alternative minimum tax and replaced it with a new corporate minimum tax set at 15% of adjusted financial statement income (AFSI) of certain large corporations, i.e., corporations with average annual financial statement income in excess of $1 billion, which is projected by commentators to "target" approximately the largest 150 companies. The Service issued guidance in this area pending the issuance of regulations in Notice 2023-7, 2023-3 IRB 390. See Sayuk, "Tax Implication of Recent Federal Legislation for Technology Companies," Corporate Taxation (WG&L) (March/April 2023); Sullivan, "Identifying Corporations Likely to Pay the New Corporate AMT," Tax Notes Federal, 8/8/2022, p. 895. The Inflation Reduction Act also added new Section 4501, the stock buy-back excise tax, which imposes a 1% non-deductible excise tax on the value of repurchased stock after 12/31/2022. The stock buy-back excise tax was added late to the legislation to counteract revenues lost by the removal of carried interest provisions. See fn 12 supra, which also discusses the most recent announcement of tax proposals set out in the 2024 Budget by the Biden Administration, which continues to embrace the "Made in America" tax proposals.

[25] Sections 864(c) (ECI defined), 882(a)(1) (foreign corporations), 871(b) (foreign individuals). ECI includes income derived from the U.S. trade or business, FDAP income to the extent derived from the assets used or activities conducted by such U.S. trade or business, and all other income from U.S. sources "effectively connected." As part of the TCJA 2017, gain or loss from the sale of a partnership interest is ECI to the extent a foreign corporation (or foreign individual) selling or redeeming its partnership interest would have realized ECI income or loss if the partnership sold its underlying assets. See new Section 864(c)(8). See TD 9919, Reg. 1.864(c)(8)-1; 1.897-7. New Section 864(c)(8) overrides the Tax Court's decision in *Grecian Magnesite Mining*, 149 TC 63 (7/13/2017), which held that gain from the redemption of a foreign corporation's membership interest for the portion not sourced to its share of FIRPTA assets of the partnership, was foreign source income, including for this purpose, goodwill. Rev. Rul. 91-32, 1991-1 CB 107, was rejected by the Tax Court. See August, "Tax Court Rejects Rev. Rul. 91-32, Holds Foreign Partner's Gain from Redemption Not ECI," Corporate

gation is sold by a foreign person; and (2) payment is made to a foreign person, such as upon maturity or in the event of partial pay-downs. which may occur when the obligation matures or when payments, if any, are made. OID which constitutes FDAP is subject to special rules with respect to: (1) redemptions; and (2) sales or exchanges that are not redemptions. Note that stated interest may still qualify under the portfolio interest exemption from FDAP.[61] Overall, the portfolio debt rules and OID rules provide for a complex matrix to journey through for the tax advisor.[62]

Capital gains of foreign corporations

U.S. source capital gains that are not required to be re-characterized under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), P.L. 96-499, or as effectively connected income of a U.S. trade or business or business profits from a permanent establishment located within the U.S. under a bilateral tax treaty between the U.S. and the country of residence of the foreign corporation, are never FDAP and are not subject to the 30% flat rate of tax under Section 881(a)(1). There are certain gains subject to tax under Section 881(a) although such tax may be reduced or avoided entirely by treaty provision. Examples of such gains include contingent payments made with respect to the sale of certain intangibles,[63] gains from the sale or disposition of OID obligations,[64] and U.S. source gain from the sale or exchange of certain mineral and timber properties.[65]

Dividends from U.S. corporation as FDAP

Dividends paid from a U.S. corporation to a foreign corporation, whether paid in cash or the value of property, are subject to the 30% flat rate tax as FDAP and withholding.[66] The rate of U.S. income tax is subject to reduction under an applicable U.S. tax treaty. [67] The rate is generally re-set under a bilateral income tax convention at 15% but in certain instances may be further reduced to 5% or less.[68] Under Section 871(m), U.S. source income treatment is required for any substitute dividend under a securities lending or sale-repurchase transaction or "dividend equivalent" payments sourced from certain notional principal contracts and equity-favored obligations.[69]

The scope of the term "dividend," for purposes of FDAP, goes beyond distributions sourced from earnings and profits under Section 301. It includes distributions from earnings and profits allocated to payments made in redemption of stock under Sections 302, 304, or 306 as well as dividend treatment resulting from application of Section 305.[70] There may be instances that a U.S. corporation paying a "dividend" for purposes of Subchapter C may

Taxation (WG&L) (Nov/Dec. 2017). The TCJA 2017 overrides the non-U.S. source capital gain holding of the Tax Court in *Grecian Magnesite*, supra. The new provision applies to sales, exchanges, and dispositions on or after 11/27/2017. Corresponding withholding rules, such as Section 1446 and Section 1445, applied for sales, exchanges, and dispositions occurring after 12/31/2017.

[26] See Section 864(c)(4). See also special "look-back" ECI sourcing rules in Sections 864(c)(6) and (c)(7) discussed below. The branch profits tax (BPT) is an additional tax of 30% on a foreign corporation's earnings and profits attributable, i.e., "the dividend equivalent amount," to its U.S. ECI when such profits are withdrawn or deemed withdrawn from the U.S. Sections 884(a), 884(b). The dividend equivalent amount is, in general, the branch current year (net) earnings and profits less the portions of such earnings reinvested in branch operations. The applicable current year's earnings and profits are first reduced for U.S. income tax under Section 11. Accordingly, the BPT base is current branch earnings, decreased by any increase in the corporation's investment in the branch and increased (to the extent of previously reinvested earnings) by any decrease in that investment. The rationale for the BPT is to produce the same outcome where a U.S. corporation pays a dividend to foreign shareholders. The rate of the BPT may be reduced by applicable treaty. Section 884(e)(2)(A)(i). Where the applicable treaty does not specify a BPT rate, the treaty rate provided for dividends paid to a foreign corporation resident in the foreign treaty country by its wholly owned U.S. subsidiary generally applies for BPT purposes. Section 884(e)(1)(A)(ii). In order to benefit from the treaty, a foreign corporation must be a "qualified resident" of such foreign country. Section 884(e)(1)(B). The branch profits tax is subject to treaty override. See 1981 U.S. Model Income Tax Treaty, Article 24(3) (nondiscrimination clause). Various treaties prohibit the branch profits tax, e.g., U.S.-China treaty, Article 23; U.S.-Norway treaty, Article 25; U.S.-Iceland treaty (no provision). See IRS Notice 87-56, 1987-2 CB 367; Reg. 1.884-1(g)(4)(B). The branch profits tax may be reduced where the foreign corporation has a U.S. permanent establishment. See, e.g., U.S.-Canada treaty, Article. X(6). See also 2006 U.S. Model Income Tax Treaty, Article 24(6). Under Section 884(f)(1), interest paid by a U.S. trade or business conducted by a foreign corporation (or having gross income treated as ECI) is treated as if paid by a domestic corporation. The interest payment is required to be U.S. sourced and is subject to the 30% flat rate tax under Section 881, e.g., the branch-level interest tax or BLIT, subject to treaty override provided the foreign corporation receiving the branch-level interest is a qualified resident. See Blessing, "The Branch Tax," 40 Tax Law. 587 (1987); Brown, "Federal Income Taxation of U.S. Branches of Foreign Corporations: Separate Entity or Separate Rules?" 49 Tax L. Rev. 133 (1993); Cummings, "Avoiding the Branch Profits Tax," 170 Tax Notes Fed. 85 (1/4/2021); Lederman & Hirsh, "Final Branch Regulations Fail to Clear the Thicket of Complexity," 78 J. Tax'n 110 (1993).

[27] It is important to note that the corporate alternative minimum tax was repealed by the Tax Cuts and Jobs Act of 2017, P.L. No. 115-97, section 12001 (12/22/2017), and was effective for tax years beginning after 2017 but before 2022 in computing regular taxable income or resulting in a refundable credit. The CARES Act (the 2020 Coronavirus Aid, Relief and Economic Security Act) denies the refundable credit outcome for a tax year beginning after 2018. See P.L. No. 116-136, section 2305(a) (3/27/2020). Under the Inflation Reduction Act of 2022, the corporate alternative tax is now based on an applicable corpo-

be required to withhold on the gross amount of the distribution even in instances where such amount may be greater than the resulting dividend income.[71] A dividend paid by an existing 80/20 domestic company under Section 871(a)(2)(B)(i) is not FDAP.

Royalties and license payments as FDAP

Royalties and payments made by U.S. users for licenses and similar arrangements for the use of intangible property owned by a foreign corporation (or non-U.S. person) are treated as FDAP.[72] This includes payments for the use of patents, copyrights, secret processes and formulas, goodwill, franchises, trademarks, tradenames, and brands. Accordingly, royalty payments for the use of intangibles within the U.S. which are not ECI of a U.S. trade or business (or permanent establishment) of a foreign corporation or non-resident licensor, are subject to the flat 30% tax and applicable withholding rate subject to treaty modification.[73] The governing standard is for royalty income to be sourced based on the country in which the licensed property is used and not the jurisdiction in which the licensor resides or maintains its principal place of business.[74] The dividing line between the licensing of intangible property (FDAP) from gains from the sale of intangible property is not always clear and has been the subject of litigation. This is because gains from the sale of property, including intangible personal property, do not subject a foreign corporation to tax under Section 881(a) unless otherwise provided to the contrary in the Code.

Generally, a sale results where the transfer is made of all substantial rights of ownership.[75] Even where there is a transfer of all or substantially all ownership rights to potentially qualify the transaction as a "sale" of intangible property, gains from such sale to the extent "contingent on the productivity, use or disposition of the property" are treated as FDAP and taxed at the gross 30% rate.[76] A payment that is indefinite in amount or as to time is generally not treated as "contingent" for purposes of this rule.[77]

There also is the issue of multiple or "cascading" royalties, which describes a series of directly connected licensing payment streams where each segment may be subject to FDAP as U.S. source royalty income. The "cascading" effect is produced by the sublicense of the intangible property by the licensee again for use in the U.S. Another area having the potential for generating multiple levels of FDAP income can arise from cross-licensing arrangements where unrelated parties enter into a reciprocal licensing arrangement to use intellectual property such as patents.[78] The Service has issued guidance in this area, permitting the use of a "net consideration method" of accounting with re-

ration's "adjusted financial statement income" (AFSI) less certain "alternative foreign tax credits." Section 55(b)(2)(A)(i). The new corporate alternative tax only applies to the extent that 15% of the AFSI exceeds the "applicable corporation's" regular corporate income tax. Sections 55(a), 59(k). An applicable corporation is any corporation (excluding S corporations, regulated investment companies, or REITs) that meets an "average annual adjusted financial statement income test" during a testing period ending after 12/31/2021. The average annual adjusted financial statement income for the three taxable year period ending on the taxable year for most domestic corporations must exceed $1 billion; under a parallel test that applies to "foreign-parented corporations," the average annual AFSI must be $100 million or more. See Rizzi, "Corporate Taxation Under the Inflation Reduction Act," Corporate Tax'n (Nov/Dec. 2022).

28 Where a foreign corporation has a U.S. subsidiary, dividends paid by the U.S. subsidiary to its parent will be subject to 30% withholding under Section 1442 subject to treaty rate reduction. A number of U.S. trading partners have negotiated reduced treaty rates of 5% to 15% for dividends and in a few instances at 0%. See U.S.-U.K. Income Tax Treaty (2001), Article 10(3).

29 Section 881. See Section 871(a)(2), Section 871(b) as to a nonresident's U.S. source FDAP income from net capital gains. But see Sections 897, 864(c)(8) (added by TCJA 2017), which codifies Rev. Rul. 91-32, 1991-1 CB 107 by providing that a nonresident alien individual's or foreign corporation's sale of an interest in a partnership engaged in a U.S. trade or business will generally be treated as ECI, including amounts attributable to goodwill or other intangibles. *Grecian Magnesite Mining*, 149 TC 63 (2017), overruling Rev. Rul. 91-32, supra. See August, "Tax Court Rejects Rev. Rul. 91-32, Holds Foreign Partner's Gain from Redemption Not ECI," Corp. Tax'n (Nov/Dec 2017).

30 See U.S. Model Act (2016), Article 4. The focus of this article is on the U.S. taxation of foreign corporations and only provides limited coverage of branch companies and foreign partnerships as well as other non-resident persons. See U.S. Model Act (2016), Article 4.

31 Section 881(a)(1). See former Sections 871(i)(2) and 881(d), which exempted from FDAP a portion of dividends paid by a so-called "80-20" domestic corporation to foreign corporations and nonresident aliens. Qualification required that the corporation realize at least 80% of its gross income from the active conduct of a foreign business during a three-year testing period preceding the year of payment. Section 861(c)1).

32 Section 881(a)(2).

33 Section 881(a)(3).

34 Section 881(a)(4).

35 See Sections 881(c), 871(h).

36 See Sections 881(a)(1)-(4); 871(a)(1)(A)-(D). See also Reich, "Taxing Foreign Investors' Portfolio Investments: Developments and Discontinuities," 79 Tax Notes 1465, 1474-76 (1998).

37 See Section 894(c) (foreign person not permitted reduced withholding rate under tax treaty on income realized by a partnership or other fiscally transparent entity for U.S. income tax purposes where: (1) the income is not treated as income of the person on the foreign country; (2) the treaty contains no provision relating to the applicability of the treaty to income derived through a partnership; and (3) the foreign country imposes no tax on the distribution of the income from the entity to the person.

38 See also Sections 1441(c)(1), 1442(b).

spect to cross-licensing payments whereby cash payments are taken into account for capitalization and withholding purposes.[79]

Source of income from leases, licenses, and services distinguished

As discussed, the sourcing rules under Sections 861 and 862 instruct whether income from payments of a particular transaction will be treated as U.S. source or foreign source income or partly both based on an allocation provision. As noted, personal services are sourced under the "place of performance" standard.[80] In comparison, rental income of tangible property is sourced on where the property is located.[81] Royalty and licensing income associated with intangible personal property is sourced according to where the intangibles are used, which is where the legal protection sought by the licensee is sought.[82] For example, a licensee remits fees to the manufacturer of copyrighted software for use in the United States. The manufacturer or developer of the software is a foreign corporation based in Brazil which does not have, at present, a tax treaty with the United States. The payment is U.S. source income, assuming that the Brazilian corporation does not carry on a trade or business within the U.S.

Two investment tax credit cases from the 1980s focused on the distinction between payments made for the licensing or use of property from a contract requiring the performance of services. The cases involved domestic taxpayers, so sourcing of licensing versus services income was not the relevant issue for determination but the analysis on the characterization of the payments can be applied under Section 861. In *Smith, TCM 1989-318*, the issue before the Tax Court was whether medical equipment was leased to a tax-exempt hospital or whether it was to provide services to the hospital. If the transaction was a lease for income tax purposes, the petitioners would not be allowed investment tax credits (ITCs) for the medical equipment. On the other hand, were the equipment used by the petitioners to perform services for the hospital, the ITCs would be allowed. In applying a seven-factor test based on several published revenue rulings issued by the Service, as well as the Court of Claims decision in Xerox Corp., 656 F.2d 659 (Ct. Cl. 1981), the court determined that a purported lease of xerox equipment on the premises of a hospital was a lease, not a service contract. Similarly, in Musco Sports Lighting, Inc., TCM 1990-331, aff'd 943 F2d 906 *(8th* Cir. 1991), the taxpayer-manufacturer installed sports lighting equipment on governmental and tax-exempt organization property.[83] The customers entered into a "service agreement" with Musco Sports and agreed to remit payments for four-five years with the option to purchase the lighting equip-

[39] The withholding on FDAP income provisions are applied independently from the 30% flat rate tax under Section 881 although in many instances the two rules will be applied in tandem. See Regs. 1.1441-2(b)(1), 1.1441-1(b)(7)(iii). In certain instances, however, the tax on a foreign corporation's FDAP under Section 881 will not be subject to withholding under Section 1442. See, e.g., Reg. 1.1441-4(a)(3) (exception for certain notional contracts described in Section 871(m)). *Central De Gas de Chihuahua, S.A.*, 102 TC 515 (1994) (held the word "received" under Section 881 includes the fair rental value of equipment between related companies even though the foreign corporation deemed lessor did not actually receive payments of rents from an affiliate Mexican corporation under common control); *Proctor & Gamble*, 961 F.2d 1255 (6th Cir. 1992) (Section 482 standard applied to U.S. corporation's wholly-owned foreign subsidiary). In general, Sections 1442 and 881 overlap. See August, "Altera and Cost-Sharing Requirements Under Section 482Another Tax Court Rebuke to the IRS," 18 No. 1. BUSENT 04 (2016) (WESTLAW); Stark and Baillif, "Do Section 482 Allocations to Foreign Entities Trigger a Withholding Obligation?" 82 J. Tax'n 178 (1995); Myers, "Section 482 and Subpart F: An Internal Revenue Code Dilemma," 11 AMUJILP 1973 (1996).

[40] Section 861(a)(3). There are certain limitations on qualifying under the exception set forth in Section 861(a)(3). Four requirements must be met: (1) the services are performed while the individual is temporarily in the U.S.; (2) the individual's presence in the U.S. during the tax year is less than 90 days; (3) the compensation amount is $3,000 or less; and (4) the services are performed as an employee or independent contractor of: (i) a nonresident alien or a foreign corporation or partnership that is not engaged in a trade or business in the U.S. or (ii) an office of a U.S. citizen or resident, domestic corporation, or domestic partnership in a foreign country or U.S. possession. See *Miller*, TCM 1997-134 (compensation not FDAP where it was uncertain what portion of the contract would be performed in the U.S. during the year payment was made).

[41] *Piedras Negras Broadcasting Co.*, 127 F.2d 260 (5th Cir. 1942) (radio advertising revenue); Rev. Rul. 60-55, 1960-1 CB 270 (sales commissions for soliciting orders overseas where services performed outside of U.S.); Rev. Rul. 83-177, 1983-2 CB 112 (payments for employer's breach of contract for services treated as foreign source based on location where services were to be performed); *Korfund Co.*, 1 TC 1180 (1943) (covenant not to compete payments received by non-resident alien not to compete in U.S.). Compare, Rev. Rul. 2004-109, 2004-2 CB 958.

[42] Section 861(a)(3). See Gordon, "Services, Licensing, and Technical Sales Contracts Under U.S. Income Tax Treaties," 15 Tax Notes Int'l 1033 (9/29/1997); Kirsch, "The Role of Physical Presence in the Taxation of Cross-Border Personal Services," 51 BC L. Rev. 893 (2010); Lowell, Tilton, Sheldrick, & Donahue, "Tax Issues in the Provision of Outbound Services", 8 J. Int'l Tax'n 296 (1997).

[43] See Reg 1.861-4(b)(1). See, e.g., *Foglesong*, 691 F.2d 848 (7th Cir. 1982); *Garcia*, 140 TC 141 (2014) (allocation of royalty and personal service income of famous professional golfer).

[44] Revoking Rev. Rul. 76-66, 1976-1 CB 189. Cf. *Linesman*, 82 TC 514 (1984).

[45] See *Dillin*, 56 TC 228 (1971), acq. 1975-1 CB 1; *Goosen*, 136 TC 547 (2011). But see Section 861(a)(3) (nonresident alien performing limited amount of services within the U.S.).

[46] Interest paid by foreign partnerships engaged in a U.S. trade or business is not U.S. source income. Cf. *Coldwater Seafood Corp.*, 69 TC 966 (1978) (payments by wholly owned U.S. subsidiary of

ment at the end of the contract term. The year in issue in *Musco Sports Lighting, Inc., supra,* was prior to the effective date of Section 7701(e) which became effective in 1983, and therefore the court applied the pre-Section 7701(e) standard announced in Smith, supra. The Tax Court held that the petitioner was not entitled to ITCs on the athletic lighting since the lighting systems for the athletic fields were property acquired by the tax-exempt organizations and governmental agencies. Payments made by the petitioner were determined to be lease payments and not payments on service contracts.

In the Deficit Reduction Act of 1984, Congress enacted Section 7701(e) in an effort to distinguish between a lease and a service contract. Six factors are set forth in the statute in making this determination; to-wit: (1) the service recipient has physical possession of the property "leased;" (2) the service recipient controls the property; (3) the service recipient has a significant economic or possessory interest in the property; (4) the service provider does not bear economic risk of loss by substantially increased expenditures if there is nonperformance under the contract; (5) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and (6) the total contract price does not substantially exceed the rental value of the property for the contract period.

A case under Section 7701(e) was finally presented to the Fifth Circuit Court of Appeals in *Tidewater Inc.*[84] In T*idewater,* the owner and operator of ocean-going ships serving the offshore energy industry in both U.S. and foreign waters, sought a tax refund of $9M claimed under the Foreign Sales Corporation Act (FSA) and accordingly entitled to realize benefits provided under the FSC provisions.[85] The central issue before the Fifth Circuit was whether the Tidewater vessels chartered to its customers were "export property" under former Section 927(a)(1) and supporting regulations. Under Section 927(a)(1)(B), qualified export property required that the vessels be held "primarily for lease," which in this case was through sublease to a third party. Resolution of the issue turned on whether the charter arrangement is more like a lease than a service agreement. The government argued that the criteria under Section 7701(e) should be used. Tidewater contended that Section 7701(e) does not apply to the FSC provisions, only to investment tax credit issues. The Fifth Circuit disagreed with Tidewater and opined that Section 7701(e) applied federal income tax purposes in general based on the unambiguous language of the statute. The appeals court viewed the most critical of the factors was whether Tidewater or

foreign parent corporation treated as U.S. source income and subject to Section 1442 withholding despite being reported as a reimbursement of expenses or costs of goods sold). But see Section 988(a)(3)(C), which treats certain interest on a loan by a U.S. person or related person to a 10% owned foreign corporation in a currency other than the U.S. dollar as U.S. source interest.

[47] Sections 861(a)(1), 862(a)(1). The source of investment or business income is a critical factor or determinant in computing foreign tax credits whether for U.S. income tax purposes or with respect to the domestic tax laws of a foreign company or resident.

[48] Section 884(f)(1)(A) ("as if" it were interest paid by a domestic corporation). Where the interest attributable to the U.S. trade or business paid by the foreign corporation is greater than such amount, the excess of the branch interest is treated as FDAP under Section 881. See Section 884(f)(1)(B) (allocable interest).

[49] See, e.g., *John F. Betz & Son, Ltd.*, 10 BTA 1104 (1928) (Pennsylvania limited partnership operating brewery business in U.S. required to withhold tax from interest paid on mortgage bonds to foreign trustee for benefit of foreign corporate owner of mortgage bonds; court required interest to be treated as U.S.-source income).

[50] Section 871(i)(2)(B)(ii).

[51] Section 871(i)(2) (qualifying "interest on deposits" that are not ECI; U.S. financial institution may still have a reporting obligation with respect to the bank deposit interest paid to a non-U.S. person).

[52] Sections 881(c)(1), 871(h)(1). Regs. 1.881-2(a)(6), 1.871-14(a). Interest (including original issue discount) paid on an obligation will qualify as "portfolio interest" provided the obligation is in "registered form" and the person who would otherwise be required under Section 1442(a) to deduct and withhold tax from the payment of interest receives a statement that the beneficial owner of the obligation is not a U.S. person. See Sections 881(c), 163(f), 149(a)(3). The regulations under Section 163(f) pertaining to the "registered form" of obligation requirement cross-refer to the regulations under Section 103. Under the Section 103 regulations, an obligation is in "registered form" if one of the three methods is used by the issuer and its agent: (1) the obligation is registered as to principal and any stated interest with the issuer or its agent and is transferable only by surrender of the old instrument and the reissuance of that instrument or the issuance of a new instrument to the new holder (per Temp. Reg. 5f.103-1(c)(1)(i); (2) the right to receive principal and any stated interest is transferable only through a book entry system maintained by the issuer or its agent (per Temp. Reg. 5f.103-1(c)(1)(ii); or (3) the obligation is registered as to principal and interest with the issuer or its agent and is transferable through both of the two methods just described (per Temp. Reg. 5f.103-1(c)(1)(iii)). Where the registered form requirements are not satisfied, the interest is not "portfolio interest." See also *American Metallurgical Coal Co.*, TCM 2016-139 (U.S. subsidiary did not meet reporting requirements for portfolio interest exemption to withholding tax on fixed or determinable annual or periodical (FDAP) income paid to foreign corporation, and thus the U.S. subsidiary was liable for 30% withholding tax on gross amounts of distributions it made to its foreign corporation parent).

[53] Section 881(c)(2). Portfolio interest includes interest on debt instruments issued before 3/19/2012 that are not in registered form, i.e., issued in bearer form or "non-registered" in accordance with former Section 163(f)(2)(B) (so-called "foreign targeted obligations" which could only be sold to non-U.S. persons). See Foreign Account Tax Compliance Act, section 502(f),

the customer had control of the vessel. Under the facts, the Fifth Circuit held that characterization of the transaction as a lease was proper and therefore the vessels were "export property" under the FSC regime.

Income from computer programs and cloud transactions

As mentioned, income from copyrights, patents, trademarks, or similar intangibles may be treated as "royalties" and therefore FDAP under a "license" arrangement, or, gain from the sale of the property in issue if substantially all rights are transferred, or as services income if the income is principally derived in the form of compensation for the owner's services in developing the property.[86] Where the taxpayer receives payments but does not have ownership in the intangible property, the transaction is treated as compensation. Where less than substantially all of a taxpayer's rights are transferred, the transaction is characterized, in general, as a license.[87]

Reg. 1.861-18 provides rules for classifying income from computer programs as well as income from services and know-how.[88] There are several species involving the transfer of a computer program, services, or know-how including: (1) a transfer of a "copyright right" in the program, which is treated as a sale if "all substantial rights" in the copyright as to a particular country are transferred or a license producing royalty income if less than all substantial rights are transferred;[89] (2) a transfer of the program or intangible, which is treated as a sale where "the benefits and burdens" of ownership are transferred and, if not, then the transaction constitutes a lease yielding rental income;[90] (3) a contract for services with respect to the development or modification of the program;[91] or (4) for "know-how relating to computer programming techniques," which would, in general presumably be treated as licensing income unless the transferee acquires ownership rights with respect to the "know-how."[92]

The regulations under -18 of Section 861 as to computer software transactions, issued in 1999 (also known as the "software regulations"), did not seem to provide a complete or comprehensive basis for addressing characterization and sourcing issues related to "cloud computing" transactions, a more recent phenomenon.[93] While computer software technology involved the purchase or lease of a license to install and run software on the taxpayers' computers, cloud computing permits consumers to access the internet or virtual space where the software is located through one or more provider's servers to run its data on the host company's software, hardware, and data storage with a developer perhaps serving as an

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P.L. 111-147 (3/18/2010) (repeal of the foreign targeted obligation exception). Therefore, Section 871(h)(2) was amended by Congress in FATCA to make portfolio interest of a nonresident person exempt from U.S. income tax and 30% withholding unless the bond is in a registered form or meets the FATCA requirements. See Packman and Rivero, "Increased Disclosure, Penalties, and Audit Periods Curtesy of the Foreign Account Tax Compliance Act," Journal of Tax'n, May 2010.

[54] Sections 871(h)(3)(B), 881(c)(3). Attribution rules under Section 318 apply with certain modifications. With respect to a partnership lender, the 10% ownership limitation is presumably applied at the partner level. Regs. 1.1441-5(c)(2), 1.1441-14(g)(3)(i). See *New York Guangdong Finance, Inc.*, TCM 2008-62, aff'd 588 F.3d 889 (5th Cir. 2009) (taxpayer not exempted, pursuant to the U.S.-China income tax convention, for withholding taxes on interest received by the lender as its principal place was Hong Kong and was not "resident" in the U.S. as loan which taxpayer received from the wholly-owned subsidiary of a Chinese lender was, in substance, not a loan from the parent lender).

[55] But see Sections 881(c)(5)(A), 954(b)(3).

[56] Section 871(h)(4)(A). Another form of contingent interest may be provided by the IRS in regulations. Section 871(h)(4)(A)(ii). If an obligation earns both contingent and noncontingent interest, only the contingent portion is denied portfolio interest treatment.

[57] The list of exceptions on "contingent" versus "non-contingent" interest is not all inclusive. See Sections 881(c)(4), 871(h)(4)(C)(vi).

[58] See 1993 Revenue Reconciliation Act, P.L. 103-66 (8/10/1993), COMREP ¶ 8811.0995 (RIA Checkpoint).

[59] Sections 871(h)(4)(B) and 881(c)(4).

[60] See Section 871(g)(1) (definition of "original issue discount obligation").

[61] A payment is subject to tax as OID only to the extent that the tax does not exceed the amount of the payment less any tax that applies on interest, if the payment is interest. Sections 871(a)(1)(C)(ii), 881(a)(3)(B).

[62] An excellent starting place for taking this "journey" is Kuntz, Peroni, & Bogdanski, U.S. International Taxation (WG&L), ¶ C2.03 (Income Subject (or Not Subject) to Withholding Under Sections 1441 and 1442).

[63] Section 881(a)(4).

[64] Section 881(a)(3)(A).

[65] Section 881(a)(2). See also Sections 631(b), 631(c).

[66] As mentioned, the FATCA provisions should also be addressed on withholdable payments to an FFI or a NFFI under Sections 1471 and 1472 respectively. See International Update, "IRS Provides Guidance on FATCA Penalty Relief and Withholding and Reporting Procedures," Corporate Tax'n (WG&L) (July/Aug 2019); Mukadi, "FATCA: Getting Rid of U.S. Clients Will Not Get You Off the Grid," 23 J. Int'l Tax'n 36 (Nov. 2012); Noked, "FATCA, CRS, And the Wrong Choice of Who to Regulate," 22 Fla. Tax. Rev. 77 (2018); Oei, "The Offshore Tax Enforcement Dragnet," 67 Emory L.J. 655 (2018).

[67] See, e.g., U.S. Model Income Tax Convention (2016), Article 10.

[68] The U.S. Model Tax Treaty (2016), Article 10, provides that dividends paid by a resident of one country to a resident of the other country, which does not have a permanent establishment in the country of the payor, may be taxed in both countries. However, the maximum tax in the country of the payor is (1) 5% of the gross dividend if the beneficial owner is a company own-

intermediate party between the consumer and the owner of the technology. The attraction of cloud computing to businesses and investors is most obvious. It does not require an initial investment in capital to develop the software as well as the hardware and related costs.

Therefore, it was unclear based on the computer software rules whether cloud computing income should be characterized as royalty, rental, or services income. Cloud computing transactions may, in general, be described as involving three models: (1) a software as a service ("SaaS"); (2) a platform as a service ("PaaS"); and (3) infrastructure as a service ("IaaS"). SaaS allows customers to access applications on a provider's cloud infrastructure through an interface such as a web browser. It is generally understood that SaaS transactions are the predominant cloud computing transaction. PaaS allows customers to deploy applications created by the customer onto a provider's cloud infrastructure using programming languages, libraries, services, and tools supported by the provider. IaaS allows customers to access processing, storage, networks, and other infrastructure resources on a provider's cloud infrastructure.

A cloud computing transaction typically does not involve a transfer of a copyright right or copyrighted article or any provision of development services or know-how relating to computer programs or programming.[94] The problem with issuing tax rules on cloud computing is that these transactions occur entirely in the virtual world, i.e., there is little connection between the revenue-generating activity with a particular geographic location. The potential incongruities between source of revenue and geographic activity can yield no taxation at all or double taxation.[95] There is an associated problem of classification of payments for cloud services.

Proposed Regulations, in Prop. Reg. 1.861-19,[96] provide specific rules for cloud transactions. The Treasury, in its proposed rulemaking, acknowledged, as commentators had already announced, that in general, a cloud transaction involves access to property or use of property, instead of the sale, exchange, or license of property, and therefore should be classified as either a lease of property or the providing of services.

The Treasury then looked to Section 7701(e) and relevant case law that delineate the factors to be employed in characterizing a cloud computing transaction as either a lease of property or the rendition of services.[97] In particular, Section 7701(e)(1) instructs that a contract that purports to be a service contract will be treated instead as a lease, if, based on all facts and circumstances: (1) the service recipient is in physical possession of the property, (2) the service recipient controls the property, (3) the service recipient has a significant economic or

ing directly at least 10% of the voting and value of stock of the company paying the dividends and (2) 15% of the amount of the gross dividend in all other cases.

[69] Reg. 1.871-15(c). There are various exemptions from application of Section 871(m) provided in the regulations such as the payment of a dividend equivalent in certain merger and acquisition transactions, distributions also taxed under Section 305(c), and equity-based compensation. See Regs. 1.871-15(c)(2)(i)-(k).

[70] See, e.g., Rev. Rul. 92-85, 1992-40 IRB 10 (Section 304 deemed dividend to a foreign or domestic corporation subject to U.S. income tax, subject to Section 1442 withholding at 30% rate, subject to applicable treaty rate, for dividends paid to 10% or greater corporate shareholders). Section 304 may apply to certain cross-border redemptions of stock. For example, Section 304(a)(2) applies to a subsidiary's purchase of parent stock, e.g., a "downstream stock sale." In situations where Sections 304(a)(1) and (a)(2) may apply, Section 304(a)(2) will, in general, take priority. On the other hand, Section 304 presumably does not apply to the sale of lower-subsidiary stock to a higher-tier subsidiary, e.g., an "upstream stock sale." Rev. Rul. 74-605, 1974-2 CB 97. Nor does Section 304 apply to an acquisition of a corporation in an intercompany transaction or to any intercompany item from such transaction. Reg. 1.1502-80(b). See Calianno, Cordonnier, and Difronzo, "New Proposed Section 367 Regulations Provide Welcome Guidance...", 32 J. Corp. Tax'n 19 (2005).

[71] There are a myriad of special rules in this area. For example, under Section 881(e), qualified dividends received from a regulated investment company (RIC) are not subject to FDAP under Section 881(a)(1). Moreover, "any short-term capital gain dividend" (per Section 871(k)(2)) received from a RIC is exempt from tax under Section 881(a)(1).

[72] Regs. 1.871-7(b), 1.881-2(b). See, e.g., *Wodehouse*, 337 U.S. 369 (1949); *MacDonald*, 55 TC 840 (1971); *Mylan, Inc.*, TCM 2016-45; *Bloch*, 200 F.2d 63 (2d Cir. 1952); Rev. Rul. 74-555, modified by Rev. Rul. 76-283, 1976-2 CB 222 (correcting Rev. Rul. 74-555 on the proper phrase to use regarding Section 861(a)(4) that rental or royalties for the use of or the privilege of using copyrights in the United States are treated as income from "sources within the United States" and not from "sources without the United States"). See also, Lokken, "The Sources of Income from International Uses and Dispositions of Intellectual Property," 36 Tax L. Rev. 233 (1981).

[73] See, e.g., U.S. Model Tax Treaty (2016), Article 12.

[74] But see *SDI Netherlands B.V., F.K.A. SDI International B.V.*, 107 TC 161(1966) (source of royalty payments may be changed from the U.S. to a foreign country through a foreign intermediary). In *SDI Netherlands, B.V.*, the Tax Court rejected the Service's argument that the petitioner was subject to U.S. withholding tax on royalties it paid to its parent Bermudan corporation. The Bermuda corporation, SDI Bermuda, owned the worldwide rights to use IBM software which it licensed to the petitioner-corporation which in turn sublicensed it to a U.S. corporation. The royalties paid by the U.S. corporation to SDI Netherlands was acknowledged by the petitioner to be U.S. source income under Section 881 and otherwise subject to withholding as FDAP under Section 1442(a), but exempt from U.S. income tax and therefore withholding under Section 894 and the U.S.-Netherlands Tax Treaty, former Article 9(1). The Service argued that the royalties retained their character as U.S. source income when the Netherlands corporation in turn paid royalties to the Bermuda corporation. In rejecting this argument, the Tax Court characterized the Service's reliance on the analysis of Rev. Rul. 80-362, 1980-2 CB 208 as misplaced. The court found that the

possessory interest in the property, (4) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (5) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and (6) the total contract price does not substantially exceed the rental value of the property for the contract period.

Section 7701(e)(2) provides that the factors in Section 7701(e)(1) apply to determine whether any arrangement, not just contracts which purport to be service contracts, is to be treated as a lease. The list of factors is neither weighted, as discussed, nor all-inclusive. In general, cloud computing will involve payment for the rendition of services but again, must be examined under the filter of each specific transaction and the "all relevant" factors test. More difficult questions relate to the source of the income as well as carrying on a trade or business and permanent establishment issues. Relevant treaty considerations must also be factored.[98]

Rental income of real or personal property as FDAP

Rental income with respect to either real or personal property geographically located in the U.S. that is not effectively connected with respect to the conduct of a U.S. trade or business is treated in the same manner as royalties paid by U.S. licensees.[99] It is subject to 30% tax on the gross rent amount unless ECI, in which case the rental income would be taxed on a "net basis."[100] Again, the withholding rules under Sections 1441 and 1442 come into play and there is also the potential application in particular instances for application of FIRPTA withholding under Section 1445 or partnership withholding in accordance with Section 1446, as discussed below.

Where an owner or agent of the owner conducts management activities with respect to the property, the rental income may be characterized as ECI.[101] This outcome at times is more desirable since it permits the taxpayer to report income from the property on a "net" basis so that cost recovery allowances, interest, and taxes may be deducted from gross rents in computing the income subject to U.S. income tax. Even with respect to "passive" ownership of real property held for rent that is not ECI, a foreign corporation or non-resident alien may elect under Section 882(d) (foreign corporation) or Section 871(d) (non-corporate foreign person) to treat income from the property as ECI in order to apply directly related expenses against the rental income to avoid the 30% flat tax on gross rents.[102] Once made the election remains in force unless the Service later consents to its revocation.[103]

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petitioner-corporation was not a mere conduit of its U.S. parent and cited *Northern Indiana Public Service Co.*, 105 TC 341 (1995), aff'd 115 F3d 506 (7th Cir. 1997). In Rev. Rul. 80-362, the IRS held that where a foreign person, A, licenses a U.S. patent to another foreign person, X, who then sublicenses the patent to a U.S. person for use in the U.S., royalties paid by X to A, as well as royalties from the U.S. user to X, are from sources in the United States. See GCM 38409 (1980). Notwithstanding the Tax Court's holding in *SDI Netherlands*, the Service should be expected to apply Rev. Rul. 80-362, supra, in a non-treaty exemption situation. See McIntyre, "The Tax Court's Indefensible Decision in SDI Netherlands," 78 Tax Notes 115 (1998); King, Note, "Royalty Payments from U.S. Source to Foreign Corporation Did Not Retain Character: SDI Netherlands v. Commissioner," 50 Tax Law. 863 (1997); Cunningham, "Sourcing Royalties Paid by Foreign Intermediaries," 76 Tax Notes 959 (1997); Ruchelman & Adrion, "SDI Netherlands Begets Confusion by IRS, Tax Court and Commentators," 15 Tax Notes Int'l 1367 (1997); VanderWolk, "Brewer's Prognosis for SDI Netherlands Not 'Out on a Limb,'" 77 Tax Notes 1415 (1997); Brewer, "A Prognosis for SDI Netherlands," 77 Tax Notes 1413 (1997); Amico, "The IRS in the SDI Case: Were They Only Bluffing?" 14 Tax Notes Int'l 961 (1997).

[75] See Sections 865(d)(1)(B), 865(a), 865(d). See Rev. Rul. 69-156, 1969-1 CB 101, modifying Rev. Rul. 57-317, 1957-2 CB 909 (grant of patent right to a foreign corporation in exchange for stock will qualify under Section 351 non-recognition treatment provided the grant consists of substantial rights in the patent and would constitute a "sale or exchange" and not a "license," citing Reg. 1.1235-1 and *Carroll Pressure Roller Corp.*, 28 TC 1288 (1957), acq., C.B. 1958-2; *A.E. Hickman*, 29 TC 864 (1958), acq. C.B. 1958-2. .

[76] Reg. 1.881-2(c)(1)(iii). See, e.g., *Merck & Co. v. Smith*, 261 F.2d 162 (3d Cir. 1958) aff'g 155 F.Supp. 843 (DC PA 1957) (transfer of substantial rights in a patent qualifies for capital gains treatment).

[77] See Reg. 1.871-11(a).

[78] Rev. Proc. 2007-23, 2007-1 CB 675 (qualified patent cross licensing arrangements (QPCLA)). For an excellent article critiquing the practice of "royalty-free license commitments" and case law pertaining to such agreements including remedies for breach, see Greenbaum, "Puzzles of the Zero-Rate Royalty", 27 Fordham Intell. Property, Media and Entertainment Law Journal 1 (Fall, 2016). See also, Barnett "The 'License as Tax' Fallacy," 28 Mich. Tech. Law Rev. 197 (2022).

[79] Rev. Proc. 2007-23, 2007-10 IRB 675 (qualified patent cross-licensing agreements); PwC In & Out, "Cross-Licensing Agreements: IRS Procedure for W/H on Net Consideration," 18 J. Int'l Tax'n 12 (May 2007).

[80] Section 861(a)(3).

[81] Sections 861(a)(4), 862(a)(4).

[82] Id.

[83] The case involved whether the petitioner was entitled to claim ITCs under Section 38(a). The ITC credit did not apply to property used by governmental units or tax-exempt organizations. The taxpayer argued that many of its customers were neither governmental units nor tax-exempt organizations. The petitioner argued that it was merely providing lighting services to its customers and were this the conclusion reached by the court, it would be permitted to claim the ITCs as reported on its return.

[84] *Tidewater Inc.*, 565 F.3d 299, 303 (5th Cir. 2009), aff'g 100 AFTR2d 2007-6360 (DC LA 2007). See Sprague, Characterizing Cloud Transactions—Applying Section 7701(e) to Remote

Foreign source income attributable to U.S. office or fixed place of business as effectively connected income

Section 864(c)(4)(A) sets forth the general rule that unless otherwise provided in subparagraphs (B) and (C), no income, including FDAP and capital gains or losses, that is otherwise foreign sourced, may be aggregated with U.S. trade or business income in computing ECI subject to U.S. income tax on a net basis. Section 864(c)(4)(B), however, converts foreign source income to be ECI provided certain requirements are also satisfied; to-wit: (1) the foreign corporation must be engaged in a U.S. trade or business during the taxable year;[104] (2) the foreign source income consists of rents, royalties, dividends, interest, or amounts received for the guarantees of indebtedness and either is derived in the active conduct of a banking, financing, or similar business within the U.S. or is received by a corporation the principal business of which is trading in stocks or securities for its own account;[105] or (3) is derived from the sale or exchange (outside the U.S.) through such U.S. office or other fixed place of business of inventory personal property described in Section 1221(a)(1) unless such property is sold or exchanged for use, consumption, or disposition outside the U.S. and the foreign corporation (or nonresident person) has an office or other fixed place of business in a foreign country that participated materially in such sale.[106]

Section 864(c)(4)(D) provides, however, that no income from foreign sources is ECI with the conduct of a trade or business within the U.S. by a foreign corporation if it is either: (1) dividends, interest, or royalties paid by a corporation in which the foreign corporation (or other nonresident person) (within the meaning of Section 958(a)) owns more than 50% of the voting power of all classes entitled to vote, or (2) is subpart F income per Section 952(a) (unless otherwise excluded such as "high kick-out" subpart F income).[107]

Section 864(c)(5) provides applicable rules for Section 864(c)(4)(B) in determining whether foreign source income is ECI. The factors required to be taken into account include whether such income (or loss) is derived from assets used in or held for use in the conduct of such trade or business, or the activities of such trade or business were a material factor in the realization of the income (or loss).[108]

First, Section 864(c)(5)(A) provides that in determining whether a foreign corporation (or other nonresident person) has an office or other fixed place of business in the U.S., whether the agent of the taxpayer so maintains an office or other fixed place of business in the U.S. shall be disregarded unless such agent (1) has the authority, and regularly exercises such authority,

Access Transactions: Part I, 42.9 TAX MGMT. INT'L J. 559, 559 (2013).

[85] As a substitute for the GATT controversial U.S. domestic international sales corporation (DISC), the FSC rules permitted the exemption.

[86] *Goosen*, 136 TC 547 (2011) (payments for use of person's name and likeness are royalties; on site endorsement fees treated as royalties in part and compensation in part); *Garcia*, 140 TC 141 (2013) (allocation of endorsement fees 65% to royalties and 35% to compensation for personal services); Lokken, "The Sources of Income from International Uses and Dispositions of Intellectual Property," 36 Tax L. Rev. 233, 294–298 (1981); Brewer, "How to Earn Millions in U.S.-Source Income for Doing Nothing", 83 Tax Notes 1 375 (5/31/1999); Gordon, "Services, Licensing, and Technical Sales Contracts Under U.S. Income Tax Treaties," 15 Tax Notes Int'l 1033 (9/29/1997); *Grodt & McKay Realty, Inc.*, 77 TC 1221 (1981); Lokken, "The Sources of Income from International Uses and Dispositions of Intellectual Property,", 36 Tax L. Rev. 233, 269–276 (1981).

[87] *Wodehouse*, 337 US 369 (1949); *Rohmer*, 153 F.2d 61 (2d Cir.), cert. den. 328 US 962 (1946); *AMP, Inc.*, 492 F. Supp. 27 (MD Pa. 1979), aff'd unpub. order (3d Cir. 1980) (foreign subsidiaries' payments to U.S. parent for patent rights constituted royalties for source purposes, even though each subsidiary had exclusive rights in particular foreign country for patents' life and payments were characterized as sale proceeds for capital gains purposes). But see Rev. Rul. 68-443, 1968-2 CB 304 (royalties for use of trademark on products to be used in foreign country are foreign source income, even though products sold in the United States).

[88] TD 8765, 1998-42 IRB 5. The regulations apply for purposes of Sections 367, 482, 679, 861-999 and apply, in general, to contracts made after 11/30/1998. See, e.g., Chaze & Jennings, "Guiding Taxpayers Through the U.S. IRS Computer Program Classification Rules," 81 Tax Notes 777 (11/9/1998); Morrison, "Source of Income in International Software Sales," 41 Tax Mgmt. Int'l J. 565 (2012); Levenson, Shapiro, Mattson & Maguire, "Taxation of Cross-Border Payments for Computer Software," 17 Tax Notes Int'l 1723 (11/30/1998).

[89] Regs. 1.861-18(b)((1)(i); 1.861-18(f)(1); 1.8861-18(h), Ex. 5. Reg. 1.861-18(c) provides that a transfer of a computer program is classified as the transfer of a copyright right if there is a non-de minimis grant of any of the following four rights: (1) the right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease, or lending; (2) the right to prepare derivative computer programs based upon the copyrighted computer program; (3) the right to make a public performance of the computer program; or (4) the right to publicly display the computer program. Reg. 1.861-18(f) further categorizes a transfer of a copyright right as either the sale or license of the copyright right and a transfer of a copyrighted article as either the sale or lease of the copyrighted article.

[90] Reg. 1.861-18(f)(2). See Reg. 1.861-18(h), Ex. 3, Ex 7, Ex. 12, and Ex. 13.

[91] Reg. 1.861-18(b)(1)(iii). In general, where a person developing a computer program has no interest in the program and is to be paid for the development or modification work regardless of the financial success of the project, the compensation received is services income.

[92] Reg. 1.861-18(b)(1)(iv).

to negotiate and conclude contracts in the name of the foreign corporation or has a stock of merchandise from which he regularly fills orders, and (2) is not a general commission agent, broker, or other agent of independent status acting in the ordinary course of his business.

A second applicable principle, contained in Section 864(c)(5)(B), requires that such U.S. office or fixed place of business must be a material factor in the production of such income, gain, or loss and such place of business must regularly carry on such income activities. In addition, Section 864(c)(5)(C) provides a rule of limitation with respect to the sale of inventory or dealer property from such office or other fixed place of business within the U.S. whereby the amount of income shall be the income, gain, or loss properly allocable thereto, but, in the case of a sale or exchange described in clause (iii) of Section 864(b)(4)(B) (ECI with U.S. trade or business), the income which shall be treated as attributable to an office or other fixed place of business within the U.S. shall not exceed the income which would be derived from sources within the U.S. had the sale or exchange been made in the US.

Reg. 1.864-4(c)(1)(i) provides a set of operating rules under Section 864(c)(2) in making the determination on whether U.S. source FDAP or capital gains or loss is ECI. The two "principal tests to be taken into account" are: (1) an "asset-use" test, i.e., whether the income, gain, or loss is materially derived from the deployment of assets used in the conduct of a trade or business in the United States; or (2) a "business-activities" test, i.e., whether the activities of the trade or business conducted in the United States are a material factor in the realization of the income, gain, or loss.[109]

The asset-use test will, in general, be satisfied where the asset is used or held for the principal purpose of the present conduct of the U.S. business. This rule frequently is applied in determining whether U.S. source interest or dividend income is derived from the manufacture or sale of tangible goods. Active business income assets were the foundational cause which resulted in the realization of the passive income component. Capital gain and income from assets actually used in the conduct of the business generally have a sufficient nexus to the activities of the U.S. trade or business operations to be included in computing ECI.[110] The asset-use test focuses on specific income producing assets of the U.S. business operations.

Under the business-activities (and material factor) standard, a broader view is taken in determining whether U.S. business activities of such enterprise are a material factor in the realization of such items of income, gain, or loss. Income or gain from property acquired and held

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[93] See Mazur, "Taxing the Cloud," 103 Calif. L. Rev. 1 (February 2015); Kingson, "Taxing the Future," 51 Tax L. Rev. 641, 642 (1996); Salinas, "A Challenge to Section 861-type Principles or Nexus Redefined: A Critique of Global Trends and Developments Concerning the Taxation of Digital Platforms," Corporate Tax'n (Nov/Dec 2020); Carman, "Pinning Down a Cloud: Source Rules in the Metaverse," Tax Notes (2/23/2023).

[94] There are other transactions not entirely involving computing but still involve on-demand network access to "cloud" space or technology. These cloud transactions share similarities with the three generic types of cloud computing. Examples include streaming music and video, transactions involving mobile device applications ("apps"), and access to data through remotely hosted software. These transactions may not involve a transfer of a copyright right or copyrighted article, or a provision of development services or know-how relating to computer programs or programming. REG-130700-14, 84 Fed. Reg. 40,317, 40,318 (8/14/2019).

[95] SaaS cloud transactions should generally be viewed as the payment for services since the user or consumer will not receive copyright rights or ownership rights in the software and program. The question therefore becomes what is the source of the services income. In general, services income is sourced to the place whether the services are performed. *Piedras Negras Broadcasting Co.*, 127 F2d 260 (5th Cir. 1942), aff'g 43 BTA 297 (1941). What if the server is located in the U.S. while all services are rendered in a foreign country by the developer or cloud computing company? There are also important tax treaty issues raised by cloud computing services, as under existing treaties there is no provision for cloud computing, so the issue becomes one of whether cloud computing income is for royalties or for services. OECD, "Addressing the Tax Challenges of the Digital Economy, Action 12015 Final Report," at 147 (2015). For a comprehensive and insightful look at this area, see Mazur, "Taxing The Cloud", 103 Calif. L. Rev. 1 (2015). See Shakow, "The Taxation of Cloud Computing and Digital Content," 140 Tax Notes 333 (7/22/2013); Orrego, "Cloud Services and Tax Treaties: Classifying Payments in Chile," Tax Notes International (1/4/2023); Carman, "Pinning Down a Cloud: Source Rules in the Metaverse," Tax Notes (2/23/2023); Salinas, "A Challenge to Section 861-type Principles or Nexus Redefined: A Critique of Global Trends and Developments Concerning the Taxation of Digital Platforms," Corporate Taxation (WG&L), Nov/Dec 2020.

[96] REG-130700-14, 84 Fed. Reg. 40,317, 40,318 (8/14/2019).

[97] Id.

[98] See Spencer, "The OEDC Pillar One: An Update," Journal of International Taxation, (WG&L), Nov. 2022. See digital service tax developments, e.g., France, Law No. 2019-759 (7/24/2019) (3%); India, Finance Act, section 165 (6% on specified services), Finance Act, section 153 (2020) (2% e-commerce operator); United Kingdom, Finance Act 2020 (2% digital services tax).

[99] See Rev. Rul. 73-522, 1973-2 CB 226.

[100] Section 881(a). The ability of the U.S. to tax rents and gains from the sale of real property is generally not restricted or eliminated by tax treaty. Frequently a tax treaty will specifically state that the source country has the right (jurisdiction or nexus) to tax income and gains from real property. See Rev. Proc. 2022-27, 2022-1 CB 297, section 4.01(3).

[101] Sections 882(d), 871(d). *Lewenhaupt*, 20 TC 151, 163 (1953), aff'd per cur., 221 F2d 227 (9th Cir. 1955). See *De Amodio*, 34 TC 894 (1960), aff'd, 299 F2d 623 (3d Cir. 1962). Where the rental in-

in the ordinary course of the U.S. trade or business is also effectively connected with the business.[111] The business activities test is satisfied if the income, gain, or loss arises directly from the active conduct of the taxpayer's trade or business in the U.S., even though the income may be passive in nature.[112] The business activities test is quite important with respect to foreign corporations (and foreign persons) engaged in the licensing of intangible assets in the U.S.[113]

Gain from the sale or disposition of U.S. real property interests as effectively connected income

Overview of FIRPTA and investments by foreign corporations and persons in U.S. real property

Gain (or loss) from the sale or disposition of an interest in U.S. real property (USRPI), even if not part of the conduct of a U.S. trade or business, is nevertheless treated as income that is effectively connected with a U.S. trade or business of the foreign person.[114] An interest is an USRPI if: (1) it is an interest in real property, including minerals and other natural deposits, located in the U.S. or the U.S. Virgin Islands as well as personal property associated with the use of such real property;[115] or (2) an interest, other than solely as a creditor, in a U.S. (domestic) corporation which is or was a U.S. real property holding corporation (USRPHC) at any time during the lesser of the period of time the foreign taxpayer held the interest or the five-year period ending on the date of the sale or other disposition of the interest.[116]

A USRPHC is a domestic corporation where the fair market value of its USRPIs is 50% or more of the sum of the corporation's (1) USRPIs; (2) value of real property interests located outside of the U.S.; plus (3) any other assets used or held for use as part of a trade or business.[117] In making this assessment, the USRPIs of a 50% or more controlled subsidiary are taken into account. Therefore, Section 897 applies to gains and losses with respect to taxable dispositions of USRPIs. While FIRPTA was enacted in 1980, the corresponding withholding rules in Section 1445 were not enacted until 1984.[118]

Special provisions apply to reorganizations and liquidations of USRPHCs holding USRPIs in determining whether gain recognition results.[119] Under Section 897(e)(1), for example, a foreign corporation's disposition of a USRPI may avoid recognition treatment, which would otherwise occur as a result, if the transaction is an exchange and the foreign corporation will be subject to U.S. income tax on any gain recognized on a subsequent sale of the property.[120] Qualifying non-recognition exchanges contained in the Code include: (1) the liquidation of an 80% or more controlled subsidiary;[121] (2) an exchange of a USRPI for stock of a "controlled corporation;"[122] (3) the exchange of

come is not FDAP, there is no corresponding withholding obligation.

[102] Certain tax treaties permit the making of an election to treat real property income as trade or business income. Such treaties include U.S. tax conventions with Austria, Article 9(2), Denmark, Article 9(2), and Ireland, Article 9(1). Section 897(i) permits a foreign corporation to elect to be treated as a "domestic" corporation for purposes of Section 897 as well as for purposes of Section 1445 or Section 6039C. There are two requirements for the election under Section 897(i): (1) the foreign corporation must hold some interest(s) in U.S. real property having a value of at least 50% of the value of the corporation's real estate and business assets; and (2) the corporation must be entitled to nondiscriminatory treatment with respect to such real property interest under a U.S. treaty. Section 897(i)(1)(B). Once made the election may be revoked only with the consent of the Secretary. See Kuntz, Peroni & Bogdanski, supra, ¶ C4.10. The treaty tax election may be permitted to be made on an annual basis whereas the election made under Sections 882(d) or 871(d) is permanent. Note that Section 897 effectively overrides any tax treaty enacted prior to FIRPTA in 1980. See Section 894.

[103] Reg. 1.871-10(d). For a partnership owing a U.S. real property interest (USRPI), the election is made by each partner and not the partnership. Reg. 1.871-1(d)(3). A foreign estate or trust may make the election for purpose of determining the estate's or trust's U.S. income tax. The election may also be made by a nonresident alien beneficiary of a trust or estate, whether foreign or domestic for purposes of Sections 662 and 642.

[104] Section 864(c)(1); Reg. 1.864-5(a), as specifically discussed below.

[105] Sections 864(c)(4)(B)(i) (rents and royalties), 864(c)(4)(B)(ii) (dividends, interest, etc.); Reg. 1.864-5(b).

[106] Section 864(c)(4)(B)(iii); Regs. 1.865-5(a), 1.864-6.

[107] Sections 864(c)(4)(D), 958(a), 958(b), 952(a), 954(b)(4). But see Section 951A. In general, no subpart F income would be attributed to a foreign corporation as it would not be a U.S. shareholder under Section 951(b) unless it was a partner in a domestic partnership that was a U.S. shareholder.

[108] The regulation also applies with respect to FDAP income of a foreign person, including as a partner in a U.S. partnership.

[109] Section 864(c)(2)(B). See Regs. 1.864-4(c)(2) (asset-use test), 1.864-4(c)(3) (business-activities test). See also Reg. 1.864-4(c)(1)(iv) (direct relationship test; presumption of direct relationship).

[110] Ibid. See also Regs. 1.864-6, 1.864-7.

[111] Reg. 1.864-4(c)(2)(ii)(b).

[112] Reg. 1.864-4(c)(3)(ii).

[113] Note, as discussed, infra, that royalty income is FDAP provided fixed and determinable. Royalties are in general sourced from the jurisdiction in which the property is used. This applies to intangible assets licensing arrangements in general, including copyrights, patents, know-how, tradenames and brands, goodwill, etc. Contingent sales proceeds are not, however, so that whether a particular royalty payment stream is part of a sale or a license takes on heightened significance to a foreign taxpayer. See Section 861(a)(4). Contingent payments on licensing of intangibles is sourced to the jurisdiction in which the property is used. Note that Section 865, which generally sources gain from the sale of intangible property to the country of the licensor's

stock in a reorganization, division, or transfer of assets by a corporation in a reorganization;[123] and (4) certain transfers of property or distributions from a partnership.[124]

As with the rule of gain inclusion in Section 897(e)(1), Section 897(d)(1) similarly requires a foreign corporation which distributes USRPHC stock to a shareholder to recognize gain taxable as ECI. Section 897(d)(2) provides for nonrecognition of gain, however, if the distributee-shareholder would be subject to U.S. income taxation on a later sale or other disposition of the stock or to the extent that the regulations provide for an exception that limit the amount of gain recognized in a reorganization under Section 361(c), a non-liquidating distribution under Section 311(a), or as part of a spin-off type transaction under Section 355(c).[125] Where the foreign corporation-shareholder is a controlled foreign corporation (CFC), the distribution is subject to Section 331 and the CFC recognizes gain, if any, on the liquidating distribution.[126] This may generate subpart F income.

Under Section 897(g) gain from the sale or other disposition of an interest in a partnership or trust holding a USRPI subjects a foreign corporation (or non-U.S. person) to U.S. income tax as ECI to the extent attributable to its ratable share of the USRPI gain (or loss) even though the ownership interest itself is not a USRPI. The regulations to Section 897 look through the entity of the partnership (or trust or estate) to tax that portion of the gain allocable to the seller's share of partnership assets that are USRPIs. Any resulting gain, for purposes of Section 897(a), may not exceed the gain attributable to the foreign corporation-partner's ratable share of USRPI gain. This aggregate approach under Section 897(g) applies regardless of whether the partnership, trust, or estate is domestic or foreign.[127]

Withholding rules with respect to gains from the disposition of a USRPI are imposed on a transferee from a foreign person under Section 1445. In general, withholding of 15% of the amount realized will be required to be deducted and withheld by the transferee regardless of whether the transferee is a U.S. or foreign person.[128] Section 1445(e) sets forth special withholding provisions for USRPI dispositions in separate contexts, such as dispositions of USRPIs by domestic partnerships, trusts, or estates;[129] distributions of USRPIs by foreign corporations,[130] certain distributions of USRPHCs (or former USRPHCs) to foreign shareholders,[131] distributions of USRPIs by domestic partnerships, trusts, or estates,[132] and sales or other dispositions of interests in partnerships, trusts, or estates.[133]

There are instances where a transaction will be described in the general withholding rule for dispositions by foreign persons of a USPRI under Section 1445(a), and withholding for certain dis-

residence, is overridden to the extent Section 861(a)(4) applies. Section 865(d)(1)(B). There are allocation of income issues where licensed intangibles are used in multiple jurisdictions. See, e.g., *Wodehouse*, 179 F2d 987 (4th Cir. 1949). Compare Rev. Rul. 80-362, 1980-2 CB 208 (U.S. source royalty income despite relicensing agreement). See, in general, Postlewaite, Cameron & Kittle-Kamp, "Federal Income Taxation of Intellectual Properties & Intangible Assets" (WG&L), section 14:8 (Royalties).

[114] Section 897 was enacted by the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), P.L. No. 96-499, section 1124.

[115] Section 897(c)(1)(A)(i). Note, however, that income from the sale of an interest in USVI property is characterized as foreign-source income for certain purposes.

[116] Section 897(c)(1)(A)(ii). Potential application of Section 897(i) should be noted. This provision allows a corporation incorporated in a jurisdiction which has an income tax treaty or commercial treaty with the U.S. and contains a certain "nondiscrimination clause" to elect to be treated as a domestic corporation for purposes of Sections 897, 1445 (withholding), and 6039C. Most tax treaties of the U.S. contain nondiscrimination clauses. See U.S.-Canada, Article 25(1); Japan-U.S., Article 7(1); Netherlands-U.S., Article 25(2); United Kingdom-U.S., Article 24(1).
The corporation must qualify as a USRPHC in making the election. Reg. 1.897-8T(b). There are other requirements. Where there have been any dispositions of the foreign corporation's stock within the prior ten-year period (or, if later, since the date that the foreign corporation first held a USRPI), then either the foreign corporation or its shareholders must pay the U.S. income tax (with interest) that would have been imposed at the time of such prior dispositions if the Section 897(i) election had been made prior to such dispositions. See IRS Notice 2006-46; Regs. 1.897-3(c)(5) and 1.897-3(d). The foreign corporation, as a third requirement, must prove that at the time of the Section 897(i) election, such foreign corporation would have been a USRPHC had it been formed in the U.S. Temp. Reg. 1.897-8T. In addition, the foreign corporation must file a waiver signed by each of its shareholders warranting that the gain, if any, from the disposition of an interest in such corporation would be taken into account under Section 897(a) regardless of any contrary outcome provided under the applicable treaty provision. The election, if made, under Section 897(i)(1) may only be revoked with IRS consent. The benefit to the Section 897(i) election is that if properly and timely made, the foreign corporation will be treated as a domestic corporation solely for purposes of Section 897, allowing the foreign corporation to engage in inbound reorganization and liquidation transactions without being required to meet requirements under Sections 897(d) and 897(e) and underlying regulations. See Rev. Rul. 87-66, 1987-2 CB 168 (certain reorganization and liquidation transactions involving foreign corporations owning a USRPI, including a USRPHC). See also Netherlands-U.S. Income Tax Treaty (as amended through 2004), Article 6(5). In general, income tax treaties allow the country in which gain from the disposition of an interest in real property is situated to tax such gain. See, e.g., U.S. Model Income Tax Convention (1996), Article 13(1). See, in general, Dolan, Jackman, Tretiak & Dabrowski, "U.S. Taxation of International Mergers, Acquisitions and Joint Ventures (WG&L) ¶ 13.05. There has been commentary that FIRPTA is perhaps "outdated." See Mazin, "FIRPTA Repeal: The United States' Post-Pandemic Economic Solution to Infrastructure Reform," 56 USFL Rev. 151 (2021); Taylor, "Suppose FIRPTA Was Repealed," 14 Fla. Tax. Rev. 1 (2013); Brown, "Wither FIRPTA?," 57

positions and distributions by entities and for dispositions of ownership interests in partnerships, trusts, and estates under Section 1445(e).[134] Where Section 1445(e) is applicable, no additional withholding of tax will be required by the transferee. This overlap between Sections 1445(a) and 1445(e) may occur, for example, where a foreign corporation distributes real property to a foreign shareholder. Under Section 1445(e)(2), the foreign corporation is required to withhold a tax equal to 21% of the gain recognized and a distribution by a domestic corporation described in Section 1445(e)(3), 15% of the amount realized by the foreign shareholder-distributee. The shareholder-distributee, as the transferee of the USRPI, also has a withholding obligation under Section 1445(a). Reg. 1.1445-5(b)(1) requires that the corporate withholding be made, thereby eliminating the shareholder level withholding rule. There is also a withholding certificate exception to withholding in the regulations under Reg. 1.1445-6.

Dispositions of USRPIs by domestic partnerships with foreign partners

Under Section 1445(e)(1), a domestic partnership with one or more foreign partners is required to withhold 21% (highest Section 11(b) rate) of each foreign partner's allocable share of the amount of the gain realized by the partnership on the disposition.[135] This rule does not apply, however, with respect to foreign partnerships. Instead, the transferee of a USRPI from a foreign partnership must withhold under Section 1445(a).

The withholding dynamics are not resolved at that point in purchasing a USRPI from a foreign partnership. The foreign partnership may have a permanent establishment or may be carrying on a trade or business within the U.S. in addition to holding (and selling) a USRPI or USRPHC. The foreign partnership may also be required to withhold under Section 1446 on its ECI, which provision is discussed in more detail below. Under Section 1446(a), a partnership, foreign or domestic, is required to withhold tax on the amount of the partnership's ECI allocable to foreign partners at the maximum rate of income tax.

The "applicable percentage" of required Section 1446(a) withholding on ECI of a noncorporate foreign partner's distributive share of ECI is presently 37%, the highest rate of tax specified in Section 1. The applicable percentage on the portion of the partner's ECI allocable to a foreign corporation-partner is the highest rate of tax in Section 11(b)(1), which is presently 21%.[136] Where such foreign partnership is also subject to withholding under Section 1445(a) during its taxable year, it may credit the withholding made under Section 1445(a) against its Section 1446(a) tax liability for the same period but only to the extent such amount is allocable to its foreign partners.

Tax Law. 295, 296-97, 302 (2004); Kaplan, "Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate," 71 Geo. L.J. 1091, 1095 (1983).

[117] Section 897(c)(2).

[118] The withholding requirement applies to any person receiving a USRPI from a foreign person in a transaction that is a disposition of the interest under Section 897 and supporting regulations. See Section 1445(a); Reg. 1.1445-2(a). See Blanchard, FIRPTA Withholding Mechanics, 37 Tax Mgmt. Int'l J. 402 (2008). See also ABA Section of Tax'n Comm. on Sales, Exchanges and Basis, Report on the Application of Sections 1031 and 1445 to Exchanges of U.S. Real Property by Foreign Persons, 48 Tax Law. 471 (1995).

[119] Sections 897(d), 897(e). Reg. 1.897-1(e)(3) (determination of "percentage ownership interest;" hypothetical liquidation model).

[120] Regs. 1.897-5T(d), 1.897-5T(b)(3), 1.897-5T(c)(1) (foreign corporation distributes USRPI to shareholder—gain recognition unless Section 897(d)(2)(A) or Section 332 applies); IRS Notices 99-43, 1999-2 CB 344 (recapitalizations and Type F reorganizations for USRPCs), 2006-46, 2006-24 IRB 1044. See generally Levy, "Nonrecognition Transactions Involving FIRPTA Companies," 119 Tax Notes 933 (6/2/2008). Section 897(e)(2) grants the Treasury with broad authority to issue regulations "necessary or appropriate to prevent the avoidance of Federal income taxes" in this area.

[121] Section 332.

[122] Section 351.

[123] Sections 354, 355, 361.

[124] Sections 721, 731.

[125] Regs. 1.897-5T(c)(3), 1.897-5T(c)(1), 1.897-5T(c)(1).

[126] Section 336(a).

[127] See IRS Notice 88-72, 1988-2 CB 383 (Section 897(g) operative without issuance of regulations). The current regulations set forth rules with respect to certain partnership interests: (1) the 50% or more of the partnership's gross asset test (are USRPIs); and (2) 90% or more of the value of the partnership's gross assets consist directly or indirectly of USRPI's and cash equivalents. In such instances, the interest in the partnership is treated as a USRPI under Section 897(g) to the extent that gain is attributable to the USRPI's (but not cash, cash equivalents, or other properties).

[128] Section 1445. Joint transferees have joint and several liability as to the withholding obligation under Section 1445. Reg. 1.1445-1(b)(1). In 2015, Congress increased the rate of withholding under Section 1445(a) to 15% but is still 10% when a residence is sold for $1M or less. See Protecting Americans from Tax Hikes Act of 2015, section 324. In 2015, Congress enacted into law a withholding exemption with respect to a U.S. real property interest held by a "qualified foreign pension fund." Section 1445(f)(3). See Protecting Americans from Tax Hikes Act of 2015, P.L. 114-133, section 324(b).

[129] Section 1445(e)(1).

[130] Section 1445(e)(2).

[131] Section 1445(e)(3).

[132] Section 1445(e)(4).

[133] Section 1445(e)(5). See also Section 1445(e)(6) for certain distributions of USRPIs by RICs or REITs.

[134] There are provisions under Section 897 and the regulations providing exceptions to withholding under Section 1445 such as

Section 1461 holds the partnership liable for any underpayment of the Section 1446 tax caused by the partnership's failure to use the proper applicable percentage in computing and paying the tax. Section 1446 applies to both domestic and foreign partnerships but not to a "check-the-box" association that is organized as a partnership under applicable local law.[137]

Section 1446(a) withholding on foreign partners' share of ECI

Section 1446(a) requires a partnership having ECI during its tax year to withhold and pay over a tax equal to the "applicable percentage" of a domestic or foreign partnership's ECI allocable to one or more foreign partners.[138] The "applicable percentage" with respect to a foreign partner that is a foreign corporation is 21% and as discussed, may increase to 28% if the proposed Biden increase to corporate tax rates is enacted.[139] For noncorporate foreign partners the applicable percentage is under current law 37% and may, under the Biden Administration's proposed increase in tax rates, increase to 39.6%, the maximum federal income tax rate prior to the Tax Cuts and Jobs Act of 2017. In the event the rate of withholding exceeds a foreign partner's U.S. income tax liability, then such partner may apply for a claim for refund of an overpayment of tax.

Under Reg. 1.1446-3(a)(2)(ii) a partnership may treat the highest rate of tax applicable to a particular type of income or gain allocable to a partner, such as long-term capital gain to a non-corporate partner, recapture of Section 1250 depreciation, or gain from the sale of collectibles or crypto-currency, to be the withholding rate as to such portion of a particular foreign partner's distributive share.

In computing the required withholding for foreign partners, the regulations allow foreign partners to certify their deductions and losses to the partnership in an effort to reduce the Section 1446 withholding amount.[140] This may allow a foreign partner with carryover losses from one or more prior years to reduce the withholding amount under Section 1446 for the current tax year provided the loss is properly certified if all requirements are met.[141] Section 1446 withholding is subject to estimated quarterly tax payment requirements.[142]

Section 1446(f) withholding on sale or other disposition of foreign partner's partnership interest

In *Grecian Magnesite Mining, Industrial & Shipping Co., SA.*,[143] the Tax Court held that a foreign corporation's realized gain from a two-stage liquidation (redemption) of its partnership interest in a domestic partnership that was carrying on a mining business in the U.S. was not U.S. source income, as it was not realized in the ordinary course of a U.S. business conducted through a U.S. office or attributable to a U.S. fixed base or

where a withholding exemption certificate is applied for and received prior to the closing of the transaction based on "no resulting tax liability" or where the transferee acquires the property for use as a residence and the amount realized does not exceed $300,000. See Section 1445(b) (exempts transactions where the transferor supplies a certificate of non-foreign status, the property transferred is an interest in a non-publicly traded domestic corporation that supplies the transferee with a certificate stating that interests in the corporation are not U.S. real property interests, or the property transferred is stock that is regularly traded on an established securities market). See also Section 1445(d) (agent of transferor or transferee liable for withholding in certain instances).

[135] Section 1445(f)(3).

[136] The highest marginal rate of withholding may result in an overpayment of tax of the foreign partner based on its U.S. income tax return filed. See also Section 864(c) in determining whether income is ECI.

[137] TD 9200, 2005-23 IRB 1158.

[138] Section 1446 applies, in general, to domestic and foreign partnerships for taxable years beginning after 1987. Reg. 1.1446-3(e) (failure to withhold). Section 1446 does not apply to a partnership treated as a corporation under Section 7704(a). Special provision is made for application of Section 1446 to publicly traded partnerships that are not treated as corporations under Section 7704(a). Withholding by publicly traded partnerships applies with respect to actual distributions. Reg. 1.1446-4. See TD 9200, 2005-23 IRB 1158.

[139] Section 1446(b).

[140] Reg. 1.1446-6; IRS Form 8804-C. The applicable requirements are set forth in Reg. 1.445-6(b).

[141] See also Regs. 1.1446-5, 1.1446-6(b)(3)(i). There is also provision for reducing the amount of Section 1446 withholding by 90% of applicable state and local income taxes. Other special rules apply. See, e.g., *YA Global Investments LP et al*, 151 TC 11 (2018). See also Appel and Hirschfeld, "Withholding Tax on Phantom Gain," 11 Prac.Tax Law. 43 (Winter 1997).

[142] Reg. 1.1446-3(b). See Section 6655.

[143] 149 TC No. 3 (2017).

[144] 1991-1 CB 107.

[145] See August, "Tax Court Rejects Rev. Rul. 91-32, Holds Foreign Partner's Gain from Redemption Not ECI," Corporate Tax'n (WG&L) 2017 WESTLAW. See, e.g., *YA Global Investments, LP F.K.A. Cornell Capital Partners, LP, et al*, Tax Court No. 14546-15; No. 28751-15 (1/12/2023), published in Tax Notes Today International (1/12/2023).

[146] Section 865(e)(2), enacted into law in 1986, sets forth an added exception to the foreign-source income default rule under Section 865(a)(2), which holds that gain from a nonresident's sale of personal property is sourced without the U.S. Section 865(e)(2) provides that where a nonresident maintains an office or other fixed place of business in the U.S., income from any sale of personal property, including inventory or intangible personal property, attributable to such office or other fixed place of business, is U.S. source income other than FDAP based on its actual connection with the conduct of the U.S. trade or business, e.g., income from the sale of inventory. Section 864(c)(3); Reg. 1.864-4(b). See also Section 865(e)(3), which provides that principles contained in Section 864(c)(5) will be applied in determining whether a taxpayer has an office or other fixed place of business and whether a sale is attributable to such an office or other fixed place of business.

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permanent establishment. However, the portion of the gain attributable to the unrealized appreciation in the domestic partnership's USRPI was ECI and subject to U.S. income tax in accordance with Section 897(g) and withholding under Section 1445. The Tax Court rejected the Service's position on its long-standing revenue ruling, Rev. Rul. 91-32,[144] which held, in interpreting Reg. 1.864-4, that gain or loss of a foreign partnership from the disposition of its ownership interest in a U.S. partnership that conducts a trade or business through a fixed place of business or has a permanent establishment in the U.S. constitutes ECI gain (or loss) or gain attributable to a permanent establishment (or loss allowable to such gain), and is U.S.-source income based on a deemed asset sale construct. The Tax Court also rejected the Commissioner's call for the application of aggregate theory treatment in this context in order to look through the partnership's activities and apportion the ECI from non-ECI income.[145] The IRS' position was the disposition of an interest in a partnership was correctly treated as U.S. source income under Section 865(e)(2).[146]

The Tax Cuts and Jobs Act of 2017 overrides *Grecian Magnesite*, supra, by its enactment of Section 864(b)(8) to provide that gain or loss from the sale or exchange of a partnership interest is ECI with a U.S. trade or business to the extent that the transferor would have had ECI gain (or loss) had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The provision requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as non-separately stated income and loss. The provision also requires the transferee of a partnership interest to withhold 10% of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a foreign corporation (or non-U.S. person). If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.[147] The withholding obligation consequences are modified where the transferor has no gain under Section 864(c)(8) with respect to the transfer. The regulations provide for various exceptions to the Section 1446 withholding.

The general source rule for sales of personal property (other than inventory): place of seller's residence

Section 865 sets forth rules on source of income with respect to gain from the sale or other disposition of non-inventory or dealer personal property.[148] In such instances, gain is frequently (but not always) sourced by reference to the seller's country of residence instead of the situs where

[147] Section 1446(f)(4). See Reg. 1.864(c)(8)-1. See IRS Notice 2021-51, 2021 USTR ¶ 86,345; Notice 2022-23, 2022 USTR ¶ 86,964; Rev. Proc. 2022-43, 2022 USTR ¶ 87,661; TD 9926, 2020 USTR ¶ 86,550. See, in general, Dabrowski, Tretiak & Massed, "U.S. Taxation of International Mergers, Acquisitions and Joint Ventures" (WG&L), ¶ 6.09. As an important aside, the centralized partnership audit rules must be referenced in consideration of the amount and extent of partnership withholding that is required with respect to modifications under Section 6225(c) as well as the consequences of a push-out election under Section 6226 to a foreign partner. Indeed, tax treaty rates may be lower than the rates of income, particularly passive income, realized by the partnership either prior to audit or during a BBA audit review. In many instances a distributive share of certain species of income of a partnership will be subject to a lower rate of income tax and possibly a zero rate of income tax with respect to a foreign partner. Reg. 301.6225-2(d)(9) provides that a partnership may request a modification for a relevant partner's distributive share of an adjustment to a partnership-related item if, in the reviewed year, the relevant partner was a foreign person who qualified under an income tax treaty with the United States for a reduction or exemption from tax with respect to such partnership-related item. A partnership requesting modification under this section may also request a treaty modification under this paragraph (d)(9) regardless of the treaty status of its partners if, in the reviewed year, the partnership itself was an entity eligible for such treaty benefits. See, for example, Reg. 301.6241-6(b)(4)(ii). See, in general, August, "Tax Controversies and Litigation Under the New Centralized Partnership Audit Rules: Are You and Your Clients Ready?" (Parts 1 and 2). 34 No. 2 Prac. Tax Law. 35, 34 No. 3 Prac. Tax Law. 24 (March 2020); "Assessments and Collection of Income Tax from Partnerships, Partners and Former Partners Under the BBA Partnership Audit Rules," 49 Corporate Tax'n 3 (Parts 1 and 2) (Jan/Feb 2022); "Part Two: Take A Close Look At the Cease to Exist Rule!!!, 49 Corporate Tax'n 3 (July/August 2022); August, "New Final and Proposed Regulations on the Centralized Partnership Audit Regime," 45 Corp. Tax'n 3 (July/Aug. 2018); August and Cuff, "TEFRA Partnership Audit Rules Repeal: Partnership and Partner Impacts," ALI CLE Video Webcast, 7/17/2016; August, "The Good, the Bad, and Possibly the Ugly in the New Audit Rules: Congress Rescues the IRS From Its Inability to Audit Large Partnerships," 18 Bus. Entities 4 (May/June 2016); August, "Entity-Level Audit Rules Continue to Pose Challenges for Partners, Parts 1 and 2," 16 Bus. Entities 4 (Nov./Dec. 2014), 17 Bus. Entities 4 (July/Aug. 2015).

[148] However, specific rules contained in Sections 861, 862, and 863 may, in certain instances, control over Section 865.

[149] Sections 865(a)(1) (U.S. resident), 865(a)(2) (nonresident); *International Multifoods Corp.*, 108 TC 579 (1997) (loss by domestic corporation and its subsidiary in a foreign corporation is U.S. source loss for foreign tax credit purposes). See Section 865(i)(2) (sale includes exchange or other disposition). Erdahl, "The Domestic Source Rule for Foreign Affiliate Stock Losses—How Far Will it Extend?," 87 J. Tax'n 236 (1997); Goodman, "Sourcing of Losses on Foreign Subsidiary Stock Sales," Tax Adviser 550 (Sept. 1997); Garbino, "A Study of the International Tax Policy Process: Defining the Rules for Sourcing Income from Isolated Sales of Goods," 29 Harv. Int'l LJ 393 (1988).

[150] Section 865(a). While for many years gain from the sale of personal property was sourced at the "place of sale," e.g., the place where title to the property passes, Section 865 now provides that the source of gain from the disposition of personal property is generally the location of the seller's residence. Still, the pas-

title to the transferred property is located.[149] Therefore, as a "general" proposition, subject to several exceptions and qualifications, a U.S. resident recognizing gain from the sale of non-inventory personal property will realize U.S. source income regardless of the jurisdiction in which the sale occurs or the location of the buyer's country of tax residence.[150] Conversely, gain from the sale of non-inventory personal property by a foreign corporation from business operations located overseas will generally be foreign source income except in instances where such gain is ECI with the conduct of a U.S. trade or business or otherwise U.S. source income under a specific statutory or regulatory provision.[151]

Section 865(a), in general, applies to the disposition of personal property, both tangible and intangible.[152] Section 865(a) therefore applies to a sale involving the disposition of a group of tangible and/or intangible assets.[153] Losses from the disposition of personal property other than stock are allocated based on the class of gross income with respect to which gain or income generated by the property would have been allocated. As for taxable dispositions of stock or a bond by a foreign corporation resident in a foreign country, such gain or loss is generally foreign source.

Section 865(a)'s residence rule for sourcing gain or loss from the disposition of personal property of a foreign person, including a foreign corporation, is subject to several exceptions: (1) the source of gain income or loss from inventory property;[154] (2) gains from the sale of personal property by U.S. citizens living overseas is U.S. source income provided such gains are not subject to substantial foreign taxes;[155] (3) gains from the disposition of depreciable property is U.S. source income to the extent allocable to the U.S. depreciation deductions claimed by the taxpayer in computing taxable income from sources in the U.S.;[156] (4) the source rule for royalties under Section 861(a)(4) applies to the receipt of contingent payments for royalties (based on jurisdiction of "use");[157] (5) allows domestic corporations to report certain gains from sales of stock of foreign subsidiaries as foreign source income;[158] (6) income attributable to a U.S. resident's office situated outside of the U.S. is foreign sourced;[159] and (7) a source rule contained in an income tax treaty may provide a different outcome and override Section 865(a).[160]

Income from the sale of inventory or dealer property

Prior to the enactment of the TCJA of 2017, income from the sale of inventory property *acquired* by purchase was sourced in the country in which the sale occurred.[161] The regulations provided that the place of sale is where the seller's

sage of title test is applied with respect to sales of inventory. Sections 861(a)(6), 862(a)(6). See *Hunt*, 90 TC 1289 (1988); Rev. Rul. 55-677, 1955-2 CB 289.

[151] See, e.g., Section 897(c), where gain from the sale of stock in a USRPHC is ECI and is excepted from Section 865(a). The FIRPTA override also applies to sales of USRPIs in general per Section 861(a)(5). Another provision which overrides Section 865(a) are gains or losses from foreign currency transactions under Section 988(a)(1). But see Section 988(a)(3) (special sourcing rules for foreign currency transactions).

[152] Prior to its passage in 1986, the place-of-sale and title passage rules applied to sales of inventory and noninventory personal property. Congress decided to enact new source rules in this area to eliminate an area of abuse. Staff of Joint Comm. on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 918 (Comm. Print 1987).

[153] *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945). Accord, *Watson*, 345 US 544 (1953); *Woolsey*, 326 F2d 287 (5th Cir. 1963). See also Section 1060(a) and supporting regulations, including Regs. 1.1060-1(d), 1.338-5(b).

[154] Section 865(b) (Section 865(a) yields to or is "turned off" by Section 865(b)(1)), Section 865(i)(1). Income, gain, or loss from the sale of purchased inventory without the U.S. (other than a possession of the U.S.) and its sale or exchange within the U.S. is U.S. source income and vice-versa under Section 861(a)(6) (U.S. source); Section 862(a)(6) (foreign source); Section 863. In addition, Section 865(e) provides that notwithstanding any other provision pertaining to sources of income, income from the sale of inventory attributable to a U.S. office of a foreign corporation or foreign person is U.S. sourced. The Tax Cuts and Jobs Act, section 14303(a), modified the inventory source of income rules for taxable years starting after 2017, which is discussed in the next section.

[155] Section 865(g)(2). Special rule is in Section 865(g)(3) for certain stock sales by residents of Puerto Rico.

[156] Section 865(c)(3). See special rules for certain property in Section 865(c)(3)(B).

[157] Section 861(a)(4) (rentals and royalties).

[158] Section 865(f). This provision requires that the sale occur in a foreign country in which the foreign subsidiary is engaged in the active conduct of a trade or business and more than 50% of its gross income for the prior three-year period was realized from the active conduct of such trade or business.

[159] Sections 865(e)(1), 864(c)(5). This "foreign office or fixed place of business" exception for U.S. residents applies to noninventory property as well as stocks, bonds, or other financial assets. Conf. Rep. No. 99-481 Vol. II, P.L. 99-514. This exception only applies to sales where subject to tax by a foreign country at a minimum rate of 10% and where such tax is actually paid. Section 865(e)(1)(B). There is a waiver of the 10% tax rate rule for determining the source of income from sales of personal property by bona fide residents of certain U.S. possessions.

[160] Section 865(h).

[161] Section 861(a)(6). Section 865(b)(1) states that Section 865 does not apply to income derived from the sale of inventory property. But see Section 865(e)(2)(A).

[162] Regs. 1.861-7(a), 1.861-7(c). See e.g., *Balanovski*, 236 F2d 298, 304–305 (2d Cir. 1956), cert. denied, 352 U.S. 968 (1957); *East Coast Oil Co.*, 85 F2d 322 (5th Cir. 1936), aff'g 31 BTA 558 (1934) (oil sold and shipped C.I.F. and F.O.B. on common carriers from Mexico; place of sale was Mexico and therefore treated as for-

rights, title, and interest in the property pass to the buyer.[162] The place where the contract was negotiated and signed is not relevant under the title-passage test. Income from the purchase of inventory property, as defined by Section 865(i)(1), acquired or purchased outside of the U.S. (other than from within a U.S. possession) but which is sold within the U.S. still constitutes U.S. source income. Inventory property is defined in accordance with the definition of property held for sale to customers in the ordinary course of a trade or business under Section 1221(a)(1).[163]

Where inventory is produced, in whole or in part, by the taxpayer within the U.S. and sold outside of the U.S., or produced in whole or in part by the taxpayer outside of the U.S. and sold within the U.S., Section 863(b) provides that the net income resulting from the sale is allocated between the U.S. source and the foreign source net income portions in accordance with IRS guidelines.[164] Before TCJA 2017, Section 863(b)(1)-(3) set forth rules for the allocation of net income "partly within and without, and vice-versa" for sales of inventory property. More particularly, Reg. 1.863-3 provided guidance on how to allocate and apportion the income and set forth three alternative methods for dividing income between sales activity and production activity.

Under the Tax Cuts and Jobs Act of 2017, P.L. No. 115-97, section 14303, for taxable years commencing after 2017, Section 863(b) was amended and provides that the source of income from sales of inventory produced by the taxpayer under Section 863(b)(2) is to be determined solely on the basis of the situs of the production activities, thereby making irrelevant the location in which the sales activities are conducted. Under revised Section 863(b)(2), where inventory is produced entirely within the U.S., income from the sale of such property is U.S. source income regardless of where title-passage occurs.[165] Again, prior to the TCJA 2017, the regulations required taxpayers to divide Section 863(b)(2) sales income between production activity and sales activity and among the jurisdictions in which such activities occurred.

In TD 9921 (12/11/2020), the Treasury and the Service issued final regulations for determining the source of income partly within and partly from without the United States and vice-versa, application to Section 863, in determining the source of income for sales of some property, Section 864, in holding that certain foreign-source income is effectively connected to a U.S. trade or business, and under Section 865 in determining the source of income from a nonresident's sale of personal property, including inventory.[166] Under Reg. 1.863-3(c)(2)(i), where the taxpayer's production of inventory assets are situated both within and without the U.S., the amount of income that is

eign-source income); *Hunt*, 90 TC 1289 (1988); *Perry Group, Inc.*, 80-2 USTC ¶ 9603 (DCNJ 1980); *Exolon Co.*, 45 BTA 844 (1941), acq. 1947-2 CB 2. The Congress had asked the Treasury to review the title passage rule on the sale of inventory in the Tax Reform Act of 1986, section 1211(d); see HR Conf. Rep. No. 841, 99th Cong., 2d Sess. II-596 (1986). Where a sales transaction was engaged in for the primary purpose of tax avoidance, the title-passage rule could be replaced by a facts and circumstances test to determine where the substance of the sale occurred. See *Philipp Bros. Inter-Continent Corp*, 66-1 USTC ¶ 9421 (SDNY 1966).

[163] Section 865(i)(1). This section defines "inventory property" only for Section 865 although other provisions in the foreign tax rules adopt the Section 865(i) definition. See Sections 861(a)(6), 862(a)(6), 863(b)(2), and 863(b)(3).

[164] Section 863(b)(3); Reg. 1.863-3(f). For these purposes, "production activity" means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. A tangible asset is considered located where the asset is physically located while an intangible asset is considered located where the tangible production assets owned by the taxpayer are located. Reg. 1.863-3(c)(1).

[165] See, however, the FDII rules benefitting domestic corporate (C corporation) manufacturers under Section 250. There is a somewhat strange side-effect to the TCJA 2017 amendment in this area and that is it encourages foreign-based manufacturing particularly where produced in a low tax jurisdiction. Perhaps Congress was overly concerned that U.S. manufacturers had been gaming the foreign tax credit provisions by selling inventory in high-tax jurisdictions that were produced, in whole or in part, in the U.S.

[166] Proposed Regulations were issued on 12/30/2018 with respect to Sections 863, 864, 865, 937, and 1510 (84 FR 71836). The proposed regulations amended Reg. 1.863-3 to allocate or apportion gross income from Section 863(b)(2) gross income from sales based solely on production activity. The final regulations went through the notice-and-comment protocols under the Administrative Procedures Act of 1946, 5 USCA section 552, issued in TD 9921 (12/11/2020). The final and temporary regulations removed Reg. 1.863-3(c)(2), which set forth rules for allocating and apportioning income based on sales activity. *Kimble*, 991 F.3d 1238, 1242 (Fed. Cir.), cert. denied, 142 S. Ct. 98 (2021).

[167] See Regs. 1.863-3(c)(1) (production only within the U.S. or only within foreign countries), 1.863-3(c)(2) (production both within and without the U.S.), 1.863-3(c)(3) (anti-abuse rule). Special adjustments for depreciation, including additional first year depreciation under Section 168(k), are addressed in the final regulations to Section 863. The new final regulations eliminate the prior "50-50 method," the "independent factory price method," and the "books and records" method of allocating manufacturing inventory in the U.S. and selling inventory overseas. But see Reg. 1.865-3(d) (for allocation of produced inventory property allocable to a U.S. office; retention of 50/50 method or elect "books and records" method).

[168] Section 865(e)(2). See Regs. 1.865-3, 1.863-3(a)(2). A correlative rule applies for U.S. persons selling personal property through an office or fixed place of business located in a foreign country and provided the U.S. resident actually pays an income tax of at least 10% to a foreign country on the income from the sale. Other special rules apply. Where inventory property is involved in such instance, the general source rules for inventory sales contained in Sections 861(a)(6), 862(a)(6) and 863(b) apply.

foreign sourced is based on multiplying all income attributable to the taxpayer's production activities by a fraction: (1) the numerator is the average adjusted basis of production assets located outside the U.S.; and (2) the denominator is the average adjusted basis of all production assets located within and without the U.S.[167]

Section 865(e)(1) requires income from a foreign corporation's (or non-resident's) sale or other taxable disposition of personal property to be treated as U.S. source income if the sale is attributable to an office or fixed place of business as provided under principles set forth in Section 864(c)(5) maintained by the foreign corporation (non-resident) in the U.S.[168] Section 865(e)(2)(A) overrides the other source rules contained in Sections 861-865.[169] This special source rule applies to all sales of personal property, including inventory, depreciable personal property, and intangibles, including goodwill, attributable to the U.S. office or fixed place of business.[170] Such gains are accordingly treated as ECI with the conduct of a U.S. trade or business under Section 864(c).[171]

Gain from the sale of stock or other property by a foreign corporation that is not ECI, or otherwise falls within a stated exception that yields ECI or FDAP, is not taxable.[172] Gain from the sale of property recharacterized as FDAP is treated as U.S. source (FDAP) income under Section 881(a). This could occur with respect to the sale of stock that is "tainted" under Section 306 or a redemption described under Section 304.[173] Recharacterization as ECI can occur under Section 897 for gains from the disposition of a USRPI or stock in a USRPHC.[174] As mentioned, a taxpayer electing the benefit under Section 865(h) permits gain from the sale of stock in a foreign corporation to be treated as foreign source income, even though the gain would have otherwise been treated as U.S. source income under other provisions of Section 865, under an applicable treaty provision.

Special treatment is set forth for sourcing gains from the sale of stock by a U.S. resident corporation in a foreign affiliate under Section 865(f). Normally, such income would be U.S. source income. However, Section 865(f) allows the domestic corporation's gain from the sale of foreign affiliate stock to be foreign source income if certain requirements are met. The sale must occur in a foreign country in which the affiliate is engaged in the active conduct of a trade or business and the affiliate must have generated more than 50% of its gross income from the prior three-year period of the affiliate ending with the taxable year preceding the year of sale. An "affiliate" is based on the ownership test under Section 1504(a) without regard to the exceptions in Section 1504(b). A U.S. parent may elect to treat an affiliated group of foreign corporations if all requirements are met.[175]

[169] Part I of subchapter N of Chapter One of the Internal Revenue Code.

[170] Reg. 1.865-3(d)(3) (inventory purchased and sold by foreign corporation (person) allocable to fixed place of business in U.S.). See Staff of Joint Comm. on Tax'n, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 921–922 (1987).

[171] Certain sales of property outside the U.S. where the foreign corporation's office or other fixed place of business materially participated in the sale falls outside of Section 865(e)(2)(A). See Section 865(d)(5)(B).

[172] Section 881(a)(1). Regs. 1.865-3(d)(1), 1.864-4(c)(1). See TD 8734 (preamble). Reg. 1.1441-2(b)(2)(i).

[173] See Reg. 1.861-7(d). Where Section 306 stock is sold other than through a redemption, the source of income is FDAP in accordance with Section 306(a)(1)(A). Gain in excess of the Section 306 taint is sourced under the sale of personal property rules. Where the disposition of Section 306 stock occurs by redemption, Section 306(a)(2) characterizes the amount realized under Section 301 to the extent dividend treatment arises under Section 316. The dividend source rules apply. Gains in excess of earnings and profits would be taxed in accordance with Section 301(c)(3) and may avoid U.S. income tax. Recovery of basis should also be non-taxable.

[174] Section 897(a).

[175] Section 865(f).

[176] Section 881(a)(3)(A). Special treatment is provided for gains from the sale or exchange of timber, domestic iron ore, or coal. Sections 881(a)(2), 631(b), 631(c).

[177] Section 862(a)(5). See Reg. 1.861-6.

[178] Section 332(d)(2)(A). Section 332(d) was enacted to address a withholding tax abuse where foreign corporations use a U.S. holding company to receive tax-free dividends from operating companies, liquidate the U.S. holding company to distribute the U.S. earnings as capital gains free of U.S. income and withholding taxes, and then reestablish another U.S. holding company. S. Rep. No. 192, 108th Cong., 2d Sess. 166 (2004).S

[179] See, e.g., *Framatome Connectors USA, Inc.*, 118 TC 32 (2002), aff'd 2004-2 USTC ¶ 50,364 (2d Cir. 2004) (constructive dividend on bargain sale of assets by U.S. subsidiary to foreign parent treated as dividend under Section 881(a)). Dividend equivalent treatment is applied to certain securities lending transactions, notional principal contracts, as well as sale-repurchase agreements, where the payment is contingent upon or determined by reference to the payment of a dividend from sources within the U.S. See Sections 871(m), 1058; Reg. 1.1441-7(a)(2).

[180] Sections 871(a), 881(a)(1), 1441, 1442.

[181] See, e.g., U.S. Model Income Tax Convention (2016), Article 10 (Dividends), Article 11 (Interest), Article 12 (Royalties).

[182] See U.S.-U.K. Income Tax Treaty (2001), Article 10(3).

[183] Exceptions apply with respect to inventory property, depreciable personal property, intangible property sold for contingent payments, goodwill, and stock of certain affiliate corporations. See Kuntz, Peroni & Bogdanski, U.S. International Taxation (WG&L) ¶ 2.03.

[184] Regs. 1.863-3(a), 1.863-3(b); see TD 9921, 2020-53 IRB 1767.

[185] Section 865(e)(2)(A) overrides the other source rules contained in Sections 861-865.

There are a variety of other exceptions to the general rule in Section 865(a) that gains from the sale of intangibles by a foreign corporation are not taxable in addition to the ECI rule in Section 864(c) beyond Sections 865(d) and 865(e), etc. Another exception is gain from the disposition of an OID obligation issued by a U.S. obligor.[176] Gains from the disposition of real property located outside of the United States is foreign source income.[177] Under Section 332(d)(1), where an "applicable holding company" makes a distribution in complete liquidation of a foreign corporation, Section 301 applies instead of the normal liquidation rules under Sections 331 or 332. An applicable holding company is a domestic corporation that: (1) is the common parent of an affiliated group; (2) "substantially all" of its assets are stock of members of the group; and (3) has been in existence for less than five years before the distribution in liquidation.[178] Under Section 301, such a distribution is a dividend to the extent of the distributing corporation's earnings and profits.[179] As a dividend, the distribution is subject to the withholding tax.

Where a U.S. corporation pays a dividend sourced from its current or accumulated earnings to a foreign corporation or person, the dividend is U.S. source income and subject to 30% flat withholding subject to treaty modification or override.[180] The treaty rate is frequently set at 15%, with dividends paid to shareholders owning a stated percentage of the U.S. corporation permitted a lower treaty rate.[181] In certain instances, the tax and withholding rate can be 0% for qualified dividends.[182] Section 1248 overrides Section 865(a) with respect to gain from the sale of stock in a CFC or former CFC. The dividend source rules apply with respect to such gain. (Section 865(k)(1).)

Sales of personal property by foreign corporation or non-U.S. resident attributable to U.S. office or fixed place of business

Section 865(e)(1) sets forth the rule dividing foreign source from U.S. source income on the sale of personal property by a domestic corporation even if owned by a foreign corporation. It provides that unless an exception is set forth in Section 865 to the contrary,[183] if a U.S. corporation (or U.S. resident) maintains an office or other fixed place of business in a foreign country, income from sales of personal property attributable to such office or other fixed place of business shall be sourced outside the United States. However, tax havens or low-tax jurisdictions are not described in Section 865(e)(1). Instead, Section 865(e)(1)(B) requires that in order for the foreign office or fixed place of business rule to apply, the U.S. corporation must pay an income tax equal to at least 10% of the in-

[186] Section 865(e)(2)(B) provides, however, that income from the sale of inventory property that is sold for use or consumption outside of the U.S. is foreign source income if an office or other fixed place of business of the taxpayer in a foreign country materially participated in the sale.

[187] See Staff of Joint Comm. on Tax'n, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 921–922 (1987).

[188] Certain sales of property outside the U.S. where the foreign corporation's office or other fixed place of business materially participated in the sale falls outside of Section 865(e)(2)(A).

[189] Section 865(e)(3). See Regs. 1.863-3(c)(1), 1.954-3(a)(4), 1.1502-13.

[190] See TD 9921, supra, note 166, Preamble, part III. See also Sections 865(e)(2)(B), 864(c)(4)(B)(iii); Regs. 1.865-3(b), 1.864-6(b)(3) (whether foreign office materially participates in the sale and whether the property was for foreign use, consumption, etc.). See Fuller and Neumann, "Final Source of Income and Partnership Interests Regs," Tax Notes International, 12/21/2020.

[191] Regs. 1.863-3(a)(2), 1.865-3(a), 1.865-3(d); TD 9921, 2020-53 IRB 1767.

[192] Prop. Reg. 1.865-3(e) (cross referencing ECI allocation and apportionment rules in Regs. 1.882-4 and 1.882-5, including the "50/50 method" per -3(d)(2)(i) which was the default method).

[193] Regs. 1.864-5 (foreign source income that is ECI), 1.864-6 (income or loss attributable to an office or other fixed place of business in the U.S.), 1.864-7 (definition of office or other fixed place of business).

[194] The election of the "books-and-records method" is irrevocable unless there is consent by the IRS and may not be revoked for any tax year beginning within 48 months of the end of the tax year in which the election was made.

[195] See Section 864(c)(5)(A).

[196] See Section 864(c)(5)(B); Regs. 1.864-6(b)(1), 1.864-6(b)(2).

[197] See Section 865(c)(5)(C); Reg. 1.864-6(c)(1). This rule is "turned off" where it can be proven that an office or other fixed place of business of the nonresident in a foreign country materially participated in such sale.

[198] For treatment of certain outbound transfers of intangibles to foreign corporations, see Sections 367(a), 367(d), and 367(d)(4)(F) (defining "intangible property"); Reg. 1.367(a)-1(b)(5) (election to treat certain property as subject to Section 367(d)).

[199] Section 865(d)(4)(A). See Section 197, permitting 15-year amortization of purchased Section 197 intangibles. In instances where purchased intangibles have been amortized under Section 197, the depreciable property rules of Section 865(c) should apply.

[200] See Sections 865(d)(1)(A) (allowing application of Section 865(a)), 865(d)(4)(B) (blocks application of Section 865(c)(2)). There are exceptions to this outcome. See Sections 865(b) (inventory); 865(e) (sales income through offices or fixed place of business); 865(h) (gain from intangibles otherwise U.S. source may be foreign source income under pertinent tax treaty provision).

[201] See Sections 861(a)(4), 862(a)(4) (source based on location or place of use of leased or licensed property, including, in this case, licenses for patents, copyrights, secret processes, formulas, goodwill, trademarks, tradenames, franchises, etc.). But

come from the sale to the foreign country in which the office is situated. Note, however, the TCJA change under Section 863(b), under which for *inventory* property manufactured in the U.S., the domestic corporation manufacturer selling inventory produced in the U.S. and selling it overseas through a foreign office or fixed place of business, will still have U.S. source income based on its production activities within the U.S.[184]

As previously acknowledged, Section 865(e)(2), as an added exception to Section 865(b) to apply sourcing rules under Sections 861(a)(6), 862(a)(6), and 863 for sales of inventory property, sources income or loss from all sales of personal property (including inventory) by a nonresident, as defined for this purpose under Section 865(g)(1)(B), attributable to an office or other fixed place of business in the United States.[185] Section 865(e)(2)(A) provides that income from any sale of personal property attributable to such an office or other fixed place of business is sourced in the United States.[186] There is an exception to this rule of exception (to Section 865(a)) in Section 865(e)(2)(B) for the sale of inventory for use, disposition, or consumption outside the United States where it can be established that a foreign office of the nonresident "materially participated" in the sale. This special source rule applies to all sales of personal property, including inventory, depreciable personal property, and intangibles, including goodwill, attributable to the U.S. office or fixed place of business.[187] Such gains are accordingly treated as ECI with the conduct of a U.S. trade or business under Section 864(c).[188]

Section 865(e)(3) provides that principles contained in Section 864(c)(5) will be applied in determining whether a taxpayer has an office or other fixed place of business and whether a sale is attributable to such an office or other fixed place of business.[189] Section 865(e)(2) takes priority over Section 863(b) as well as Section 861(a)(6) and Section 862(a)(6). The exception from Section 865(e)(2)(B) should also be controlling in instances in which production of inventory by a foreign corporation (or other foreign person) occurred in the U.S. for use, disposition, or consumption outside of the U.S. provided a foreign office or other fixed place of business of the foreign corporation (or other foreign person) materially participated in the sale.[190] The income from the sale of such inventory property is sourced under the general source rules for inventory sales in Sections 861(a)(6), 862(a)(6), and 863(b).

The final regulations adopt this interpretation and treat Section 865(e)(2) as overriding revised Section 863(b)(2) but only as to the sale income component of the sale.[191] Section 865(e)(3) provides that the principles contained in Section 864(c)(5) are to be used in determining whether a nonresident has an office or other

see, *International Multifoods Corp.*, 108 TC 25 (1997) (gain from sale of franchisor's interest and trademarks was U.S. source income under the residence of the seller rule in Section 865(d)(1); Section 865(d)(3) for sale of goodwill applicable only where goodwill is separate from other listed intangibles for purposes of Section 865(d)(2)). See Jensen, Spikes & Whitehead, "Avoiding U.S.-Source Income Can Be Difficult: The Tax Court Reallocates Franchise Sale," 24 Int'l Tax J. 37 (Winter 1998); Cohen, "The Sourcing of Goodwill," J. Corporate Tax'n (WG&L) (Sep/Oct. 2012).

[202] Sections 865(d)(1)(A), 865(d)(3).

[203] Section 865(d)(1)(B). An argument may be made, however, that goodwill is always sourced to the jurisdiction in which the goodwill was generated, regardless of whether the payments are contingent on productivity, use, or disposition. Compare Section 865(d)(3) with Sections 865(d)(1), 865(d)(3).

[204] Sections 865(h)(1)(A), 865(h)(2)(A).

[205] Sections 865(h)(2)(A)(i), 865(h)(2)(A)(ii), 865(h)(2)(A)(iii) (election). Section 865(h) further overrides the "later-in-time" rule contained in Section 7852(d). S. Rep. No. 445, 100th Cong., 2d Sess. 239 (1988). Section 7852(d) provides that between a federal statute and a treaty neither shall have preferential status. In the event of a conflict, for example, between a provision in Title 26 of the United States Code and a treaty provision, the later-in-time is controlling. See *Pekar*, 113 TC 158 (1999). Still, the courts as well as the tax administrator, the Internal Revenue Service, will try to interpret the tax code and a treaty in a manner so as to avoid the conflict. Under Section 7852(d)(2) the Internal Revenue Code in place on or before 8/16/1954 shall not be applied in a manner that would be inconsistent with any treaty of the U.S. in effect on 8/16/1965.

[206] Sections 865(h)(1)(A), 865(h)(2)(A). Treaties for which the Section 865(h) election may be relevant include those with Cyprus, Egypt, Iceland, Indonesia, Israel, Japan, Korea, Morocco, and Trinidad and Tobago. See Anderson, "Analysis of United States Income Tax Treaties" (WG&L) ¶ 18.02. This treatise reveals other instances in which treaty provisions prevail over conflicting provisions in the Code, particularly with respect to the 1986 tax act.

[207] Sections 865(h)(2)(A)(i), 865(h)(2)(A)(ii), 865(h)(2)(A)(iii) (election). Section 865(h) further overrides the "later-in-time" rule contained in Section 7852(d). S. Rep. No. 445, 100th Cong., 2d Sess. 239 (1988). Section 7852(d) provides that between a federal statute and a treaty neither shall have preferential status. In the event of a conflict, for example, between a provision in Title 26 of the United States Code and a treaty provision, the later-in-time is controlling. See *Pekar*, 113 TC 158 (1999). Still, the courts as well as the tax administrator, the Internal Revenue Service, will try to interpret the tax code and a treaty in a manner so as to avoid the conflict. Under Section 7852(d)(2) the Internal Revenue Code in place on or before 8/16/1954 shall not be applied in a manner that would be inconsistent with any treaty of the U.S. in effect on 8/16/1965.

[208] Reg. 1.863-3(f)(3)(ii).

[209] See S. Rep. No. 445, 100th Cong., 2d Sess. 239 (1988). See Section 7852(d)(1) (later in time of conflicting treaty and tax provision in the Code controls and that a treaty provision and a later-enacted statutory provision should be given a harmonious construction if possible. See also Section 894(a) (Internal Revenue Code to be applied with "due regard" to any U.S. treaty obligation).

fixed place of business in the U.S. and whether such sale of inventory is attributable to such office, etc. Proposed regulations had, however, provided that in applying Section 864(c)(5) principles to be integrated with Section 865(e)(2), the resulting income must be sourced in the United States, *in part (italics for emphasis)*.[192] Accordingly, gross income or loss from the sale of personal property will be treated as ECI described in Section 864(c).[193] Under the final regulations, the "50/50 method" is the default rule or method to be used, although taxpayers may elect to use the "books-and-records method."[194]

Section 864(c)(5)(B) sets forth three applicable rules used to determine whether the taxpayer has "an office or other fixed place of business within the United States to which such income, gain, or loss is attributable."

First, a nonresident corporation will be considered to have an office or other fixed place of business in the U.S. where: (1) a U.S. agent maintains an office or fixed place of business within the U.S.; (2) has the authority to negotiate and conclude contracts for the foreign corporation or nonresident alien and regularly exercises that authority or has stock or merchandise from which he regularly fills orders on behalf of such individual or foreign corporation; and (3) is not a general commission agent, broker, or other agent of independent status acting in the ordinary course of his business.[195]

Second, income, gain, or loss will be attributable to an office or fixed place of business in the U.S. where such office, etc. is a material factor in the production of such income, gain, or loss and such office or fixed place of business regularly carries on activities of the type from which such income, gain, or loss is derived.[196]

A third applicable rule provides that the income, gain, or loss with respect to a sale of inventory property sold overseas that is attributable to an office or other fixed place of business within the United States will be the income, gain, or loss property allocable thereto, but such income will not exceed the income that would be derived from sources within the United States if the sale or exchange were made in the United States.[197]

Gain from the sale of intangible personal property

Section 865(d) provides rules for sourcing gain from the sale of an intangible. Section 865(d)(2) defines "intangible" for this purpose as any copyright, secret process, formula, patent, trademark, brand name, franchise, goodwill, or other similar property. It does not include, for example, gains from the sale or disposition of stocks and securities. Sections 865(d)(1) and 865(d)(4) provide source rules for gains from Section 865(d) intangibles other than goodwill, while goodwill is sourced in accordance with Section 865(d)(3).[198]

Gains from intangibles other than goodwill are sourced under a "three layer approach" based on: (1) gain not in excess of "depreciation adjustments" sourced per Section 865(c)(1); (2) gain for balance of payments not contingent on productivity, use, or disposition of the intangi-

[210] For treatment of certain outbound transfers of intangibles to foreign corporations, see Sections 367(a), 367(d), and 367(d)(4)(F) (defining "intangible property"); Reg. 1.367(a)-1(b)(5) (election to treat certain property as subject to Section 367(d)).

[211] Sections 865(d)(1)(A), 865(d)(3).

[212] Section 865(d)(1)(B). An argument may be made, however, that goodwill should always be sourced to the jurisdiction in which the goodwill was generated, regardless of whether the payments are contingent on productivity, use, or disposition. Compare Section 865(d)(3) with Sections 865(d)(1), 865(d)(3).

[213] Section 881(a)(1). See TD 8734 (preamble); Reg. 1.1441-2(b)(2)(i).

[214] See Reg. 1.861-7(d). Where Section 306 stock is sold other than through a redemption, the source of income is FDAP in accordance with Section 306(a)(1)(A). Gain in excess of the Section 306 taint is sourced under the sale of personal property rules. Where the disposition of Section 306 stock occurs by redemption, Section 306(a)(2) characterizes the amount realized under Section 301 to the extent dividend treatment arises under Section 316. The dividend source rules apply. Gains in excess of earnings and profits would be taxed in accordance with Section 301(c)(3) and may avoid U.S. income tax. Recovery of basis should also be non-taxable.

[215] Section 897(a).

[216] Section 865(f).

[217] Section 881(a)(3)(A). Special treatment is provided for gains from the sale or exchange of timber, domestic iron ore, or coal. Sections 881(a)(2), 631(b), 631(c).

[218] Section 862(a)(5). See Reg. 1.861-6.

[219] Section 332(d)(2)(A). Section 332(d) was enacted to address a withholding tax abuse where foreign corporations use a U.S. holding company to receive tax-free dividends from operating companies, liquidate the U.S. holding company to distribute the U.S. earnings as capital gains free of U.S. income and withholding taxes, and then reestablish another U.S. holding company. S. Rep. No. 192, 108th Cong., 2d Sess. 166 (2004).

[220] See, e.g., *Framatome Connectors USA, Inc.*, 118 TC 32 (2002), aff'd 2004-2 USTC ¶ 50,364 (2d Cir. 2004) (constructive dividend on bargain sale of assets by U.S. subsidiary to foreign parent treated as dividend under Section 881(a)). Dividend equivalent treatment is applied to certain securities lending transactions, notional principal contracts, as well as sale-repurchase agreements, where the payment is contingent upon or determined by reference to the payment of a dividend from sources within the U.S. See Sections 871(m), 1058; Reg. 1.1441-7(a)(2).

[221] Sections 871(a), 881(a)(1), 1441, 1442.

[222] See, e.g., U.S. Model Income Tax Convention (2016), Article 10 (Dividends), Article 11 (Interest), Article 12 (Royalties).

[223] See U.S.-U.K. Income Tax Treaty (2001), Article 10(3).

ble which, in general, is sourced to the seller's country of residence, subject to applicable exception; and (3) gain contingent on productivity, use, or disposition of the intangible sourced under the royalty source rules under Sections 861(a)(4) and 862(a)(4). More particularly, Section 865(d)(4)(A) provides that gain from the sale of intangible property other than goodwill is subject to three sourcing rules. First, to the extent of the portion of the gain not in excess of "depreciation adjustments," Section 865(d)(1) requires application of the source rule for depreciable property under Section 865(c)(1) regardless of whether the payments are fixed or contingent.[199] The next layer of gain, i.e., in excess of "depreciation adjustments," provided such payments are not contingent on productivity, use, or disposition, is sourced to the U.S. provided the seller is a U.S. resident and is foreign sourced income where the seller is a nonresident.[200] The third layer or the residual amount of gain, if any, attributable to payments contingent on productivity, use, or disposition of the intangible(s) being sold, requires the sourcing of gain to the country in which the intangible(s) are used.[201]

As concerns income from the sale of goodwill, non-contingent payments yielding such gains are sourced in the jurisdiction in which the goodwill was generated regardless of the seller's country of residence.[202] Goodwill payments contingent on productivity, use, or disposition should be sourced under the rule applied to royalties, i.e., the place in which the goodwill is used.[203] Under certain circumstances, Section 865(h) permits a taxpayer to elect to treat certain gain from the sale of an intangible as foreign source income.[204] This rule applies to gains from the sale of an intangible that would otherwise be treated as U.S. source income under Section 865 but is treated as foreign-source under a particular tax treaty provision.[205]

An applicable tax treaty can override application of the sourcing rules under Section 865(d). In particular, Section 865(h)(2) allows a taxpayer, in the case of gain from the sale of stock of a foreign corporation or from the sale of an intangible under Section 865(d)(2), that would be treated as U.S. source income under Section 865(d)(2), but would be treated as foreign source income under an applicable treaty provision, to elect under Section 865(h) to treat the gain as foreign source income (with foreign tax credit limitations).[206] This rule applies to gains from the sale of an intangible that would otherwise be treated as U.S. source income under Section 865 but is treated as foreign-source under a particular tax treaty provision.[207] Where a Section 865(h) election is made, the foreign tax credit limitation rules under Section 904 are applied separately to the gain and any resulting foreign taxes imposed on such gain.[208] Apparently Section 865(h) overrides the "last in time rule" contained in Section 7852(d).[209]

Gain from the sale or other disposition of goodwill is sourced in accordance with Section 865(d)(3).[210] Section 865(d)(3) provides that non-contingent payments yielding such gains

[224] See, however, Section 864(c)(4)(A) (foreign source income, gain, or loss not ECI unless exception applies). Under Section 864(c)(4)(B), foreign source income from: (1) rents or royalties derived in the active conduct of such trade or business; (2) dividends, interest, or amounts received for guarantees of debt, in the active conduct of banking, financing, or similar business, etc. as well as (3) certain sales of inventory, is ECI. Sections 864(c)(4)(B)(i)-(iii).

[225] Reg. 1.864-4(b), Ex. 1 (U.S.-source income from sales in United States of machine tools by foreign manufacturer of such tools was treated as effectively connected income under Section 864(c)(3)). This "force of attraction rule" has received some criticism. See, e.g., Dale, "Effectively Connected Income," 42 Tax L. Rev. 689, 749 (1987). See also Lemein, Lipeles, & McDonald, "International Tax Watch: Twists and Turns in U.S.-Source Rules," 84 Taxes 5 (July 2006).

[226] Reg. 1.875-1. See, e.g., *Vitale*, 72 TC 386 (1979) (case involving broader force-of-attraction rules which included dividends, interest, and other "fixed or determinable annual or periodic" income; nonresident alien was liable for tax on gain realized from distribution and subsequent sale of stock he received. Fact that transactions were consummated in U.S. during taxable year, but before partnership started doing business in U.S., did not change result); *Van Der Elst*, 223 F3d 771 (2d Cir. 1955); *North West Life Assur. Co of Canada*, 107 TC 363 (1996).

[227] See Sections 864(c)(4)(B)(i) (rents and royalties from certain intangible property in Section 862(a)(4) derived in the active conduct of U.S. trade or business), 864(c)(4)(B)(ii) (dividends, interest, etc. related to a banking, financing, or similar business within the U.S. or received by a corporation whose principal business is trading in stocks or securities for its own account), 864(c)(4)(B)(iii) (foreign gains from the sale of inventory unless attributable to a foreign-based office or fixed place of business). See Kuntz, Peroni, & Bogdanski, "U.S. International Taxation (WG&L) ¶ C1.04 (Taxation of Income Effectively Connected with U.S. Trade or Business).

[228] See, e.g., *Spermacet Whaling & Shipping Co.*, 30 TC 618 (1958), aff'd 281 F.2d 646 (6th Cir. 1960): *Linen Thread Co.*, 14 TC 725 (1950); *Blanovski*, 236 F.2d 298 (2d Cir. 1956); *Neill*, 46 BTA 19 (1942); *Herbert*, 30 TC 26 (1958), acq. 1958-2 CB 6. (Pre-Section 897 cases)

[229] *Donroy, Ltd.*, 301 F2d 200 (9th Cir. 1962), aff'g 196 F. Supp. 54 (ND Calif. 1961) (Canadian corporations taxable on shares of income of a California limited partnership which operated a business in California); *WC Johnston*, 24 TC 920 (1955) (Canadian individual taxable on his share of income of general partnership with a U.S. permanent establishment); *Unger*, TCM 1990-15 aff'd 936 F.2d 1316 (DC Cir. 1991) (Canadian limited partner was taxable on his share of partnership's gain on sale of U.S. real estate).

are sourced in the jurisdiction in which the goodwill was generated regardless of the seller's country of residence.[211] The allocation of the goodwill amount among two or more jurisdictions in which a multi-jurisdictional business is operated may be a strenuous exercise. Goodwill payments contingent on productivity, use, or disposition should be sourced under the rule applied to royalties, i.e., the place in which the goodwill is used.[212]

Gain from the sale of stock or other property by a foreign corporation that is not ECI, or otherwise falls within a stated exception that yields ECI or FDAP, is not taxable.[213] Gain from the sale of property recharacterized as FDAP is treated as U.S. source (FDAP) income under Section 881(a). This could occur with respect to the sale of stock that is "tainted" under Section 306 or a redemption described under Section 304.[214] Recharacterization as ECI can occur under Section 897 for gains from the disposition of a USRPI or stock in a USRPHC.[215] As mentioned, a taxpayer electing the benefit under Section 865(h) permits gain from the sale of stock in a foreign corporation to be treated as foreign source income, even though the gain would have otherwise been treated as U.S. source income under other provisions of Section 865, under an applicable treaty provision.

Special treatment is set forth for sourcing gains from the sale of stock by a U.S. resident corporation in a foreign affiliate under Section 865(f). Normally, such income would be U.S. source income. However, Section 865(f) allows the domestic corporation's gain from the sale of foreign affiliate stock to be foreign source income if certain requirements are met. The sale must occur in a foreign country in which the affiliate is engaged in the active conduct of a trade or business and the affiliate must have generated more than 50% of its gross income from the prior three-year period of the affiliate ending with the taxable year preceding the year of sale. An "affiliate" is based on the ownership test under Section 1504(a) without regard to the exceptions in Section 1504(b). A U.S. parent may elect to treat an affiliated group of foreign corporations if all requirements are met.[216]

There are a variety of other exceptions to the general rule in Section 865(a) that gains from the sale of intangibles by a foreign corporation are not taxable in addition to the ECI rule in Section 864(c) beyond Section 865(d) and 865(e), etc. One such exception is gain from the disposition of an OID obligation issued by a U.S. obligor.[217] Gains from the disposition of real property located outside of the United States is foreign source income.[218] Under Section 332(d)(1), where an "applicable holding company" makes a distribution in complete liquidation of a foreign corporation, Section 301 applies instead of the normal liquidation rules under Sections 331 or 332. An applicable holding company is a domestic corporation that: (1) is the common parent of an affiliated group; (2) "substantially all" of its assets are stock of members of the group; and (3) has been in existence for less than five years before the distribution in liquidation.[219] Under Section 301, such a distribution is a dividend to the extent of the distributing corporation's earnings and profits.[220] As a dividend, the distribution is subject to the withholding tax.

Where a U.S. corporation pays a dividend sourced from its current or accumulated earnings to a foreign corporation or person, the dividend is U.S. source income and subject to 30% flat withholding, subject to treaty modification or override.[221] The treaty rate is frequently set at 15%, with dividends paid to shareholders owning a stated percentage of the U.S. corporation permitted a lower treaty rate.[222] In certain instances, the tax and withholding rate can be 0% for qualified dividends.[223] .

Treatment of residual U.S. source income that is neither FDAP nor capital gains

For income that is neither FDAP nor capital gains, Section 864(c)(3), the so-called "force of attraction rule" provides that ["a]ll income, gain, or loss from *sources within the United States [which is not FDAP, net portfolio interest or gain or loss from the sale or exchange of capital assets] constitutes income effectively connected with the conduct of a trade or business within the United States*" whether or not such income, gain, or loss is derived from the trade or business being carried on in the United States during the tax year.[224] This provision would require the US source income generated from the isolated sale of inventory by a foreign corporation which is otherwise engaged in providing services in the US that is a separate trade or business under Section 864(b), as ECI.[225] The reach of Section 864(c)(3) may extend to income, gain or loss realized before the commencement of a US trade or business or after the cessa-

tion of such US trade or business during the same tax year.[226] Under Section 864(c)(4)(B), foreign-source income, gain, or loss may, if certain conditions are met, still be treated as ECI if the foreign corporation (or foreign person) has an office or other fixed place of business within the U.S. to which such income, gain, or loss is attributable.[227]

Part Two: knowing when a foreign corporation has an office, fixed base, or permanent establishment in the United States

Part One of this article focused on the migrating foreign corporation which derives income from investments or business activities conducted within the United States. The emphasis was on sourcing, effectively connected income, and sales of property, both real and personal, tangible and intangible, by foreign corporations. The source rules were discussed in detail to instruct whether the foreign corporation will be subject to a flat 30% tax and withholding or tax on a net basis of its ECI. Special rules abound, most notably the foreign investment in real property provisions in Section 897.

Part Two (to be published in a subsequent issue of this Journal), will address the questions of whether a foreign corporation (or other foreign person) is engaged in a U.S. trade or business under Section 864(b). A foreign corporation must be involved to a significant degree in the business activity. Passive investment or ownership is not a trade or business within the U.S., although as mentioned there is an exception provided for being a partner in a partnership or other flow-through entity, including a trust or estate, in which the foreign corporation or other nonresident is a member and the entity is actively engaged in a U.S. trade or business.[228] A higher threshold for requiring a foreign corporation resident in a tax treaty jurisdiction to be taxed on a net basis on its ECI from a U.S. trade or business must be satisfied — that is, that the profits derived from such business activity are attributable to a permanent establishment maintained by the foreign corporation in the United States. If the foreign person does not maintain a permanent establishment in the U.S., it may avoid income taxes on business profits. Again, ownership interests in pass-through entities must be taken into account, since there is case law that a partnership's maintaining a permanent establishment within the U.S. can be imputed to its foreign partner or partners.[229] ■

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TAXATION OF THE MODERN DAY CROSS-BORDER MERGER AND ACQUISITION

ANTHONY DIOSDI

This article examines a number of key tax considerations specific to cross-border reorganizations.

In today's global economy, corporations have operations all over the world. Typically, a U.S. parent corporation owns a group of subsidiary corporations formed within and outside the United States. In such a scenario, the foreign subsidiaries are largely held by one foreign parent corporation. In larger multinational corporations, frequently there are multiple foreign parent corporations.

This article discusses a number of key tax considerations specific to cross-border reorganizations. This article does not provide an exhaustive overview of all tax considerations but rather provides commentary on the most overlooked and misunderstood factors involved in the taxation of an international corporate reorganization.

Section 368(a)(1) corporate reorganizations

Any discussion regarding the taxation of cross-border mergers and acquisitions must begin with Section 368(a)(1). In the domestic context, Section 368(a)(1) provides for nonrecognition of gain or loss realized in connection with a considerable number of corporate organizational changes. These include acquisitive and other reorganizations as defined in Section 368(a)(1) and divisive reorganizations under Section 355. They are permitted on a tax-free basis on the rationale that they involve merely changes in the organizational forms for the conduct of business and that there should be no tax penalty imposed on formal organizational adjustments that are dictated by business considerations.

Reorganizations, as defined in Section 368(a)(1), include statutory mergers and consolidations, acquisitions by one corporation of the stock or assets of another corporation, recapitalizations, changes in form or place of organizations, and certain corporate transfers in a Title 11 or similar bankruptcy case. If the transaction qualifies as a reorganization, neither gain nor loss will be recognized by the corporation or corporations involved or by their shareholders who may exchange their stock for other stock.[1]

There are generally three requirements for a transaction to qualify as a tax-free reorganization:

- The transaction must have a business purpose.[2]
- The original owners must retain a continued proprietary interest in the reorganized corporation (the "continuity of interest" requirement).[3]

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- In an acquisitive reorganization, the acquired corporation must either continue the acquired corporation's historic business or use a significant portion of the acquired corporation's historic business assets in a business (the "continuity of business enterprise" requirement).[4]

The basic types of corporate reorganizations are discussed below:

Type A reorganization. To qualify as a Type A reorganization, the transaction must satisfy all of the applicable merger or consolidation requirements under the corporation laws of the federal or state government.[5] In the typical merger transaction, one corporation is absorbed into another corporation, with only the acquiring corporation surviving. In a typical consolidation, two corporations are combined into a new entity, and both of the old corporate entities disappear.

In addition to qualifying as a state law merger or consolidation, the transaction also must meet the continuity of proprietary interest, continuity of business enterprise, and business purpose tests developed by the courts and incorporated into the Section 368 regulations.[6]

Type B reorganization. In a Type B reorganization, the purchasing corporation acquires a controlling interest in the target corporation from the target's shareholders solely in exchange for all or part of the purchasing corporation's stock.[7] Two significant elements of the Type B reorganization should be noted at the outset.

First, and most important, the purchasing corporation must have control over the target corporation immediately after the stock acquisition from the target shareholders. "Control," for purposes of Section 368, generally requires ownership by the acquiring corporation of "at least 80 percent of the total combined voting power of all classes of stock entitled to vote" and "at least 80 percent of the total number of shares of all other classes of stock."[8] Second, the target shareholders must exchange stock solely for all or part of the acquiring corporation's voting stock or solely for all or part of the voting stock of the acquiring corporation's parent.

Type C reorganization. In a Type C reorganization, substantially all of the assets of a corporation are acquired by another corporation in exchange for part or all of the latter's voting stock or the voting stock of its parent's corporation, followed by the liquidation of the acquired corporation.[9]

Type D reorganization. A Type D reorganization allows certain distributions by one corporation (*the* "distributing corporation") to its shareholders of stock or securities in another corporation (the "controlled corporation") to be tax-free to the shareholders, and also be tax-free to the distributing corporation.[10]

Type E reorganization. A Type E reorganization involves the recapitalization of a corporation.[11]

Type F reorganization. A Type F reorganization involves "a mere change in identity, or place of organization of one corporation, however effected."[12] The major tax advantage to classification as a Type F reorganization is a preferential set of rules that will apply after the reorganization regarding loss carryovers. For example, after a Type F reorganization, in many cases, the new corporation has an opportunity to use net operating losses of an old corporation against its income.

1 *See* Sections 354, 356, 361, and 1032.

2 Reg. 1.368-1(b).

3 Reg. 1.368-1(e).

4 Reg. 1.368-1(d).

5 Reg. 1.368-2(b)(1).

6 Reg. 1.368-1(b).

7 Section 368(c).

8 Section 368(c).

9 Section 368(a)(1)(C).

10 Section 368(a)(1)(D).

11 Section 368(a)(1)(E).

12 Section 368(a)(1)(F).

13 Section 368(a)(1)(G).

14 Section 965 imposes a one-time transition tax on a U.S. shareholder's share of deferred foreign income of certain foreign corporations' accumulated deferred foreign income. A U.S. shareholder is a U.S. person who directly, indirectly, or constructively owns at least 10% of either the total voting power or total value of a foreign corporation's stock. Section 965 accomplished the transition tax by increasing the subpart F income of each specified foreign corporation that began before 1/1/2018 by the greater of the specified foreign corporation's accumulated deferred foreign income measured in functional currency as of 11/2/2017 or 12/31/2017.

15 The term qualified business asset investment or "QBAI" means the average of a domestic corporation's aggregate adjusted bases as of the close of each quarter of the domestic corporation's taxable year in specified tangible property that is used in a trade or business of the domestic corporation and is of a type allowable under Section 167. GILTI presumes that tangible property should provide an investment return of no greater than 10%.

16 Section 954 permits the exclusion of subpart F and GILTI income which is 90% of the maximum U.S. federal corporate rate.

17 The same recharacterization rules apply to domestic entities involved in a cross-border reorganization that are not C corporations.

18 Section 6038B requires U.S. persons who transfer property to a foreign corporation to report the transaction on IRS Form 926. This reporting requirement applies to outbound transfers of both tangible and intangible property. The penalty for a failure of a U.S. person to properly report a transfer to a foreign corpo-

Type G reorganization. A Type G reorganization involves a "transfer by a corporation of all or part of its assets to another corporation in a Title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under Section 354, 355, or 356."[13]

Section 368(a)(1) plays a definitional role for providing nonrecognition of gain or loss in a domestic reorganization. However, the reorganization of one or more foreign corporations will be accorded nonrecognition of gain treatment only to the extent allowable under Section 367 and other relevant provisions of the Internal Revenue Code. The rules governing the taxation of corporate reorganizations differ depending on whether the transaction is deemed to involve an outbound transfer under Section 367(a), which involves a transfer of assets or stock from a U.S. corporation to a foreign corporation, or an outbound transfer under Section 367(b), which involves a transfer of assets or stock from a foreign corporation to a U.S. corporation or from one foreign corporation to another foreign corporation.

Rules governing outbound transfers under Section 367(a)

Section 367 must be considered in any outbound, inbound, or foreign to foreign corporate reorganization. When applicable, Section 367 causes a corporation to not be treated as a corporation for purposes of applying the nonrecognition provisions of the Internal Revenue Code.

Section 367(a) requires a U.S. person transferring appreciated property to a foreign corporation to recognize a gain on the transfer. The transaction subject to Section 367(a) that is most commonly encountered is probably a transfer of property to a foreign corporation in exchange for its stock under Section 351. Section 367(a) provides a general rule of taxability with respect to outbound transfers of property in exchange for other property in transactions described in Section 332, 351, 354, 356, or 361 by stating that a foreign corporation will not be considered a corporation that could qualify for nonrecognition of gain under one of the enumerated provisions of the Internal Revenue Code.

Section 367(a) imposes a so-called "toll charge" tax on the income realized on transfers of certain tainted assets. Categories of tainted assets under Section 367(a) include: (1) property relating to inventory and certain intellectual property; (2) installment obligations, accounts receivable, or similar property; (3) property with respect to which the transferor is a lessor at the time of the transfer, unless the transferee was the lessee; (4) foreign currency and other property denominated in foreign currency; and (5) depreciable property to the extent that gain reflects depreciation deductions that have been taken against U.S.-source income.

The U.S. transferor's basis in any shares received in an outbound transfer equals the U.S. transferor's basis in the property transferred, increased by the amount of the gain recognized on the transfer. The types of corporate transactions governed by the outbound toll charge provisions include the acquisition of the stock or assets of a U.S. corporation in exchange for stock of a foreign corporation in a reorganization described in Section 368(a), which is normally within the scope of Section 367(a).

Triangular Type A mergers, whether in the form of a forward triangular merger described in Section 368(a)(2)(E), in which the shareholders of the acquired U.S. corporation exchange their stock in the U.S. corporation for stock in a foreign corporation, are treated as an indirect transfer of stock by the U.S. shareholder to the foreign corporation. The same analysis applies to a triangular Type B reorganization in which a U.S. person transfers stock in the acquired U.S. corporation to a U.S. subsidiary of the foreign corporation in exchange for stock of the foreign corporation. A U.S. shareholder is also deemed to make a transfer of stock of a U.S. corporation if substantially all of its assets are acquired by a U.S. subsidiary of a foreign corporation in exchange for stock of the foreign corporation in a Type C reorganization and the U.S. acquired corporation is then liquidated.

Section 367(b) in the context of a cross-border reorganization

Section 367(b) and its regulations apply to outbound transfers not covered under Section 367(a). Specifically, in the case of any exchange described in Section 332, 351, 354, 356, or 361 in connection with which there is no outbound transfer subject to Section 367(a)(1), a foreign corporation will be considered to be a corporation. T.D. 8862, 2000-1 C.B. 466-67, describes the policy of Section 367(b) as follows:

The principal purpose of Section 367(b) is to prevent the avoidance of U.S. tax that can

arise when the Subchapter C provisions apply to transactions involving foreign corporations. The basic thrust of Section 367(b) is to implement tax under Section 1248 in transactions that would otherwise be exempt from tax under a tax-free-exchange provision.

Under Section 1248(a), gain recognized on a U.S. shareholder's disposition of stock in a controlled foreign corporation (CFC) is treated as dividend income to the extent of the relevant earnings and profits accumulated while such person held the stock. It should be understood that the relevance of Section 1248 has diminished because of the Section 965 "transition tax."[14] The transition tax eliminated most untaxed offshore earnings and profits. In addition, the global intangible low-tax income or "GILTI" has caused most offshore income that is not classified as subpart F income to be taxed. As a result, most untaxed foreign income that can be reached by Section 1248 is the 10% QBAI[15] under Section 951A(b)(2)(A) or foreign source income deferred as the result of high rates of foreign tax and an election made under Section 954. [16]

Under Section 1248(a), gain recognized on a U.S. shareholder's disposition of stock in a CFC is treated as dividend income to the extent the relevant earnings and profits accumulated during the holding period of the stock or security. Thus, in the case of a U.S. C corporate holder of foreign stock that wishes to dispose of the stock through a tax-free provision of Section 368(a)(1), the Section 1248 conversion of gain into a dividend generally triggers an exemption from tax for such U.S. corporate shareholders pursuant to the Section 245A dividends received deduction. Section 245A(a) allows an exemption for certain foreign income of a domestic corporation that is a U.S. shareholder by means of a 100% dividends received deduction for the foreign-source portion of dividends received from "specified 10-percent owned foreign corporations" by certain domestic corporations that are U.S. shareholders of those foreign corporations within the meaning of Section 951(b).

In the case of a domestic C corporation transferring foreign stock or securities through a Section 368(a)(1) tax-free reorganization, Section 367(b) is largely irrelevant for tax purposes. On the other hand, the situation is different for individual shareholders of a C corporation. For individual U.S. shareholders, the recharacterized income under Section 1248(a) will be taxed as ordinary income rather than long-term capital gains.[17]

Concurrent application of Section 367(a) and (b)

Section 367 was originally aimed at preventing tax-free transfers by U.S. taxpayers of appreciated property to foreign corporations that could sell the property free of U.S. tax. The reach of this provision has been broadened over the years to apply to a broad spectrum of transactions involving transfers both into and out of the United States.

Today, Section 367(a) provides a general rule of taxability with respect to outbound transfers of property in exchange for other property in corporate reorganizations and split-ups. The character and source of gain produced by Section 367 is determined as if the transferor had sold the property to the transferee in a taxable transaction.

Prior to the enactment of the 2017 Tax Cuts and Jobs Act, Section 367(a) required corporations participating in a cross-border reorganization to recognize gain on outbound transfers unless: (1) the transfer qualified for an active trade or business exception, or (2) the assets consisted of stock or securities of a foreign corporation and the U.S. transferor entered into a gain-recognition agreement to preserve gain. As a result of the 2017 Tax Cuts and Jobs Act, Congress eliminated the active trade or business exception. This means that it is no longer possible to incorporate a foreign branch for purposes of a tax-free cross-border reorganization. The only exception to Section 367 that now remains for purposes of tax-free or tax-deferred for purposes of cross-border reorganizations is to transfer stock to a foreign corporation by virtue of a gain-recognition agreement.

ration equals 10% of the fair market value of the property transferred or $100,000.

[19] The term "specified 10% foreign corporation" is defined as any foreign corporation with respect to which any domestic corporation owns at least 10%. *See* Section 245A(b)(1).

[20] Section 962 permits U.S. shareholders of a CFC to elect to be subject to corporate income tax rates (under Sections 11 and 55) on the amounts that are included in their income under Section 951(a) and Section 951A.

[21] *See* Hot Topic Compliance Issues for the International Tax Practitioner (2020), Renea M. Glendinning and Alfredo R. Tamayo.

[22] Section 367(d)(2)(A)(ii)(I).

[23] For U.S. C corporations that sell goods or provide certain services to foreign customers, there is a deduction pursuant to Section 250 that reduces the effective tax rate on qualifying income to 13.125%.

Planning opportunities utilizing a gain-recognition agreement

Transfers by a U.S. person of stock or securities of a U.S. corporation to a foreign corporation are generally taxable under Section 367, unless an exception is available. One such exception is the execution of a closing agreement between the IRS and the U.S. transferor under which the transferor must agree to recognize taxable gain on the transferee corporation's later disposition of the transferred stock or securities (a "gain-recognition agreement"). According to Reg. 1.367(a)-3(b)(1), if a U.S. person is a 5% or more shareholder of the vote or value of the transferred foreign corporation immediately after the transfer and files a gain-recognition agreement, the gain-recognition provisions of Section 367(a) are not triggered.

A gain-recognition agreement is an agreement to which the U.S. transferor agrees to recognize gain if the transferred foreign corporation disposes of the transferred stock or securities during the term of the gain recognition and pay interest on any additional tax owing if a "triggering event" occurs. A "triggering event" typically takes place when a foreign corporation disposes of the untaxed U.S. property.

In most cases, a gain-recognition agreement term is 60 months following the end of the taxable year in which the initial transfer is made. This means, in certain cases, with a properly drafted gain-recognition agreement, the adverse federal income tax consequences associated with a cross-border merger or reorganization involving a U.S. corporation can be deferred up to five years, interest-free.

If a U.S. person is a 5% or more shareholder with respect to the stock of a transferee foreign corporation, the shareholder may be eligible to file a gain-recognition agreement to avoid immediate gain recognition under Section 367(a)(1). A gain-recognition agreement may be very valuable to eliminate (or defer) the tax consequences associated with the outbound transfer of stock in a cross-border merger or reorganization.

The regulations contain very specific rules as to what needs to be in a gain-recognition agreement. At a minimum, a gain-recognition agreement should contain the following:

- A gain-recognition agreement must specifically state that it is a gain-recognition agreement in accordance with Reg. 1.367(a)-8.
- A gain-recognition agreement must adequately describe the stock or securities being transferred through the agreement. In order to satisfy the conditions and requirements of Reg. 1.367(a)-8(c)(3), the gain-recognition agreement should provide the following: (a) a calculation of the amount of the built-in gain (i.e., the fair market value of the stock or securities over the tax basis) in the transferred stock or securities that are subject to the gain-recognition agreement, reflecting the basis and fair market value on the date of the initial transfer; (b) a description of the shares transfer agreement used to transfer the stock or securities; (c) the amount of any gain recognized by the U.S. transferor on the initial transfer of stock or securities; (d) the percentage (by vote and value) that the transferred stock (if any) represents of the total stock outstanding of the transferred corporation on the date of the initial transfer.
- The gain-recognition agreement should state the name, address, place of incorporation, and the taxpayer identification number (if any) of the transferee corporation.
- The gain-recognition agreement should state the date on which the U.S. transferor acquired the transferred stock or securities.
- The gain-recognition agreement should state the name, address, and place of incorporation of the transferred foreign corporation, and a description of the stock or securities received by the U.S. transferor in the initial transfer, including the percentage of stock (by vote and value) of the transferred foreign corporation received in such exchange.
- The gain-recognition agreement should include a statement of the initial transfer described in Reg. 1.367(a)-3(e), a statement that the conditions of Section 367(a)(5) and any regulations under that section have been satisfied, and a description of any adjustments to the basis of the stock received in the transaction or other adjustments made pursuant to Section 367(a)(5) and any regulations under that section.
- The gain-recognition agreement should include a statement describing the application of Section 7874 or the corporate inversion rules to the transaction.
- If a U.S. transferor (i.e. a corporation that makes a transfer or conveyance of property) is involved in the reorganization, a statement should be included in the gain-recognition agreement indicating whether the U.S. transferor was a Section 1248 shareholder (as defined in Reg. 1.367(b)-2(b)) of the transferee corporation immediately before the initial

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transfer, and whether the U.S. transferor is a Section 1248 shareholder with respect to the transferred foreign corporation immediately after the initial transfer, and whether any reporting requirements or other rules contained in the regulations under Section 367(b) are applicable, and, if so, whether they have been satisfied.

- If the initial transfer involves a transfer by a partnership, the gain-recognition agreement should include a complete description of the transfer, including a description of the partners in the partnership.
- If the transaction involves the transfer of property other than the transfer of stock or securities and the transaction is subject to the indirect stock transfer rules of Reg. 1.367(a)-3(d), the gain-recognition agreement should include a statement indicating whether: (a) the reporting requirements under Section 6038B[18] have been satisfied with respect to the transfer of such property; (b) whether gain was recognized under Section 367(a)(1); and (c) whether Section 367(d) applied to the transfer of such property.
- A gain-recognition agreement must include a statement in which the U.S. transferor agrees to comply with all the conditions and requirements of Reg. 1.367(a)-8, including to recognize gain under the gain-recognition agreement in accordance with Reg. 1.367(a)-8(c)(1)(i) to extend the period of limitations on the assessment of tax.
- The gain-recognition agreement must include a statement that the U.S. transferor is informed of any events that affect the gain-recognition agreement, including triggering events or other gain-recognition events.
- The gain-recognition agreement must provide a description of the event (such as a triggering event) and the applicable exception, if any, that gave rise to a new gain-recognition agreement (such as a triggering event exception), including the date of the event and the name, address, and taxpayer identification number (if any) of each person that is a party to the event.
- The gain-recognition agreement should state if the U.S. transferor elects or does not elect to include income in any gain-recognition agreement during the year during which a gain-recognition event occurs.
- The gain-recognition agreement should include a statement describing any disposition of assets of the transferred corporation during such taxable years other than in the ordinary course of business.

Section 338 election

Not all acquiring corporations will want to acquire corporate shares of the target. The acquisition of corporate stock may expose a buyer to potential negative tax consequences of the target corporation. On the other hand, a foreign corporate buyer of the assets of a corporation will not likely inherit the U.S. tax exposure of a U.S. target corporation. In addition, an asset purchase generally provides the buyer with the opportunity to select the desired assets, leaving unwanted assets behind.

In a taxable purchase of the target[esq]s stock, an election can be made to treat the purchase of stock as a purchase of the target's assets, provided certain requirements are satisfied. The buyer, if eligible, can make a unilateral election under Section 338(g) or, if available, a joint election under Section 338(h)(1) to recharacterize a taxable stock acquisition as a deemed asset acquisition. The main advantage to the buyer is the step up on the basis of the assets deemed acquired to the fair market value on the date of purchase. It also eliminates the historic earnings and profits and ends the target's tax year. After the 2017 Tax Cuts and Jobs Act, this step-up is of enhanced value because, in addition to permitting increased depreciation and amortization deductions, this increased asset basis generally has the effect of reducing future GILTI inclusions (by both reducing the amount of "tested income" and increasing the amount of "qualified business asset investment").

When a Section 338 election is made, the target CFC is deemed to sell its assets and must recognize any gain from the deemed asset sale. If the seller is a domestic corporation, the CFC target's gain on non-trade or business assets typically is classified as subpart F income, and the remaining gain (with respect to trade or business assets) instead is classified as tested income for GILTI purposes. The CFC's tax year closes, and its subpart F income and GILTI through the date of the sale are included in the gross income of the domestic seller.

With a Section 338 election, the domestic seller also will be taxed on the gain from the sale of the CFC stock, with the basis of such stock being increased to account for any inclusions under subpart F and GILTI for the year (including the subpart F and GILTI income generated by the deemed asset sale). Subject to holding period requirements, the stock gain will be recharacterized as a dividend under Section 1248. However, dividends reclassified

under Section 1248 may be eligible for a deduction under Section 245A. Section 245A(a) allows a deduction equal to the foreign-source portion of a dividend received from a specified 10% owned foreign corporation.[19] Consequently, Section 1248 dividends may be eligible for a deduction under Section 245A. However, this deduction is only available to the extent of the CFC's previous year's untaxed earnings and profits that cannot be classified as subpart F income or GILTI, as well as earnings arising from gain on the deemed sale of assets that are not subject to subpart F or GILTI.

A selling corporation may also prefer utilizing a Section 338 election. This is because there may be a preference among U.S. corporate sellers toward dividend characterization under Section 1248 (i.e., a stock sale), which may be exempt from U.S. tax under Section 245A, as compared to gain that may be classified as either GILTI or subpart F income (i.e., an asset sale), which would trigger a 10.5% or 21% U.S. corporate tax. If sufficient earnings and profits exist, corporate sellers may thus be expected to prefer stock sales over asset sales. In the absence of sufficient earnings and profits, utilizing a Section 338 election to convert subpart F income or gain taxable at 21% to GILTI at 10.5% may be preferable.

Domestic corporate buyers of a foreign corporation's assets classified as a CFC will generally also prefer making a Section 338 election as a result of the Section 245A deduction. However, the U.S. shareholders of a domestic corporation may have serious negative tax consequences as the result of a Section 338 election. The 100% dividends received deduction under Section 245A is only available to domestic C corporations. This deduction is not available for individual shareholders. This means that gain realized from a Section 338 election will result in a subpart F or GILTI inclusion to the individual shareholders of the domestic acquiring corporation. Assuming an individual shareholder does not make a Section 962 election,[20] gain from a deemed asset sale will be taxed at ordinary rates.

Section 964(e) considerations

Another tax provision that corporation shareholders involved in a cross-border corporate acquisition should consider is Section 964(e)(4). Generally, Section 964(e)(1) provides that if a CFC sells or exchanges stock in another foreign corporation, the gain recognized on the sale or exchange is treated as a dividend to the same extent as it would have been under Section 1248(a) if the CFC were instead a U.S. person. If the shares of the entity which is being sold was a CFC at any time during the prior five years, gain generally is classified as a dividend to the extent of the shareholder's proportionate amount of the target CFC's earnings and profits.

Under Section 964(e)(4)(A), the "foreign source portion" (which is 100% assuming the CFC was not engaged in a trade or business and had no 80% owned U.S. subsidiary to which the amounts are attributable) of any amount characterized as a dividend under Section 964(e)(1) is treated as subpart F income, is includible in the gross income of U.S. shareholders of such CFC, and is eligible for the Section 245A deduction in the same manner as if the income was classified as a non-subpart F dividend. Because Section 245A is available only to U.S. C corporations, gains realized by U.S. C corporation shareholders from such a disposition are exempt from U.S. tax, while the same gain realized by an individual U.S. shareholder is taxable as ordinary income.[21]

Special rules for intangibles under Section 367(d)

Section 367(d) provides special rules for the transfer of intangibles to foreign corporations. Cross-border mergers and acquisitions present special problems if the transferring corporation wishes to transfer intangibles to a foreign corporation. Gain-recognition agreements cannot be utilized to avoid recognition under Section 367(d).

In order to better understand Section 367(d), it is important to understand the history of Section 367(d). Prior to 1984, U.S. corporations would develop intangibles and deduct the costs associated with developing the intangible against its U.S.-source income. U.S. corporations would then often transfer intangibles to a foreign corporation tax-free. Even if a toll-charge tax was imposed at the time of transfer, the tax would not necessarily adequately compensate the government. Thus, Sections 367(d) and 482 were enacted.

Under Section 367(d), intangibles are treated as a special class of a tainted asset. Section 367(d)(4) defines the term "intangible property" to include a patent, invention, formula, process, design, pattern, know-how, copyright, literary composition, musical com-

position, artistic composition, trademark, trade name, brand name, franchise, license, contract, method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, technical data, goodwill, going concern value, or workforce.

In every case involving the transfer of such assets in a transaction falling within Section 351 or 361, the transferor will be treated as having sold the property in exchange for payments that are contingent on the productivity, use or exchange for payments that are contingent on the productivity, use, or disposition of such property. These imputed or constructive royalty payments must reflect the amounts that would have been received annually in the form of such payments over the useful life of such property.[22] These imputed or constructive royalty payments must reasonably reflect the amounts that would have been received annually in the form of such payments over the useful life of such property.

Section 367(d) provides that in the case of intangible property in a Section 351 or 361 exchange, the royalty income with respect to such transfer is to be commensurate with the income attributable to the intangible. This means that the constructive royalty is calculated in an amount that represents an arm's length charge for the use of the property under the regulations of Section 482. Under certain circumstances, a U.S. transferor may transfer intangibles to a foreign corporation taxed entirely at the time of transfer as a taxable sale if certain circumstances are satisfied.

In the context of a cross-border reorganization, the transferor of intangible property to a foreign corporation will be treated as having sold "intangible property" discussed above in exchange for payments that are contingent on the productivity, use, or disposition of such property. Section 367(d) provides that in the case of any transfer of intangible property, the transferor corporation must recognize royalty income with respect to such transfer to be commensurate with the income attributable to the property. This means a constructive royalty must be calculated in an amount that represents an arm's length charge for the use of the intangible property (as per the regulations under Section 482).

Example. An example as to how Section 367(d) operates in a typical cross-border reorganization is discussed below.

DC, a U.S. corporation, owns all of the stock of FS, a foreign corporation. (FS is a controlled foreign corporation (within the meaning of Section 957(a)). DC incurs and deducts under Sections 162 and 174 various expenses relating to the development of a patented invention. After completing development of the patented invention, DC transfers the patent to FS in a transaction that, in the absence of Section 367(d), would qualify for nonrecognition treatment under the Internal Revenue Code. FS will use the patent in its trade or business. Section 367(d) will treat DC as having sold the patent to FS in exchange for payments that are contingent on the productivity, use, or disposition of the patent. These constructive royalty payments are calculated in an amount which reflects an arm's length charge for the use of the patent over the useful life of the patent.

In light of the deemed royalty regime, a taxpayer may find it advantageous to structure the transfer of intangible property to a foreign corporation as an actual license rather than as a contribution. One advantage of an actual license may be eligible to be taxed under the Foreign Derived Intangible Income or FDII provisions of the Internal Revenue Code,[23] which could be significantly less than the deemed royalty regime of Section 367(d). One disadvantage of an actual licensing agreement is that the royalty payments may be subject to foreign withholding taxes, although tax treaties often reduce or eliminate the withholding rate.

Anti-inversion rules

Parties involved in cross-border reorganizations must be mindful of the anti-inversion rules of Section 7874. These rules may apply to (1) cause a domestic corporation to recognize gain on the transfer of assets or (2) cause an acquiring foreign corporation to be treated as a domestic corporation for all purposes of the Internal Revenue Code. Section 7874 identifies two different types of corporate inversion transactions and provides a different set of tax consequences to reach each type of inversion transaction.

The first type of inversion is a transaction in which, pursuant to a plan or series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction; (2) the former shareholders of the U.S. corporation

hold (by reason of holding stock in the U.S. corporation) 80% or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50% ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. Section 7874 denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Internal Revenue Code.

In determining whether a transaction meets the definition of an inversion, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded.

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80% ownership threshold is not met. In such a case, if at least a 60% ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits.

The anti-inversion rules do not apply where: (1) the transferee is a foreign partnership; (2) less than substantially all of the assets are transferred; or (3) substantial activities are conducted in the country where the new holding company is located. According to the regulations, the substantial activities test is satisfied only if the following requirements are satisfied:

Group employees.

- The number of group employees based in the relevant foreign country is at least 25% of the total number of group employees on the applicable date.
- The employee compensation incurred with respect to group employees based in the relevant foreign country is at least 25% of the total employee compensation incurred with respect to all group employees during the testing period.

Group assets.

- The value of the group assets located in the relevant foreign country is at least 25% of the total value of all group assets on the applicable date.
- The value of the group assets located in the relevant foreign country is at least 25% of the total value of all group assets on the applicable date.
- The group income derived in the relevant foreign country is at least 25% of the total group income during the testing period.

Anytime U.S. corporate shares or assets of a domestic corporation are transferred to a foreign corporation, the anti-inversion rules must be carefully considered.

Reporting requirements

In order that the IRS will be informed of outbound transfers by Section 367, Section 6038B requires the U.S. corporations and persons involved to notify the IRS of the existence of these transactions. A U.S. corporation and U.S. person who transfers property to a foreign corporation must attach Form 926 (Return by Transferor of Property to a Foreign Corporation) to their regular tax return for the year of the transfer. The penalty for failing to timely file a Form 926 equals 10% of the fair market value of the property transferred or $100,000.

Conclusion

Section 367 imposes a toll charge tax on the income realized on the transfer of certain tainted assets. Acquisition of the stock or assets of a U.S. corporation in exchange for stock of a foreign corporation in a merger or reorganization described in Section 368 is normally within the scope of Section 367. In certain cases, a gain-recognition agreement can be utilized to mitigate the immediate income tax consequences of Section 367. Even if a gain-recognition agreement can be utilized to mitigate the immediate gain recognition associated with Section 367(a), Section 367(d) may trigger a deemed royalty for any intangible transfer abroad. Finally, the U.S. has anti-inversion rules under Section 7874 that must be carefully considered in any cross-border reorganization or asset acquisition. ■

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THE "DEEP STRUCTURE" OF THE DIVIDEND EXCEPTION

ROBERT RIZZI

The new one-percent excise tax on stock buybacks[1] as part of the Inflation Reduction Act of 2022[2] raises a host of questions. The IRS has already issued guidance to help taxpayers with some of these questions,[3] and is open to issuing more help.[4] However, the scope of the new tax, and some of the exceptions to it, highlights structural issues in the tax system.

The statute

Many of the open questions for the stock repurchase tax arise from the fact that the statute taxes a "form" of transaction. Section 4501(a) imposes a non-deductible excise tax as a percentage of the fair market value of any stock of a corporation[5] that is "repurchased" during the taxable year.[6] Section 4501(c)(1) provides that "repurchases" include two forms of transactions:

- Section 317(b) redemptions: "The term repurchase means a redemption within the meaning of § 317(b) with regard to the stock of a covered corporation (§ 317(b) redemption)."[7]
- Transactions "economically similar" to Section 317(b) redemptions: the term repurchase also includes "any transaction determined by the Secretary of the Treasury or her delegate (Secretary) to be economically similar to a § 317(b) redemption (economically similar transaction)."[8]

There are additional provisions for transactions involving stock of certain affiliates of the issuer; these types are not discussed in this column.[9] However, the focus on the redemption form of corporate transactions highlights some underlying problems with the tax.

Exception for dividends

The stock repurchase tax does not apply to transactions in the form of "dividends." The statute thus states that the excise tax "shall not apply * * * to the extent that the repurchase is treated as a dividend for purposes of this title [of the Code]."[10] The Notice supplements this exclusion with an "excepted" list of transactions that are not subject to the tax,[11] including "dividends," and then explains certain important additional aspects with two additional concepts.[12]

First, the Notice provides the mechanism for computing the amount of a given transaction that may fall within the dividend exception, stating that "the fair market value of stock repurchased by a covered corporation is [treated as] a reduction for purposes of computing the covered corporation's stock repurchase excise tax base to the extent the repurchase is treated as a distribution of a dividend under § 301(c)(1)."[13] The referenced subsection is to the "waterfall" that treats distributions of current or accumulated dividends as taxable under Section 316.

Second, the Notice provides a method for evaluating a corporate taxpayer's position that a particular repurchase by the taxpayer is a dividend for purposes of the exception – as opposed to a redemption treated as a sale or exchange under Section 302(a) and therefore subject to the stock repurchase tax — by creating a "rebuttable presumption" that the transaction is *not* a dividend and is therefore not within the dividend exception. This non-dividend presumption provides generally as follows:

- A repurchase that is a redemption to which Section 302 applies is presumed to be subject to Section 302(a) (that is, that one or more of the tests in Section 302(b) applies);
- The presumption can be rebutted with regard to a particular shareholder "solely" *by estab-*

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lishing with "sufficient evidence" that the shareholder treats the repurchase as a *dividend on the shareholder's tax return; and*

- "Sufficient evidence" for purposes of rebutting the presumption can only be shown "if the covered corporation— (A) provides information reporting, as applicable, to the redeemed shareholder, providing that the repurchase constitutes a dividend; (B) obtains certification from the shareholder that the repurchase constitutes a redemption treated as a § 301 distribution under § 302(d), * * * including evidence that applicable withholding occurred if required."[14]

Because of these hurdles, it is not clear whether this rebuttable presumption can be rebutted. Even in the case of an entirely pro rata redemption of a single class of stock, which would usually be the hallmark of dividend treatment,[15] obtaining the necessary "certification" from hundreds or thousands of distributee shareholders (since Section 4501 applies to public corporations) may not be practical.[16] Nonetheless, the scope of the dividend carve-out from the stock repurchase tax will be an important issue for many such transactions.[17]

Form issues for "dividends"

The question of what is a "dividend" and how should dividends be taxed has been a practical and theoretical issue for decades.[18] In the mid-1970s, for example, leading corporate tax practitioners engaged in a spirited debate on the question.[19] Distinctions between redemptions treated as sales or exchanges and distributions treated as dividends out of earnings and profits were the subject of conflicting cases long before then.[20] In general, the IRS generally pushed for dividend treatment, while individual taxpayers sought capital gain outcomes, although litigation incentives sometimes flipped when the distribution was to a corporate shareholder eligible for the dividends-received deduction under Section 243.

The taxation of dividends has generally not, with the exception of dividends in the form of issuer stock,[21] been in doubt. However, the nature of dividends, and whether they represent income to the shareholders in the sense of bestowing an economic benefit (or otherwise an accretion to wealth as one measure of income for tax purposes) has long been debated. Thus, the analysis of dividends in one of the early articles posed the issue as follows:

> A dividend does not confer an economic benefit on its recipient. The distribution leaves the shareholder no richer, since his directly owned assets increase only by the same amount that the beneficial ownership of those assets represented by his stock interest diminishes.[22]

> To suggest that the proper test is whether the shareholders are better off economically after the cash distributions than before is incorrect since no dividend distribution enlarges the net worth of the shareholders. A dividend merely transfers part of the value represented by the

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[1] In new Section 4501. There are already proposals to increase the rate from 1% to as much as 4%, including in the 2023 State of the Union speech. See Reuters, "Investors Focus on Buybacks, Billionaire Tax in Biden Speech," Reuters, 2/8/2023. Legislation was then proposed. See Press Release from Office of Sen. Brown, "Brown, Wyden Introduce Legislation to Increase Tax on Stock Buybacks," 2/14/2023 ("Today, U.S. Senators Sherrod Brown (D-OH) and Ron Wyden (D-OR) introduced the Stock Buyback Accountability Act of 2023, which would increase taxes a publicly-traded company spends on buying back its own stock from one percent to four percent. This will help reinvest in the economy, while also preventing abuse and reducing tax avoidance, both of which are significant risks from stock buybacks.")

[2] Section 4501 was added to a new chapter 37 of the Code by the enactment of the Inflation Reduction Act of 2022, Pub. L. 117-169, 136 Stat. 1818 (8/16/2022) (the "2022 Act"); Committee Reports for the 2022 Act in H. Rept. 117-130, Book 1; H. Rept. 117-130, Book 3; H. Rept. 117-130, Book 2. The Tax Section of the American Bar Association has submitted an extensive report to the IRS. See "Comments on Section 4501 Excise Tax on Certain Repurchases of Corporate Stock," 12/7/2022 ("ABA Report").

[3] See IRS Notice 2023-2, "Initial Guidance Regarding the Application of the Excise Tax on Repurchases of Corporate Stock under Section 4501 of the Internal Revenue Code," 12/27/2022 (the "Notice").

[4] "The Treasury Department and the IRS anticipate that the forthcoming proposed regulations will be consistent with the guidance provided in this section 3." Notice p. 8. See also list of dozens of open issues, Notice pp. 47-51.

[5] Specifically, a "covered corporation." The term "covered corporation" means any domestic corporation the stock of which is traded on an established securities market (within the meaning of Section 7704(b)(1)). Section 4501(b).

[6] Section 4501(a). A de minimis exception applies if, during the taxable year, the aggregate fair market value of the covered corporation's repurchases of its stock does not exceed $1,000,000. Section 4501(e)(3).

[7] Section 4501(c)(1)(A).

[8] Section 4501(c)(1)(B). The Notice provides a list of transactions that are, and are not, economically similar. See Notice pp. 16-18.

[9] For these purposes, "the term specified affiliate means, with regard to any corporation, (i) any corporation more than 50 percent of the stock of which is owned (by vote or by value), directly or indirectly, by the corporation, and (ii) any partnership more than 50 percent of the capital interests or profits interests of which is held, directly or indirectly, by the corporation." Section 4501(c)(2)(B).

[10] Section 4501(e)(6).

[11] Notice pp. 6-7.

[12] Notice p. 7.

[13] Or under Section 356(a)(2), in the case of "boot" received in a reorganization. This column does not address this category of potential "dividends," which in any case should be relatively limited. See *Clark*, 489 U.S. 726 (1989). See also Rev. Rul. 93-61, 1993-2 CB 118.

[14] Notice p. 26 (emphasis added).

[15] See Bittker & Eustice: Federal Income Taxation of Corporations & Shareholders (WG&L) ¶ 9.03[1] ("An ordinary dividend does not disturb shareholders' relative interests in the assets and earning capacity of the corporation, whereas a non–pro rata redemption does").

> [shareholder's] ownership interest in the corporation out of corporate solution and into his personal possession, reducing the value of his corporate interest by the same amount received by him and thus leaving his over-all net worth unchanged.

As the article continues:

> For tax purposes, therefore, a dividend distribution should be regarded simply as an occasion for imposing tax. A dividend is nothing more or less than a taxable event, which individual shareholders usually seek to avoid and corporate shareholders may seek to incur in preference to capital gain.[23]

Under this view, since there is no real economic consequence to a dividend (only a tax one), form not substance can control the characterization of such payments.[24] If form does control, this view could impact the scope of planning for the new stock repurchase tax.

Pre-sale dividends

The challenge of determining whether a payment from a corporation to shareholders is a dividend or instead a sale or exchange is illustrated in connection with so-called "pre-sale dividends," in which earnings are bailed out prior to a corporate sale. These distributions by target corporations prior to a stock sale reflect the fact that corporate buyers are often not interested in "buying cash." The tax consequences of one form of this transaction were highlighted in *Waterman Steamship Corp.*[25]

The basic facts of that case are well known, but bear a brief summary. At the time of the transaction, the taxpayer-seller was the sole owner of two subsidiary corporations, both of which were the targets. The basis of the targets' stock in the hands of Waterman Steamship was approximately $700,000. One of the two targets, Pan-Atlantic Steamship, had substantial undistributed E&P – approximately $2.8 million. The acquiring corporation, McLean, and an affiliate, made a purchase offer for $3.5 million for the two subsidiaries but Waterman Steamship countered that a dividend should be distributed first before any sale and that the purchase price should be set at $700,000.

The timing of the subsequent steps is important. On January 21, 1955, the board of directors of Pan-Atlantic declared a $2.8 million dividend, to be distributed not in cash, but instead in the form of a transfer of promissory notes. That was done at noon. At 1:00PM on that day, the board of Waterman Steamship approved the sale for $700,000. At 1:30PM, McLean loaned Pan-Atlantic Steamship (its new subsidiary) $2.8 million, which was then used to pay off the notes that had been issued 90 minutes earlier.

The taxpayer argued that the $2.8 million pre-sale distribution of the notes was a dividend (and not taxable to it as an intercompany dividend[26]); since the sales "price" ($700,000)

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[16] It is possible that the market may respond to this challenge by including appropriate documentation as a condition to receiving payments, especially in the case of pro rata redemptions. Shareholders with little or no tax basis in their shares would be indifferent, in light of the uniform federal income tax rate on "qualified" dividends and long-term capital gain, Section 1(h)(11), as would tax-exempt shareholders.

[17] See ABA Report § IV.C. This presumption for purposes of Section 4501 of non-dividend treatment for a distribution in redemption of stock contrasts with Section 302(a), which defaults in the other direction — to dividend treatment for a redemption, unless one of the tests in Section 302(b) is met.

[18] See, e.g., *Davis*, 397 U.S. 301 (1970).

[19] See Kingson, "The Deep Structure of Taxation: Dividend Distributions," 85 Yale L. J. 861 (1976); and Roberts et al. "A Report on Complexity and the Income Tax," 27 Tax L. Rev. 325 (1972) (which involved a report of the New York State Bar Association Tax Section) (herein "Kingson"); and see a critique by one of the authors of the latter of the analysis of the former, in Ginsburg, "The Deep Structure of Taxation," published as a lengthy letter to the editor in 86 Yale L. J. 798 (1977) (herein "Ginsburg"), and then finally see "Author's Reply" (by Prof. Kingson) in 86 Yale. L. J. 806 (1977). See also Blum, "Drawing the Line Between Dividends and Investment Adjustments: A Proposal for More Consistency," 55 Taxes 30 (1977).

[20] Bittker & Eustice: Federal Income Taxation of Corporations & Shareholders (WG&L) ¶ 9.01 ("Before 1954, the general rule was that redemptions were treated as sales unless 'essentially equivalent to the distribution of a taxable dividend,'" citing a more extended discussion of early law in Bittker & Redlich, "Corporate Liquidations and the Income Tax," 5 Tax L. Rev. 437, 470–473 (1950)).

[21] *Eisner v. Macomber*, 252 U.S. 189 (1920).

[22] See Kingson at 863 (emphasis deleted). At least one court has tracked this reasoning. See *Casner*, 450 F. 2d 379, 399 (5th Cir. 1971):

[23] See Kingson at 865.

[24] See response to Prof. Kingson's analysis, Ginsburg, pp. 801-802. This approach has also been applied by IRS Chief Counsel to transactions styled as redemptions. See GCM 32825, 4/24/1964 ("From the foregoing, it can be seen that the so-called economic benefit theory is an inappropriate criterion in stock redemption cases.")

[25] *Waterman Steamship*, 430 F.2d 1185 (5th Cir. 1970).

[26] Under the consolidated regulations in effect at the time, the distribution did not reduce the tax basis of the stock of Pan-Atlantic in the hands of Waterman Steamship.

[27] 430 F.2d at 1192.

[28] Kingson p. 872. The article states: "The court did not specifically discuss the tax treatment of * * * the buyers. * * * [but] Pan-Atlantic must be considered to have distributed those notes as a dividend * * * to McLean." The article continues: "Waterman, then, implicitly accepted the Service's view that the economic substance of a distribution to the seller incident to a bootstrap acquisition is a dividend to the buyer." Id. This is also the part of the analysis in *Casner*, 450 F. 2d 379 (5th Cir. 1971). In *Casner*, the court concluded that the pro rata payment of unwanted cash dividends to selling shareholders by their corporations prior to the signing of any binding stock purchase contracts constituted dividends to the buyer followed by the payment of the dividend amounts by the buyer to the selling shareholders as additional purchase price for the stock. The IRS does not follow *Casner*. See Rev. Rul. 75-493, 1975-2 C.B. 108.

matched tax basis, the taxpayer claimed no net gain. However, the appellate court disagreed, stating:

> The so-called dividend and sale were one transaction. The note was but one transitory step in a total pre-arranged plan to sell the stock. In substance, Pan-Atlantic neither declared nor paid a dividend to Waterman, but rather acted as a mere conduit for the payment of the purchase price to Waterman.[27] Thus, the distribution of the promissory notes was not respected as a dividend to Waterman Steamship but was instead treated as part of the payment of purchase price from the buyer.

This is fair enough, but a necessary corollary of the court's analysis is that the dividend from Pan-Atlantic must have gone to the purchaser.[28] If the transactions in Waterman Steamship are treated based upon the IRS recharacterization, then the distribution from the target would be treated as paid to the new owner, followed by the cash being used as part of the purchase price for the stock of the target (or targets) in a direct purchase by the buyer, not the issuer; there would be no redemption.[29]

A number of pre-sale dividend cases followed *Waterman Steamship and came to different results*.[30] In light of potential uncertainty concerning when such pre-sale dividends would be respected as such or instead treated as part of the purchase price, the IRS developed tests to help distinguish between the two characterizations. Thus, in Revenue Ruling 75-493,[31] the IRS ruled that cash paid to a shareholder prior to sale of stock was a dividend, where the buyer had no legal obligation to purchase the stock upon the declaration and payment of the amount to the shareholder. In that ruling, an individual owned all the stock of the target and the target paid out a cash dividend of "unwanted cash." The next day, the acquiring corporation and the seller executed agreement for the sale of the target stock for a "fixed dollar amount." The ruling provides that payment of the distribution did not reduce the buyer's obligation to pay the agreed upon purchase price and "was not part of the consideration paid" for the stock, but instead was a dividend.[32]

Zenz transactions

Contrast this with the typical "Zenz"-type transaction.[33] In the *Zenz case*, the distribution of cash taking the form of a repurchase of a portion of the issuer's outstanding common stock was integrated with the sale to a third-party buyer of the remaining target shares, so that the series of transactions had the effect of a complete termination of all of such shareholders' interest in the corporation;[34] the result would be for such Zenz transactions to fall outside the dividend exception, regardless of whether such acquisitive transactions are related to the underlying policies of Section 4501.[35]

In *Zenz*, it should be noted, the IRS had argued that the distribution step should be treated as a dividend.[36] That the two transac-

[29] Compare *Zenz*, discussed below, notes 34-35. The two examples in the Notice cited below, infra note 35, focus on the source of the cash for the purchase; although distinguishable from *Waterman Steamship*, by extension the approach in these examples could look to the steps as a redemption.

[30] See comprehensive analysis of the issues in Bowen, "Presale Dividends," 71 Taxes 800 (Dec. 1993); see also Bittker & Eustice: Federal Income Taxation of Corporations & Shareholders (WG&L) ¶ 8.07[2][a] ("Identification of the proper taxpayer is often troublesome in the case of a 'bootstrap sale' of stock, in which dividends are credited against the purchase price").

[31] Rev. Rul. 75-493, 1975-2 C.B. 108.

[32] Id.

[33] *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954) acq. Rev. Rul. 54-458, C.B 1954-2, 167; Rev. Rul. 55-745 C.B. 1955-2, 223. See Rev. Rul. 75-447, 1975-2 C.B. 113; see also Rev. Rul. 78-250; 1978-1 C.B. 83.

[34] Technically as a "complete liquidation" of the shareholder's interest under then-Section 115(c), but often analogized to a complete redemption under Section 302(b)(3); see also PLR 200125010 (6/22/2001).

[35] This is confirmed in Notice p. 34, Examples 3 and 4. As to the underlying policies, see ABA Report § I. ("Based on our understanding of the legislative intent of section 4501 * * * we suggest that there are two purposes that section 4501 aims to achieve: (i) To discourage stock buybacks that are intended to artificially inflate the trading price of the corporation's stock, earnings per share ("EPS") or other metrics; and (ii) to incentivize investment of corporate cash into human capital and productive business assets.") There is no formal legislative history stating these policy goals.

[36] 213 F.2d at 916.

[37] O'Connor & Malkuch, "Buyer Beware of Zenz Transactions," Tax Adviser, 2/1/2015.

[38] See note 8, supra.

[39] The "exclusive list" of such economically similar transactions include: acquisitive reorganizations (to the extent of boot); certain single corporation reorganizations; and Section 355-type splitoffs. See Notice pp. 14-20.

[40] Notice, p. 34, Example 3 ("(This treatment results from the fact that Target funded $60x of the consideration received by Target's shareholders in exchange for their Target stock.)")

[41] The analysis would have to take into account secured and unsecured loans to various entities, including special purpose vehicles; new and recycled forms of financing in the capital "stack" inserted at different tiers; upstream and downstream guarantees of various types and contingencies; use of hybrid structures; and other customized arrangements, as well as step-transaction considerations.

[42] See discussion accompanying notes 22-24, supra.

[43] For example, the use of constructive ownership rules, including options, under Section 318 to cause a redemption to be treated as a dividend under Section 302(b)(2). See, e.g., Erickson & Wang, "Exploiting and Sharing Tax Benefits: Seagram and Du Pont," 3/25/1999 ("The substantial tax savings were achieved through clever tax planning on the part of both Seagram and Du Pont, which resulted in the redemption of over 95 percent of Seagram's Du Pont holdings being taxed as a dividend instead of a sale.")

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tions took place as part of one integrated plan (resulting in a termination of the interest of the shareholder) was key to the Sixth Circuit's ruling.[37] Taxpayers, on the other hand, will have an incentive to resuscitate the IRS argument, including by de-linking the steps, if possible.

Economically similar transactions

The risk that the stock repurchase tax could apply to a large number of "economically similar transactions"[38] has been mitigated by the relatively narrow range of such transactions identified in the Notice.[39] None of these include straight cash purchases of stock of a corporation from its shareholders by a third-party. The possibility that the stock repurchase tax might nonetheless apply to even these transactions if a dividend is involved is suggested in one example in the Notice, which focuses on the source of cash for part of the purchase, although that example involved a redemption in form.[40] Converting dividends into transactions subject to the new tax using a source-of-cash rationale would be potentially problematic, especially given the fungibility of corporate cash and the complexity of financing arrangements for typical M&A transactions.[41]

Conclusions

The stock repurchase tax penalizes certain forms of transactions involving transfers of property for stock, and exempts "dividends." These forms have the same economic impact on the distributing corporation — a reduction of assets in corporate solution. Some of the forms also have similar impacts on shareholders; as noted by the commentators cited above, the "deep structure" of dividends is simply a relocation of assets to shareholders, rather than an accretion of an economic benefit.[42] To the extent the tax treatment turns on using dividends in form, planning into that form will be popularized.[43]

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