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Principles Relating to Organization and Taxation of Foreign Investment Activity in the United States

by Stanley C. Ruchelman*

I. Introduction

The acquisition of a business in the United States by a foreign person involves considerations that go beyond tax or legal matters. The issues of paramount importance to most clients, at least from the viewpoint of a professional tax adviser, are more mundane. Will the proposed investment generate operating profits measured by an accounting system that generates accurate and understandable information? Will the value of the investment appreciate over time? Will the particular investment meet the goals of the investor? Once those questions are answered satisfactorily by the investor, his next goal is to maximize his profits and to avoid costly mistakes. In the latter framework, tax advice becomes an important consideration.

The tax advice generally requested by clients may be divided into two broad areas. The first is structural: how should the investment vehicle be organized in order to maximize the repatriation of profits? The second area of advice relates to operating matters: how will the profits of the venture be reported so as to minimize that tax?

This article will attempt to address both areas of concern. In light of the detailed treatises that have been written on U.S. taxation, however, the presentation will be limited to an overview. The author's goal is to provide the reader with a starting point for his own research.

II. Available Structures

The choice of structure through which an investment should be made depends upon the type of business that will be conducted, the nature of the investor, and the goals behind the investment. Most of those goals will likely be related to matters other than U.S. taxation. Once the investor explains his goals and the parameters of the proposed investment, the tax adviser can perform his function in the planning process.

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A. Individual Personal Investment or Sole Proprietorship

This investment vehicle involves direct ownership of a business conducted in the United States or a revenue producing physical asset such as real estate, and is in contrast to stock ownership of a business operating in the United States. Direct ownership of a business by a foreign individual generally will cause that individual to be taxed in the United States. Internal Revenue Code section 871(b)¹ provides in part that the ordinary rates of tax will be imposed on a foreign individual's income which is effectively connected with the conduct of a trade or business in the United States. The rules for determining when income is considered to be effectively connected are discussed in Part III.B. below.

If the foreign individual is married to a nonresident alien spouse, the U.S. tax imposed on effectively connected income is computed by reference to the rates for married individuals filing separate returns.² Where both spouses are nonresident aliens, an election to file a joint return is not available.³ This results in a greater tax liability because the rates for separate returns are more steeply graduated than those for joint returns.⁴

Individuals rarely acquire businesses directly. The reasons, which include significant U.S. and foreign tax considerations, go beyond the amount of tax under one set of rates in comparison to the tax under a second rate.

An individual who acquires a U.S. business and actively operates that business from a location in this country flirts with becoming a resident of the United States for tax purposes. Continuous presence in the United States, a significant investment in a business, active participation in managing that business, and the social, economic, and ancillary contacts that could develop in a community could expose the foreign person to a risk of inadvertent relinquishment of nonresident status.⁵ He will be present in the United States and will begin to appear to be more than a sojourner.

Residents of the United States are subject to U.S. tax on worldwide

¹ I.R.C. § 871(b) (West Supp. 1981). All statutory references are to the Internal Revenue Code of 1954 as amended through Oct. 31, 1981, unless otherwise indicated.

² These rates are provided in I.R.C. § 1(d) (rates for 1982, reprinted in [1982 Index] Fed. Tax Rep. (CCH) ¶ 414).

³ The rule in the text should be compared with the rules available to a married couple of which one spouse is a citizen or resident of the United States at the end of the year. See I.R.C. § 6013(g), (h). Subject to certain conditions (including reporting worldwide income for the full year), those individuals may elect to file a joint return.

⁴ Under the rate schedule for 1982, the tax for a married couple filing a joint return and having \$60,000 of taxable income is \$17,705. If the same couple reported the same income in the husband's return and a separate return were filed, the tax would be \$23,724. Moreover, see I.R.C. § 1(a), (d) (rates for 1982, reprinted in [1982 Index] Fed. Tax Rep. (CCH) ¶ 414). I.R.C. § 1348 (1976 & Supp. III 1979).

⁵ See *Escobar v. Commissioner*, 68 T.C. 304 (1977); see also *Sochurek v. Commissioner*, 300 F.2d 34 (7th Cir. 1962), involving residency for purposes of benefits granted U.S. citizens who are residents of foreign countries.

income.⁶ Moreover, U.S. residents are subject to tax on the undistributed income of foreign personal holding companies,⁷ and on the unrepatriated profits of controlled foreign corporations to the extent those profits are generated by Subpart F income.⁸ U.S. residents also are required to report ownership or signatory authority over foreign bank accounts⁹ and are subject to the anti-boycott rules of the Code.¹⁰

If the foregoing provisions, by themselves, are not sufficient to discourage direct ownership of a U.S. business, a foreign person who owns U.S. situs property at death may cause his estate to be subject at least in part to U.S. estate tax.¹¹ The gross estate of a nonresident alien individual is comprised of property situated in the United States.¹² Clearly, the business assets or real property in the United States would be viewed as situated in the United States. If a foreign individual is considered domiciled in the United States, and thus a resident for purposes of estate tax, his entire estate is subject to tax.¹³ The gross estate will include all property, irrespective of situs.¹⁴

Finally, there may be foreign tax reasons which make direct ownership inadvisable. For example, the investor's home country may impose tax on the worldwide income of its individual residents, but not include unrepatriated income of offshore companies within its tax base even when those companies are owned by residents. Thus, the investor may wish to defer the taxable event in his home country with the use of a corporation.

In further illustration, the investor's home country may tax gains derived from the sale of shares of stock more favorably than from the sale of business assets. Thus, for an investor interested in capital appreciation, stock ownership may be more desirable than direct ownership of business assets.

Finally, the investor may be a resident of a country with which the United States has an income tax treaty. In that event, the treaty may include a standard provision calling for the exchange of information between the tax authorities of the two countries.¹⁵ If the investor wishes to retain absolute privacy as to his investments in the United States, then direct ownership is inappropriate.

⁶ Treas. Reg. §§ 1.1-1(b), 1.871-1(a), 26 C.F.R. §§ 1.1-1(b), 1.871-1(a) (1981).

⁷ I.R.C. § 551 (Supp. III 1979).

⁸ Id. § 951 (1976).

⁹ Treas. Reg. § 103, 31 C.F.R. § 103 (1981).

¹⁰ I.R.C. § 999 (1976 & Supp. III 1979).

¹¹ The threshold of residence for estate tax purposes is higher than for income tax purposes. Under 26 C.F.R. § 20.0-1 (1981), domicile is required.

¹² I.R.C. § 2103 (1976).

¹³ Id. § 2001(a) (1976 & Supp. III 1979).

¹⁴ Id. § 2031(a) (1976).

¹⁵ See, e.g., Proposed United States-Canada Income Tax Treaty, art. XXVII (exchange of information), 1 Tax Treaties (CCH) ¶ 8103A.

B. Individual or Corporate Portfolio Investments

In comparison to the situation of a sole proprietorship, the control of business operations is likely not to be a key goal of the foreign person who wishes to make a portfolio investment in the United States. This type of investor is generally interested in diversifying his investment so that he benefits from the business acumen of professional operating management. For this investor liquidity of investment is important; to the extent the portfolio investment is comprised of publicly traded stocks and securities, liquidity will exist.

(1) *Passive Income.* The type of income likely to be generated for the portfolio investor will be (i) dividends and interest and (ii) capital gains. Dividends and interest are components of a class of income known as fixed and determinable, annual and periodic income.¹⁶ For ease of illustration, that class of income will be referred to as "passive income." Passive income in the hands of a foreign person is taxed in the United States only when the income is deemed to have arisen from sources within the United States. As a general rule, dividends and interest are deemed to arise in the United States when paid by a U.S. corporation.¹⁷ For a portfolio investor, passive income is generally subject to a thirty percent withholding tax imposed on the gross amount of the income.¹⁸ If a U.S. treaty is involved, this rate may be reduced to fifteen percent for dividends and eliminated entirely for interest.¹⁹

(2) *Capital Gains.* Foreign corporations generally are not taxed in the United States on capital gain income.²⁰ For an individual investor, only "U.S. source" capital gains may be taxed, and tax is imposed only if the investor personally is present in the United States for at least 183 days during the taxable year in which the gain is reported.²¹ The investor is allowed to set off capital losses incurred during the year in computing the taxable gain; however, only losses allocated to the United States are available as a set-off.²² The tax is imposed at the rate of thirty per-

¹⁶ I.R.C. § 871(a)(1)(A) (1976).

¹⁷ Id. § 861(a)(1) (West Supp. 1981) in regard to interest; id. § 861(a)(2)(A) in regard to dividends. There are circumstances in which dividends and interest paid by a domestic corporation will be deemed to arise from sources outside the United States. If, for a three-year measuring period which ends with the year preceding that in which the dividends or interest is paid, more than 80% of the domestic corporation's gross income is derived from sources outside the United States, the dividend or interest is considered to be foreign source income in the hands of the recipient. Id. §§ 861(a)(1)(B), (a)(2)(A) (West & West Supp. 1981). In addition, there are times when dividends and interest paid by a foreign corporation will be viewed to arise in the United States. See id. § 861(a)(1)(D), (a)(2)(B). See *infra* text accompanying notes 79-83.

¹⁸ I.R.C. § 871(a) (West Supp. 1981). See id. §§ 1441, 1442 (1976) with respect to payment of the tax through withholding at source.

¹⁹ See, e.g., Treas. Dep't Model Income Tax Treaty of May 17, 1977, arts. 10, 11 (Dividends and Interest respectively), 1 Tax Treaties (CCH) ¶ 153.

²⁰ I.R.C. § 881 (1976) contains no provisions to tax these gains.

²¹ Id. § 871(a)(2) (1976).

²² Id.

cent of the taxable gain.²³

The rules under which the source of gain is determined differ from the rules pertaining to the source of loss. Gains from the purchase and sale of personal property are treated as derived entirely from the country in which the property is sold.²⁴ The gains are considered to be sourced in the country in which the rights, title and interest of the seller are transferred, generally where beneficial ownership and risk of loss pass to the buyer. The location of transfer usually can be controlled by contract; however, the regulations provide that the general rule will not apply where a sale is arranged for the primary purpose of tax avoidance.²⁵ In such cases, other factors such as the location of negotiations, the place at which the agreement was executed, the location of the property, and the place of payment are to be considered.²⁶ The validity of these regulations has been questioned in light of case law to the contrary.²⁷

The regulations relating to the allocation of losses provide that losses are allocable to the class of gross income (that is, foreign or U.S. source income) to which such assets ordinarily give rise in the hands of the taxpayer.²⁸ Thus, a loss incurred on the sale of a share of stock in a domestic corporation should produce U.S. source loss even if beneficial ownership passes outside the United States.²⁹

C. Trusts

A trust is generally suggested as a vehicle to acquire a U.S. business when anonymity is a significant goal of the investor. The anonymity desired, however, is frequently offset by complications of U.S. law.

A frequent scenario in the case of a trust is that the stated foreign settlor and the stated foreign beneficiary of the trust are nominees for the true parties in interest. Quite often the settlor is an attorney for a foreign bank and the beneficiary is his secretary. The trust frequently is controlled by an unnamed foreign individual who has provided the funds for the investment.

If the trust contains sufficient characteristics to be classified as a grantor trust under Part IE of Subchapter J of the Code,³⁰ the grantor will be subject to tax as if he made the investment directly.³¹ Thus, the grantor must file an income tax return and the corpus of the trust will be included in the grantor's estate to the extent the corpus is comprised of

²³ *Id.*

²⁴ Treas. Reg. § 1.861-7(a) (1960).

²⁵ *Id.* § 1.861-7(c).

²⁶ *Id.*

²⁷ See *A.P. Green Export Co. v. United States*, 284 F.2d 383 (Ct. Cl. 1960); *Barber-Greene Americas, Inc. v. Commissioner*, 35 T.C. 365 (1960).

²⁸ Treas. Reg. § 1.861-8(e)(7)(i) (1981).

²⁹ Except as noted previously, dividends paid by a domestic corporation would be U.S. source income. See *supra* note 16.

³⁰ I.R.C. §§ 671-679 (1976 & Supp. IV 1980).

³¹ *Id.* § 671; Treas. Reg. § 1.671-2(c) (1960).

U.S. situs assets.³²

If the trust is not considered to be a grantor trust, the ordinary rules of Part IB, C, and D of Subchapter J apply.³³ To the extent distributions are made currently,³⁴ the beneficiaries are treated as if they received the income directly.³⁵ Thus, tax is determined in their hands and credit may be claimed for the withholding tax imposed on the trustee.³⁶ If the trust accumulates income, however, the trust is treated as a separate taxpayer.³⁷ In that event, if the trust is a foreign trust and the income is passive, then the thirty percent tax is imposed.³⁸ If it is a domestic trust or if the income is treated as "effectively connected income"³⁹ in the hands of a foreign trust, the trust is subject to the ordinary rates of tax.⁴⁰ Finally, if an accumulation distribution is subsequently made, the beneficiary will be taxed and the throwback rules will apply.⁴¹ While the beneficiaries will be entitled to a credit for taxes paid by the trust, refunds will not be allowed even though the tax in their hands might be less than the tax imposed on the trust.⁴² The tax would be less for the beneficiaries where, for example, (i) the trust is a domestic trust, (ii) the trust derived capital gain on which U.S. tax has been paid, and (iii) the beneficiaries would have been exempt from U.S. tax on the gain had it been received directly.⁴³

D. Sales Agency or Distributorship

The desires of the foreign person who raises questions about sales agencies or distributorships differ markedly from those of the sole proprietor, the portfolio investor or the grantor of a trust. This person, which we shall assume is a corporation, is likely to be in a manufacturing business in its home country and is interested in penetrating the U.S. market. In comparison to the sole proprietor, this person does not wish to become involved directly in the operation of a U.S. business, at least not in the near term. Rather, this person is interested in its own business of manufacturing in its home country. In comparison to the portfolio investor, this person does not wish to have a liquid investment in the United

³² I.R.C. § 2104(b) (1976); Treas. Reg. §§ 1.671-2(a), -3(a) (1981).

³³ See Treas. Reg. § 1.678(a)-1 (1981).

³⁴ I.R.C. § 663(b) (Supp. III 1979) provides that distributions made within 65 days after the close of a taxable year of a trust are deemed to have been made on the last day of that year.

³⁵ Id. §§ 651, 661 (1976).

³⁶ Treas. Reg. § 1.1462-1(b) (1960).

³⁷ I.R.C. § 641(a)(1) (1976 & Supp. III 1979).

³⁸ Id. § 871(a)(1)(A) (1976).

³⁹ See *infra* text at Part III.B.

⁴⁰ I.R.C. §§ 641(b), 871(b) (1976 & Supp. III 1979). The ordinary rate of tax for a trust is the tax a U.S. resident individual would pay under id. §§ 1, 3 (rates for 1982, reprinted in [1982 Index] Fed. Tax Rep. (CCH) ¶¶ 414, 443). See Treas. Reg. § 1.1462-1(b) (1960).

⁴¹ I.R.C. §§ 665-668 (West & West Supp. 1981).

⁴² Id. § 666(e) (1976).

⁴³ IRS Private Letter Ruling 7933075 (May 21, 1979). This ruling concerned I.R.C. §§ 871, 874 (West & West Supp. 1981).

States and is not interested in capital appreciation. Rather, this person is looking to increase production in order to better utilize fixed investment; in that manner, its goal is to increase the profits of an existing business. Finally, in comparison to the grantor of a trust, this person wants notoriety in the form of brand name recognition.

This investor's main U.S. tax concern is to avoid being drawn into the United States tax jurisdiction with respect to its manufacturing profits. Thus, it will likely arrange for its product to be distributed by a distributor in the United States, or in the alternative to be sold by a sales agent in the United States. The distributor or agent may be wholly independent or may be a subsidiary⁴⁴ formed to serve that function. Whether the agent is dependent or independent will be determined by the desire of the manufacturer to establish a marketing organization.

The mere appointment of an agent will not, by itself, insulate the foreign person from U.S. tax exposure. The key issue is whether the foreign person maintains a stock of inventory in the United States from which the distributor or agent regularly draws in filling orders.⁴⁵

If the foreign person maintains a stock of inventory in the United States, it follows that sales will be made in the United States. If we assume that the foreign person is a manufacturer, it will have income from the manufacture of goods in its home country and the sale of inventory in the United States—either to the distributor or to the customer of the agent. This type of income is referred to as income not specified in Code section 861 or 862⁴⁶ and is treated as income partly within and partly without the United States. The Code requires that the income must be allocated between those two classes.⁴⁷

The regulations provide three possible methods of allocation to be applied in a specific order.⁴⁸ First, if the manufacturer regularly sells part of its output to wholly independent distributors in such a way as to establish fairly an independent factory price, that price may be used to allocate a portion of the manufacturing and sales income to manufacturing activities. The remainder is deemed to be selling income.⁴⁹ This method possibly could be used when the foreign corporation sells to a U.S. distributor but it likely would not apply when the foreign corporation exclusively utilizes a sales agent in the United States.⁵⁰

If an independent factory price cannot be established, the taxable income from the manufacture and sale is first computed. Half of that

⁴⁴ For the tax treatment of subsidiaries, see *infra* text accompanying notes 96-105.

⁴⁵ See I.R.C. § 863 (West Supp. 1981).

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ Treas. Reg. § 1.863-3(b)(2), 26 C.F.R. § 1.863-3(b)(2) (1981).

⁴⁹ See *id.*

⁵⁰ For purposes of the discussion in the text, a distributor is deemed to take title to the inventory at some point prior to the sale for consumption. In comparison, it is assumed that an agent never takes title, but merely sells on behalf of its principal.

income is allocated on the basis of property used to manufacture and sell. The average book value (or actual value) of property located within the United States is compared to the average book value (or actual value) of property worldwide. The remainder is allocated on the basis of sales; sales within the United States are compared to sales worldwide.⁵¹

Finally, a separate accounting method of allocation may be used if the approval of the IRS is obtained.⁵²

In planning this investment, the tax adviser should examine carefully the allocation of income to the U.S. "presence." Because sales activity by an agent would be attributable to its principal,⁵³ a consistent pattern of sales activity in the United States is likely to be viewed as the conduct of a trade or business in the United States. A similar result is likely to follow if sales are made from a stock of inventory to a distributor.⁵⁴ To the extent that a portion of the manufacturing and sales income is attributable to the sales function, the income would be taxed as business income effectively connected with the conduct of a trade or business in the United States.⁵⁵

The tax adviser can assist his client in minimizing its tax risk in these circumstances. The simplest method is to insure that the stock of inventory in the United States is maintained only by the distributor, not the foreign person. If this can be accomplished, the manufacturer will have no recurring sales activity in the United States and will have no agent in the United States carrying on its business.⁵⁶ If possible, the sale to the distributor should be structured so that title to the inventory passes outside the United States. In only rare circumstances can a foreign sale result in effectively connected income.⁵⁷ In no case can a sale of inventory that produces foreign source income be taxed in the United States if the foreign company maintains no office in this country.⁵⁸

In some instances, the distributor will not want to carry the cost and risk of the inventory. In such case it may be possible to avoid U.S. tax by recourse to an income tax treaty if one is applicable to the foreign corporation. A prerequisite for the imposition of U.S. tax on the business profits of a treaty country resident is a "permanent establishment."⁵⁹ Ordinarily, neither the maintenance of a stock of goods nor an agent

⁵¹ See examples pertaining to Treas. Reg. § 1.863-3(b)(2), 26 C.F.R. § 1.863-3(b)(2) (1981).

⁵² *Id.*

⁵³ *Handfield v. Commissioner*, 23 T.C. 633 (1955); cf. *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), *aff'd* on another issue 221 F. 2d 227 (9th Cir. 1955).

⁵⁴ Cf. Rev. Rul. 76-322, 1976-2 C.B. 487, involving a sale of inventory goods by an Australian company to its U.S. subsidiary. The sales were on consignment. The ruling holds that the Australian company had no permanent establishment in the U.S. A fortiori, the Australian company was not engaged in business in the U.S.

⁵⁵ I.R.C. § 864(c)(3) (1976).

⁵⁶ Cf. Rev. Rul. 73-158, 1973-1 C.B. 337.

⁵⁷ I.R.C. § 864(c)(4)(A) (1976).

⁵⁸ See *id.* § 864(c)(4)(A), (B).

⁵⁹ See *infra* text accompanying notes 193-203.

devoid of the power to bind its principal will suffice as a permanent establishment.⁶⁰

E. Branch of a Foreign Company

(1) *Circumstances Prompting a Branch.* An investor that intends to establish a branch of a foreign corporation in the United States probably has accepted the jurisdiction of the United States to impose tax on the branch's business in this country. A branch of a foreign corporation may range from being a relatively small part of a larger business enterprise to, for all intents and purposes, the entire operating enterprise. The former generally occurs when a foreign bank establishes a branch or an agency in the United States. The latter often occurs when a single purpose development company is formed outside the United States by foreign individuals to develop real estate in the United States.

A branch may also be used when start-up losses are anticipated. The use of a branch may enable the foreign corporation to utilize U.S. losses as a set-off against home country profits. If the home country allows groups of corporations to report income on a consolidated basis or the equivalent,⁶¹ the foreign corporation is likely to form a separate subsidiary⁶² in an attempt to limit legal liability. When that occurs, the entire business of that subsidiary likely will be found in the operations of its U.S. branch. If the home country does not allow for consolidated reporting, the foreign corporation may establish its own branch in the United States. In that type of circumstance, the branch probably will be a relatively small part of a larger operating entity.

(2) *Computation of Branch's Income and Deductions.* When a branch is established, the two broad areas for tax planning involve (i) special rules for the computation of income and (ii) exposure to U.S. withholding tax when the foreign corporation pays dividends or interest.

Once the branch begins U.S. operations, the foreign corporation is subject to tax on income that is effectively connected with the conduct of its trade or business within the United States. For purposes of computing taxable income, deductions are allowed only if and to the extent that they are attributable to income that is effectively connected with that trade or business.⁶³ The IRS has the authority to establish rules for pur-

⁶⁰ Rev. Rul. 76-322, 1976-2 C.B. 487, involves a consignment sale by an Australian corporation to its wholly owned distributor in the United States. The distributor sold the inventory in its own name to customers. The practice of the subsidiary was to acquire the consigned goods for a prearranged price immediately prior to delivery. The Australian company did not have a permanent establishment in the United States.

⁶¹ An example of a reporting system which is the equivalent of a consolidated return is group relief in the United Kingdom. Group relief, in general, allows the trading losses of one member of a 75% group to be claimed as a deduction in computing the tax accounts of another member of the group.

⁶² For tax treatment of U.S. subsidiaries, see *infra* text accompanying notes 96-105.

⁶³ I.R.C. § 882(c)(1)(A) (1976).

poses of determining the allowable deductions.⁶⁴

(a) *In general.* Because the foreign corporation, not the U.S. branch, is the taxpayer, the foreign corporation may deduct expenses incurred at the home office when computing U.S. taxable income.⁶⁵ The regulations emphasize the factual relationship between the deduction and gross income.⁶⁶ Although most deductions will be definitely related to specific items of gross income, there are others that are only generally related to total gross income and some that are treated as not definitely related to any item of gross income.

A deduction is considered definitely related to an item of gross income and therefore allocable to such gross income if it is incurred as a result of an activity or in connection with property that produces gross income.⁶⁷ The income need not be properly reported for the year in which the expense is incurred for the expense to be directly related to that item of gross income. Thus, where a deduction is incurred as a result of an activity or in connection with property which has generated or could reasonably be expected to generate gross income, that deduction is considered definitely related to such gross income even though no income is reported in that year. Definitely related expenses, or direct expense, include expenses specifically incurred to earn U.S. income. Illustrations of direct expenses include travel expenses of head office personnel visiting the U.S. on business matters of the branch, moving expenses for personnel and their families transferred to the United States, telex and telephone charges related to discussions of U.S. operations, and salaries of foreign personnel working in the home office on branch business matters.⁶⁸

The regulations specifically allow deduction of a reasonable allocation of indirect expenses.⁶⁹ However, no guidance is provided as to how the allocation should be made. Possible formulas to use for allocation of indirect expenses include gross income (gross income of the U.S. branch divided by total gross income of the foreign corporation), assets, number of personnel, payroll expense incurred, space utilized and time spent.⁷⁰ When allocating indirect expenses for purposes of computing U.S. taxable income, the foreign corporation is not required to use the same method that is used for the purposes of any other country's tax.

All deductions claimed on the U.S. tax return are subject to the limitations of U.S. law. Thus, some items of home office expense are not

⁶⁴ The regulations which govern the allocation and apportionment of deductions appear at Treas. Reg. §§ 1.861-8, 1.882-4, 1.882-5; 26 C.F.R. §§ 1.861-8, 1.882-4, 1.882-5 (1981).

⁶⁵ See I.R.C. § 882(c)(1)(A) (1976); Treas. Reg. § 1.861-8(a)(2); 26 C.F.R. § 1.861-8(a)(2) (1981).

⁶⁶ Treas. Reg. § 1.861-8(b); 26 C.F.R. § 1.861-8(b) (1981).

⁶⁷ Id. § 1.861-8(b)(2).

⁶⁸ Id. § 1.861-8(g). For example, Example (21) is addressed to supportive expenses incurred outside the United States by a foreign corporation.

⁶⁹ Id. § 1.861-8(c)(1).

⁷⁰ Id.

deductible even though they relate to the operations of the U.S. branch. An item presently causing trouble for foreign corporations operating in the United States is head office travel and entertainment expense for which U.S. substantiation rules are not met.⁷¹

(b) *Interest expense*. The establishment of a U.S. branch will likely be accompanied by borrowing to fund the operation. The borrowing will result in interest expense. The extent to which that interest expense is deductible, however, is not entirely dependent on the actual amount paid or accrued. Special rules apply to the computation of interest expense for purposes of computing taxable income.⁷²

Under the regulations, a foreign corporation's worldwide debt-to-equity ratio is applied to its branch to determine the amount of debt for income tax purposes.⁷³ Thus, if a foreign corporation has \$100,000,000 in assets, of which \$40,000,000 were raised by debt and \$60,000,000 were raised by shareholder capital, the worldwide debt-to-equity ratio is two to three. If the corporation has a U.S. branch with \$30,000,000 of average total assets, the branch is deemed to have \$12,000,000 of debt and \$18,000,000 of capital. The actual amount of debt incurred is disregarded in computing debt for tax purposes. In lieu of the worldwide debt-to-equity ratio of the foreign corporation, the foreign corporation may elect a 1:1 ratio.⁷⁴ If the foreign corporation is a bank, it may elect a 19:1 ratio.⁷⁵

Once the amount of the branch's debt has been computed, the regulations allow foreign corporations to choose one of two methods to determine the appropriate interest rate. These methods are referred to in the proposed regulations as "the branch book/dollar pool method" and "the separate currency pool method."⁷⁶ When a method is chosen, it may not be changed without the consent of the IRS.

Under the branch book/dollar pool method, the interest rate is determined by dividing the total interest expense incurred by the branch during the year by the average amount of liabilities reported on its books for the year.⁷⁷ That rate is then multiplied by the amount of debt as computed for tax purposes. Under the separate currency pool method,

⁷¹ I.R.C. § 274(d) (1976).

⁷² Treas. Reg. § 1.882-5; 26 C.F.R. § 1.882-5 (1981). The regulations applicable to foreign corporations are based on the theory that *capital* is fungible. Id. § 1.861-8(e)(2) explains that (i) all business activities and assets require funds, (ii) funds may be derived from operations, shareholder capital, and borrowings, and (iii) management has significant flexibility in applying specific funds for specific uses. Accordingly, an allocation of interest expense based on asset values must be used in lieu of a direct tracing method or a method based on gross income. Compare the regulations that apply to U.S. persons with foreign operations which are based on the theory that money is fungible and that interest expense should be allocated to reflect the manner in which capital is employed.

⁷³ Id. § 1.882-5(b)(2)(ii); see also id. § 1.882-5(c)(2).

⁷⁴ Id. § 1.882-5(b)(2)(i).

⁷⁵ Id.

⁷⁶ Id. § 1.882-5(b)(3).

⁷⁷ Id. § 1.882-5(b)(3)(i).

the computations are somewhat more complex. In essence, the average interest rate paid by the foreign corporation in each particular currency is computed. The interest expense in each currency is allocated to the U.S. branch on the basis of its liabilities incurred in each particular currency, as adjusted for tax purposes.⁷⁸

(3) *Taxation of Dividends and Interest.* The foregoing discussion is likely to have greater application to a U.S. branch that is a portion of a larger enterprise. If the branch comprises the enterprise, the area of concern shifts to the U.S. taxation of dividends and interest paid by that corporation.

When a foreign corporation engages in a trade or business in the United States, there is a presumption under the regulations that interest and dividends paid by that corporation are considered to be from sources within the United States.⁷⁹ Since this income would be considered passive income, it would be subject to a thirty percent tax in the hands of a foreign recipient.⁸⁰

The presumption of U.S. source income may be rebutted if it is demonstrated to the satisfaction of the IRS that less than fifty percent of the foreign corporation's gross income from all sources for a specified period is effectively connected with the conduct of the trade or business in the United States.⁸¹ If fifty percent or more of the gross income of a foreign corporation for the specified period is effectively connected with the conduct of a trade or business within the United States, an allocable portion of the interest and dividends paid by that corporation is treated as domestic source income. That portion is the amount which bears the same ratio to the total amount paid as the foreign corporation's effectively connected gross income for the period bears to its worldwide gross income for the same period.⁸²

The imposition of U.S. tax on the payment of dividends and interest by a foreign corporation operating in the U.S. through a branch very likely may be unanticipated by the foreign investor. In essence, interest on a loan to a foreign corporation to fund operations outside the United States could be subjected to both U.S. and foreign withholding tax. It should be pointed out that, in lieu of the foregoing treatment of dividends and interest, many countries impose a tax on the payment of all interest paid by a local branch and on the remittance, or deemed remit-

⁷⁸ Id. §1.882-5(b)(3)(ii).

⁷⁹ Id. §§ 1.861-2(b)(3)(1) (1975) (relating to interest); id. § 1.861-3(a)(3)(i)(a) (relating to dividends), 26 C.F.R. § 1.861-3(a)(3)(i)(a) (1981).

⁸⁰ I.R.C. §§ 871(a)(1)(A), 881(a)(1) (1976) (dealing with individual recipients and corporate recipients, respectively).

⁸¹ The rules for determining the specified period are the same as those discussed previously in connection with interest paid by a domestic corporation which derives less than 20% of its gross income from sources within the United States. See *supra* note 17 and accompanying text.

⁸² I.R.C. § 861(a)(1)(D), (a)(2)(B) (1976) (dealing with interest and dividends, respectively).

tance, of all profits from the branch to the home office.⁸³

F. Partnership (General or Limited)

The foreign investor wishing to utilize the partnership vehicle for an investment in the United States usually is interested in acquiring improved real estate, such as a shopping center, or developing unimproved real estate. Invariably, a local developer or real estate manager requires funding for a development project or an acquisition. The partnership vehicle affords the foreign person who has the funds the ability to finance the U.S. person who has the opportunity.

Under state law, distinctions may exist between unincorporated joint ventures, limited partnerships, and general partnerships. For tax purposes, however, the foreign investor's tax treatment under all three vehicles will be controlled by the same set of rules.⁸⁴ Unincorporated joint ventures are treated as partnerships to the extent the venturers intend to carry on business and divide the resulting gains.⁸⁵

A partnership is not a taxable entity in the United States.⁸⁶ Rather, the partners are liable for tax in their individual capacities. As a general rule, the character of each item of income, gain, loss, deduction, or credit included in a partner's distributive share of partnership results is determined as if the item were realized directly by the partner.⁸⁷ If the partnership is engaged in business in the United States, its foreign partners are considered as being so engaged.⁸⁸ This rule is applicable to limited partners of limited partnerships as well as to general partners.⁸⁹

The tax problems that commonly arise when a foreign person participates in a U.S. partnership include the full range of partnership related tax issues plus those distinctly applicable to foreign persons. A principal issue faced in many purely domestic partnership situations is the special allocation of partnership items. When a foreign person invests in the United States through a partnership, no current benefit is provided from operating losses. A foreign partner is likely to have little or no income effectively connected with the conduct of a trade or business in the United States other than the distributive share in this particular partnership. Accordingly, the "tax shelter" effect of partnership losses is of no current value. The U.S. partner, on the other hand, fre-

⁸³ See, e.g., *The Venezuelan Branch Profits Tax*, (Impuesta Sobre La Renta), tit. IV, ch. II, art. 49 (1968), discussed in Rev. Rul. 75-377, 1975-2 C.B. 294, involving a tax on a deemed distribution of profits.

⁸⁴ It is assumed that the limited partnership is not viewed to be an association taxable as a corporation under Treas. Reg. § 301.7701-2 (1954). In any event, many foreign investors in U.S. real property desire a degree of control in the partnership operations which would preclude use of a limited partnership.

⁸⁵ Treas. Reg. §§ 301.7701-2(a), -3(a) (1954).

⁸⁶ I.R.C. § 701 (1976).

⁸⁷ Id. § 702(b).

⁸⁸ Id. § 875(1).

⁸⁹ Rev. Rul. 75-23, 1975-1 C.B. 290.

quently has sufficient outside income to make the losses attractive. The issue presented is to allocate the losses to the U.S. partner without running afoul of the requirement that all such special allocations must have substantial economic effect.⁹⁰ In general, this is accomplished by allocating a greater percentage of both income and loss to the U.S. partner for a specified period of time or until certain operating goals are achieved. The income and loss so allocated need not match the distribution pattern.⁹¹

A second issue that is raised frequently by the IRS is whether the partnership as an entity is engaged in a trade or business. In general, this issue is raised for development partnerships and is intended to deny deductions for operating expenses by classifying them as nondeductible pre-operating expenditures.⁹² Acceleration of operations and operating income will likely overcome this type of issue. In the alternative, the partnership may elect to amortize start-up expenditures over a sixty-month period.⁹³

A third issue that often arises relates to the special status of one of the partners as a nonresident alien or foreign corporation. An analysis of the income of the partnership generally is required to determine whether it has derived income that would be passive income in the hands of a foreign person. The partnership is required to withhold U.S. tax on a foreign partner's distributive share of passive income.⁹⁴ Finally, if the foreign partner is an individual, his taxable estate may include his distributive share of the partnership's U.S. situs property.⁹⁵

G. Affiliate or Subsidiary U.S. Corporation

The organization of an affiliate or subsidiary U.S. company provides only limited opportunity for tax planning. Care should be taken if the investor is a foreign individual in order to guard against U.S. estate tax. Shares of stock in a U.S. corporation are deemed to be U.S. situs property for estate tax purposes.⁹⁶ Estate tax exposure can be avoided if the foreign individual holds his interest through a foreign holding company. Except in unusual circumstances, shares of stock in foreign corporations are deemed to be situated outside the United States.⁹⁷

If the foreign person owns an existing U.S. corporation, considera-

⁹⁰ Treas. Reg. § 1.704-1(b)(2), 26 C.F.R. § 1.704-1(b)(2) (1981).

⁹¹ Id. § 1.704-1(b)(1).

⁹² The IRS successfully argued this point in *Todd v. Commissioner*, 77 T.C. 246 (1981), and *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980); however, the contention was dismissed in *Blitzer v. United States*, 1981-1 U.S. Tax Cas. (CCH) (Stand. Fed. Tax Rep.) ¶ 9262 (Ct. Cl. Mar. 12, 1981).

⁹³ Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605 § 102(a), 94 Stat. 352 (to be codified at I.R.C. § 195(a)).

⁹⁴ Treas. Reg. § 1.1441-4(f), 26 C.F.R. § 1.1441-4(f) (1981).

⁹⁵ See *Sanchez v. Bowers*, 70 F.2d 715 (2d Cir. 1934).

⁹⁶ I.R.C. § 2104(a) (1976).

⁹⁷ Treas. Reg. § 20.2105-1(f), 26 C.F.R. § 20.2105-1(f) (1981).

tion should be given to having the two companies form an affiliated group.⁹⁸ An affiliated group can join in the filing of a consolidated return⁹⁹ so that losses of one member company can be used to offset income of another.

A consolidated return, however, can be filed only if an affiliated group exists. In broad terms, an affiliated group is defined to mean a chain of includible corporations comprised of a common parent and one or more subsidiaries in which stock representing eighty percent of the voting power is owned by the other members.¹⁰⁰

Two U.S. corporations owned by a foreign person cannot form an affiliated group because, with limited exception,¹⁰¹ a foreign corporation cannot qualify as an includible corporation and can never be the "common parent."¹⁰² Accordingly, to file a consolidated return, one domestic company must own the other or they both must be owned by a third domestic company.

Even if a consolidated return cannot be filed, the two U.S. companies will be considered to be component members of a controlled group of companies.¹⁰³ Component members must share the benefit of only one graduated tax bracket for corporations and are entitled to only one accumulated earnings credit.¹⁰⁴ Where no questions are asked by the tax adviser, information as to the existence of a second company generally is not volunteered.

If a U.S. subsidiary is formed, profits of that subsidiary will be repatriated in the form of dividends subject to the thirty percent withholding tax. If the foreign investor is a resident of a tax treaty country, or forms a holding company in that type of country, the U.S. withholding tax on dividends can be reduced to as little as five percent.¹⁰⁵

H. Acquisition/Merger

The considerations involved in the acquisition of a U.S. company by purchase or by tax-free reorganization are legion. Before the tax adviser attempts to plan for all the statutory requirements that are necessary to qualify a transaction as a merger,¹⁰⁶ a straight triangular merger,¹⁰⁷ a

⁹⁸ I.R.C. § 1504 (1976 & West Supp. 1981).

⁹⁹ Id. § 1501 (1976).

¹⁰⁰ Id. § 1504(a) (West Supp. 1981).

¹⁰¹ Id. § 1504(d) (1976). Section 1504(d) allows Mexican and Canadian subsidiaries to be treated as domestic corporations if they are maintained to comply with local law applicable to title and operation of property.

¹⁰² Id. § 1504(a), (b) (West & West Supp. 1981).

¹⁰³ Id. § 1563 (1976).

¹⁰⁴ Id. § 1561 (1976 & Supp. III 1979).

¹⁰⁵ See, e.g., Treasury Department's Model Income Tax Treaty of May 17, 1977, art. 10 (Dividends), 1 Tax Treaties (CCH) ¶ 153.

¹⁰⁶ I.R.C. § 368(a)(1)(A) (1976).

¹⁰⁷ Id. § 368(a)(2)(D). Section 368(a)(2)(D) involves the merger of the target company into a subsidiary of the acquiring parent company where the target's shareholders receive shares of stock in the foreign parent.

reverse triangular merger,¹⁰⁸ a stock-for-stock exchange,¹⁰⁹ or a stock-for-assets acquisition,¹¹⁰ a fundamental question must be answered. Will the selling party accept shares of stock in a foreign company? Often, the alternative of a tax-free reorganization is precluded because the necessary shares of stock are not as attractive as cash.¹¹¹ Accordingly, we shall address the tax planning opportunities of a taxable acquisition.

A taxable acquisition can involve the acquisition of shares of stock or assets. In the former case, the selling party is the shareholder. In the latter, it likely will be the target company.

Where stock is acquired, the purchase price may include a premium over and above book value of assets. Unless the target company is liquidated, the premium will not be utilized in computing taxable income.¹¹²

If the target company is liquidated within two years of acquisition, the purchase price will be allocated to various assets acquired.¹¹³ While this type of liquidation is generally considered a tax-free liquidation,¹¹⁴ there probably will be certain "recapture" items in the hands of the target company which will result in the recognition of gain or income. For example, if the target company's inventory is valued under the LIFO inventory method,¹¹⁵ the value of the inventory stated on the balance sheet will reflect the oldest costs incurred. Under LIFO, cost of goods sold is computed by reference to the most recent costs incurred for inventory. As a result, the balance sheet does not reflect current costs. In periods of inflation, the inventory measured under LIFO principles tends to be understated in comparison to the inventory measured under FIFO.¹¹⁶ Upon liquidation, the difference in value of the inventory (that is, the understatement under the LIFO method) must be recognized by the target company as gain from the sale of inventory.¹¹⁷

¹⁰⁸ Id. § 368(a)(2)(E). Section 368(a)(2)(E) involves the merger of the acquiring company into the target company where the target company's shareholders receive shares of stock in the foreign company.

¹⁰⁹ Id. § 368(a)(1)(B).

¹¹⁰ Id. § 368(a)(1)(C).

¹¹¹ In addition, a favorable IRS ruling is required in order to have a tax-free reorganization in connection with a transaction in which (i) a U.S. person transfers shares of stock in a U.S. corporation for shares of stock in a foreign corporation, (ii) a U.S. corporation transfers assets to a foreign corporation, or (iii) a U.S. corporation transfers property to another U.S. corporation and as part of the transaction a U.S. person receives stock in a foreign "controlling" corporation. I.R.C. § 367 (1976); Treas. Reg. § 7.367(a)-1(b)(3) (1977). The IRS has announced when, in what circumstances, and under what terms and conditions favorable rulings will be issued. See Rev. Proc. 68-23, 1968-1 C.B. 821.

¹¹² See I.R.C. § 334 (1976).

¹¹³ Id. § 334(b)(2).

¹¹⁴ Id. §§ 332(a), 336(a) (West & West Supp. 1981) (dealing with the corporate shareholder and the target company, respectively).

¹¹⁵ I.R.C. § 472 (1976) provides for the last-in, first-out method.

¹¹⁶ FIFO refers to the first-in, first-out method.

¹¹⁷ I.R.C. § 336(b) (West Supp. 1981), effective with regard to distributions pursuant to plans adopted after December 31, 1981. See Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 403(b)(3), 94 Stat. 229 (to be codified in scattered sections of 26 U.S.C.).

The Economic Recovery Tax Act of 1981¹¹⁸ expanded the definition of the term "section 1245 property" with respect to property depreciated under the accelerated cost recovery system.¹¹⁹ For property acquired prior to 1981, only personalty subject to depreciation was classified as section 1245 property.¹²⁰ The definition has now been expanded to include realty¹²¹ although exceptions are provided.¹²² When section 1245 property is disposed of, gain is recognized and treated as ordinary income to the extent of previously claimed depreciation deductions. The recognition rule overrides the general nonrecognition provisions applicable to liquidations.¹²³

If the target owns shares of a Domestic International Sales Corporation (DISC) or is a U.S. shareholder of a controlled foreign corporation, similar recapture rules are provided for accumulated DISC income¹²⁴ and for the undistributed earnings and profits of controlled foreign corporations¹²⁵ at the time of liquidation. Finally, if liquidation results in an early disposition of investment credit property, the previously claimed credit must be recomputed so that the period of actual use is substituted for useful life.¹²⁶ If, as a result of the recomputation, the amount of the credit is reduced with respect to a particular asset, tax is increased by an appropriate amount in the year of liquidation.¹²⁷

The task for the tax adviser is twofold. First, he should attempt to limit the exposure area if a stock purchase and liquidation is anticipated. Generally, recapture of accumulated DISC income and a deemed distribution of the earnings and profits of controlled foreign corporations can be avoided if, prior to its acquisition, the target company contributes its equity interest in those companies to a domestic subsidiary. That type of transfer does not trigger recapture. Thereafter, when the target is acquired and liquidated, no triggering event will be viewed to have taken place. To the extent recapture cannot be avoided, the tax adviser must

¹¹⁸ Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (to be codified in scattered sections of 26 U.S.C.) [hereinafter cited as ERTA].

¹¹⁹ *Id.* § 204.

¹²⁰ I.R.C. § 1245(a)(3) (West Supp. 1980) (amended 1981).

¹²¹ ERTA, *supra* note 118, §§ 204(c), 201 (to be codified at I.R.C. §§ 1245(a)(5), 168. Depreciable real estate was subject previously to a more limited recapture rule addressed to the excess of accelerated depreciation over straight line depreciation. See I.R.C. § 1250(b)(1) (1976) (amended 1981).

¹²² ERTA, *supra* note 118, § 204(c).

¹²³ *Id.* § 1245(a)(1) (1976).

¹²⁴ The tax deferred profits of a DISC are deemed to be distributed and subject to tax. *Id.* § 995(c) (1976 & Supp. III 1979).

¹²⁵ *Id.* § 1248(e) (1976).

¹²⁶ *Id.* § 46(c), as in effect prior to ERTA, provided that the amount of the credit varied in accordance with the useful life of the property. Full credit could only be obtained for property with a useful life of at least seven years. As a result of ERTA, full credit is available for property with a class life of at least five years. For ERTA's effect, see ERTA, *supra* note 118, § 211 (amending I.R.C. § 47(c) (West Supp. 1981)).

¹²⁷ I.R.C. § 47 (West & West Supp. 1981).

alert his client so that the tax exposure can be taken into account in negotiating the acquisition price.

III. Taxation of Foreign Investment Activity in the U.S.

The preceding portion of this article was addressed to various organizational structures that are available to the foreign investor in the United States. Each structure was viewed to be appropriate for specific types of investors, each having different investment goals. In discussing the investment alternatives, the appropriate U.S. tax consequences were discussed in order to place the investor, his goals, and his contact with the U.S. tax jurisdiction in perspective. The following portion of the article will discuss in greater detail U.S. tax principles applicable to the foreign investor.

A. *Trade or Business*

The concept of a trade or business in the U.S. is nebulous at best. The general rule is that for a trade or business to exist, there must be continuous activity in the active pursuit of profit. Thus, it is not likely that one transaction will cause a foreign person to be viewed as being in a trade or business but numerous transactions may produce that result.¹²⁸ Some authority exists, however, for the proposition that one transaction in the U.S. of a type that is ordinarily carried on in a person's foreign business will be considered a U.S. trade or business.¹²⁹

In most cases, the issue of a trade or business is easily determined because of the goals and clear activity of the person. For example, a U.S. branch of a foreign corporation that sells on a regular basis in the United States or that manufactures in this country will be engaged in a trade or business. At that point, the real issue is to determine what income, in addition to operating profits, is "effectively connected" with that trade or business.

B. *Effectively Connected Income*

(1) *In General.* A foreign person that is engaged in a U.S. trade or business must segregate income into two classes: income that is not effectively connected and income that is effectively connected with the conduct of a U.S. trade or business. The latter income is subject to the ordinary graduated rates of tax provided in section 1 for individuals and section 11 for corporations or the tax provided in section 1201 in the case of capital gains.¹³⁰ The nonresident alien individual may also be subject to the minimum tax on items of tax preference under section 55. The investment credit and the foreign tax credit may be applied in reduction

¹²⁸ *European Naval Stores Co., S.A. v. Commissioner*, 11 T.C. 127 (1948).

¹²⁹ Rev. Rul. 58-63, 1958-1 C.B. 624.

¹³⁰ I.R.C. § 871 (West & West Supp. 1981).

of the tax liability.¹³¹

Because the ordinary rates under section 1 are progressive, the amount of taxable income positively affects the effective tax rate. In determining the appropriate marginal rate of tax, items of income that are not effectively connected to the conduct of trade or business in the United States are excluded.¹³²

The determination of whether a foreign person is engaged in a trade or business in the United States is made on an annual basis for each particular taxable year.¹³³ The income need not be connected to the trade or business conducted in a particular taxable year for it to be treated as effectively connected income for that year. The determining factors are that the person is engaged in business in each of the two years and that the income for the second year is attributable to the business conducted in the first year.¹³⁴ If a foreign person is not engaged in a trade or business in the United States during the year in which income is derived, that income is not considered to be effectively connected income.¹³⁵ In this type of circumstance, it does not matter that income was generated by a trade or business conducted in an earlier year. Such income would, however, be considered to be income from U.S. sources and thus, if it is passive income, it would be subject to the thirty percent withholding tax.¹³⁶

If an individual is engaged in a trade or business in the United States during a taxable year, any item of U.S. source income other than passive income or capital gains is treated as effectively connected income.¹³⁷ This rule is intended to reach casual business transactions that are intentionally or unintentionally routed around the trade or business in the United States.

(2) *Passive Income*. If a foreign person is engaged in a trade or business in the United States, the "asset-use" test or the "business-activities" test generally applies to determine whether a specific item of passive income is treated as being effectively connected to the conduct of that trade or business.¹³⁸ Generally, the asset-use test is of primary significance for passive income where the trade or business activities of the taxpayer do not give rise directly to the realization of the income. An asset will generally be treated as used in, or held for use in, the conduct of the trade or business in the United States if any one of the following three tests are met.¹³⁹ Under the first test, the asset must be held for the prin-

¹³¹ Treas. Reg. § 1.871-8(d) (1974).

¹³² I.R.C. § 871(b)(2) (1976).

¹³³ Treas. Reg. § 1.871-8(c)(1) (1974).

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ See *infra* text accompanying notes 147-49.

¹³⁷ I.R.C. § 864(c)(3) (1976).

¹³⁸ *Id.* § 864(c)(2).

¹³⁹ Treas. Reg. § 1.864-4(c)(2)(ii), 26 C.F.R. § 1.864-4(c)(2)(ii) (1981).

cial purpose of promoting the present conduct of the trade or business in the United States. This test is met, for example, when shares of stock are acquired and held to assure a constant source of supply for a particular trade or business. Under the second test the asset must be acquired and held in the ordinary course of trade or business conducted in the United States. This test applies to interest on a trade account receivable. Under the third test the asset must otherwise be held in a direct relationship to the trade or business conducted in the United States. An asset is held in a direct relationship to the U.S. trade or business if held to meet the present needs of that trade or business. Anticipated future needs, such as future diversification into a new trade or future plant replacement, are not sufficient to meet this test. Moreover, an asset generally will be presumed to be held in direct relationship to a trade or business if it is acquired with funds generated by that business, the income from the asset is retained in the business, and significant management and control over the investment of the asset is exercised by personnel actively involved in the conduct of the U.S. business.

The business-activities test generally is applied with respect to passive items of income that arise directly from the active conduct of a trade or business. This would include interest derived by a dealer in stocks or securities; gain from the sale or exchange of capital assets by an investment company; royalties derived by a licensing company; and service fees derived by a service business.¹⁴⁰

For the portfolio investor described in Part II.B. above, trading activities in stocks, securities and in many instances commodities, will not be viewed as a trade or business in the United States no matter how many trades are effected during the year.¹⁴¹ Corporations are covered by the same rule with the exception of widely held investment companies having their principal office in the United States.¹⁴²

(3) *Foreign Source Income*. If a foreign person has an office in the United States, certain limited classes of foreign source income may be considered to be effectively connected with the conduct of a trade or business in the United States. These are (i) rents or royalties derived in the active conduct of a licensing business conducted in the United States; (ii) dividends, interest, and gains from the sale of stocks or securities derived in the active conduct of a banking or similar business, or derived by a corporation whose principal business is trading in stock or securities for its own account and whose principal office is in the United States; and (iii) income from the sale of inventory through a U.S. office.¹⁴³

No foreign source income will be attributed to an office in the United States unless that office is a material factor in the production of

¹⁴⁰ Id. § 1.864-4(c)(3)(i) (1981).

¹⁴¹ I.R.C. § 864(b)(2) (1976).

¹⁴² Id. § 864(b)(2)(A)(ii).

¹⁴³ Id. § 864(c)(4)(B).

such income and regularly carries on the business activity in issue.¹⁴⁴ Moreover, in the case of inventory, no income will be attributed to a U.S. office if (i) property is sold for use and consumption outside the United States and (ii) an office outside the United States materially participates in the sale.¹⁴⁵ If the sale produces effectively connected income, and the foreign corporation is the manufacturer, only the portion of the income attributable to the sales function—not the manufacturing function—is taxed in the United States.¹⁴⁶

C. Withholding Tax

U.S. income tax normally is collected from nonresident aliens and foreign corporations by means of withholding. In general, the obligation to withhold extends to all persons, acting in whatever capacity, having the control, receipt, custody, disposal, or payment of any item of passive income derived from sources within the United States by a nonresident alien. Tax should be withheld at the rate of thirty percent of the gross amount paid.¹⁴⁷

Implicitly excluded from withholding are capital gains. Explicitly excluded from withholding are items effectively connected with a U.S. trade or business, other than a fee paid to a nonresident alien independent contractor for the performance of services. A Form 4224 must be filed with the withholding agent to avoid having tax withheld from effectively connected income.¹⁴⁸ Basically, Form 4224 reports the name and address of the withholding agent and of the person entitled to the income, the foreign person's social security or employer identification number, the nature of the item of income for which the statement is filed, the trade or business with which such income is effectively connected, and the taxable year in respect of which the statement is made.

If the foreign person is claiming an exemption from withholding tax or a reduction in rate by virtue of an income tax treaty, a Form 1001 must be filed with the withholding agent.¹⁴⁹ The form generally is effective for three years.

D. Foreign Investment in U.S. Real Property

The Foreign Investment in Real Property Tax Act of 1980¹⁵⁰

¹⁴⁴ Id. § 864(c)(5)(B).

¹⁴⁵ Id. § 864(c)(4)(B)(iii).

¹⁴⁶ The allocation of income between manufacturing activities and sales activities is made under principles applicable to income that is partly within and partly without the United States. See the discussion of I.R.C. § 863, supra note 46 and accompanying text. In the text, it is assumed the product is manufactured outside the U.S.

¹⁴⁷ Id. §§ 1441(a), 1442(a) (1976) (dealing with nonresident alien individuals and foreign corporations, respectively).

¹⁴⁸ Treas. Reg. § 1.1441-4(a)(2), 26 C.F.R. § 1.1441-4(a)(2) (1981).

¹⁴⁹ Treas. Reg. § 1.1441-6(c) (1971).

¹⁵⁰ Omnibus Reconciliation Act, Pub. L. No. 96-499, tit. XI(c), 94 Stat. 2599 (1980) (codified in scattered sections of 26 U.S.C.).

(FIRPTA) significantly revises the manner in which foreign persons are taxed on gains from the sale or exchange of real estate in the United States. Because FIRPTA is addressed to capital gains, investors in improved real estate or fallow real estate are affected to a much larger extent than are developers. Developers can anticipate capital gains only in rare circumstances.¹⁵¹ To understand the magnitude of the revisions, a brief discussion of prior law may be helpful.

Prior to FIRPTA, gains derived by foreign persons from the sale of real estate likely would have been tax-free in the United States. As previously discussed, foreign corporations generally are not subject to U.S. tax on capital gains, unless those gains are connected to a U.S. business.¹⁵² Similarly, nonresident alien individuals are not taxed on capital gains except to the extent the gain is deemed to be from U.S. sources and only if the individual is present in this country for at least 183 days during the taxable year.¹⁵³

Accordingly, unimproved real estate could have been sold in a tax-free, capital gain producing transaction. The result probably would not have differed significantly if an election were made to enable the passive foreign investor to treat his real estate investment as if it were a trade or business¹⁵⁴ or if the investor's activity in managing improved real estate rose to the level of a trade or business. With planning, the result would have been virtually the same even if the investor had elected net tax treatment under Article X of the Antilles Treaty.¹⁵⁵ Through the use of an installment sale,¹⁵⁶ a twelve-month liquidation of the foreign corporation,¹⁵⁷ or a swap for property outside the United States, virtually all of the profits could have been shielded from tax.

¹⁵¹ *Davis v. Commissioner*, 28 T.C.M. 1167 (1969); compare *Tibbals v. United States*, 362 F.2d 266 (Ct. Cl. 1966), with *Boyer v. Commissioner*, 58 T.C. 316 (1972).

¹⁵² I.R.C. § 881 (1976).

¹⁵³ *Id.* § 871(a)(2).

¹⁵⁴ The Code allows such an election, but if made, the gains arising from the sale of property are treated as effectively connected income. The election is generally binding for all subsequent years. See §§ 871(d) (for individuals), 882(d) (for corporations).

A similar election is allowed by treaty and is often referred to as a net election. The treaty election is generally made on a year-by-year basis. Thus, it is not binding on the subsequent years. The scope of the net election varies among the treaties. See, e.g., *Income Tax Treaty*, Jan. 1, 1947, *United States-Netherlands*, art. X, 2 *Tax Treaties* (CCH) ¶ 5803 [hereinafter cited as *United States-Netherlands Income Tax Treaty*], as modified by *Protocol to Extend United States-Netherlands Income Tax Treaty to the Antilles*, Sept. 28, 1964, 2 *Tax Treaties* (CCH) ¶ 5832B [hereinafter cited as *Antilles Treaty*]. Cf. *Income Tax Treaty*, Jan. 1, 1942, *United States-Canada*, art. XIII, 56 Stat. 1399, 124 U.N.T.S. 271 [hereinafter cited as *United States-Canada Income Tax Treaty*].

¹⁵⁵ *Antilles Treaty*, *supra* note 154.

¹⁵⁶ Under the installment sale method of reporting, gain is reported as installments are received. I.R.C. § 453 (1976). The thrust of the planning was to defer reporting substantially all of the gain until a year in which no trade or business was carried on in the United States. The gain in such year would be tax-free.

¹⁵⁷ Under I.R.C. § 337 (1976), a liquidating company generally recognizes no gain on the sale of its assets. All gain is recognized by shareholders. The thrust of planning was to transfer gain to an entity that had not made a net election under the Code or a treaty.

FIRPTA introduced section 897 into the Code, revising the rules applicable to real estate capital gains. Section 897 provides that gains and losses attributable to dispositions of U.S. real property interests of a foreign person are treated as effectively connected with the conduct of a trade or business. Accordingly, net gains in the hands of a foreign corporation are subject to ordinary rates or a twenty-eight percent alternative tax, whichever produces a lower tax. In the hands of a nonresident alien, the gain is subject to a maximum tax of twenty percent.¹⁵⁸

The term "United States real property interest" is a term of art and includes not only physical real estate, but also any interest other than as a creditor in certain U.S. corporations.¹⁵⁹ These corporations are referred to as "United States Real Property Holding Corporations."¹⁶⁰ They are domestic companies having at least fifty percent in value of the aggregate of their trade or business assets and worldwide real estate assets comprised of U.S. real property interests; that is, physical real estate as well as shares in another United States Real Property Holding Corporation.¹⁶¹

Publicly traded companies generally are not considered United States Real Property Holding Corporations, irrespective of the composition of their assets, except in the hands of a shareholder owning five percent or more of the traded stock.¹⁶² Rules of attribution are provided.¹⁶³

The statute provides special look-through rules for groups of companies.¹⁶⁴ Under those rules, a company that owns at least fifty percent of another company is considered to own its proportionate share of the other company's assets.¹⁶⁵ The assets of the other company, deemed to be owned by the first company, in turn may be viewed as being owned by a fifty percent or greater shareholder of the first company.¹⁶⁶ The look-through provisions allow the IRS to apply on a consolidated basis the test to determine whether a corporation is a United States Real Property Holding Corporation.

Once a company is viewed to be a United States Real Property Holding Corporation, it retains that status for five years after its United States real property interests comprise less than fifty percent of its total real estate and business assets.¹⁶⁷ The status may be eliminated within the five year period if all United States real property interests are disposed of in taxable transactions.¹⁶⁸

¹⁵⁸ I.R.C. § 897(a)(2) (West 1980 Laws Special Pamphlet).

¹⁵⁹ Id. § 897(c)(1).

¹⁶⁰ Id. § 897(c)(2).

¹⁶¹ Id.

¹⁶² Id. § 897(c)(3).

¹⁶³ Id. § 897(c)(6)(C).

¹⁶⁴ Id. § 897(c)(5).

¹⁶⁵ Id. § 897(c)(5)(A), (B).

¹⁶⁶ Id. § 897(c)(5)(A)(iii).

¹⁶⁷ Id. § 897(c)(1)(A)(ii).

¹⁶⁸ Id. § 897(c)(1)(B)(ii).

For purposes of the statute, interests in real property held by partnerships are deemed to be owned proportionately by the partners.¹⁶⁹ Similarly, gains from the sale of a partnership interest are considered to be gains from the sale of the underlying United States real property interest, to the extent thereof.¹⁷⁰

For purposes of imposing the tax under section 897, foreign companies generally are not viewed to be United States Real Property Holding Corporations.¹⁷¹ Thus, shares in foreign corporations can be sold without imposition of U.S. tax. Tax is imposed, however, when a foreign corporation distributes a U.S. real property interest to its shareholders.¹⁷² In that case, the foreign corporation is deemed to recognize any appreciation in value in the underlying property.¹⁷³ The impact of these provisions is that a foreign person can sell his interest in a foreign corporation without tax. If the purchaser desires, however, to step up its basis in the real property by liquidating the foreign company, a tax will be paid by the foreign corporation at the time of the liquidating distribution.¹⁷⁴

FIRPTA includes not only taxing provisions but also reporting provisions¹⁷⁵ intended to identify the beneficial owners of U.S. real property. The reporting obligation is imposed through a chain of corporations under a look-through rule.¹⁷⁶

Notwithstanding this technical requirement, the law contains an exception when a foreign corporation required to report the identity of its shareholders furnishes the Treasury Department with sufficient security to insure that any tax imposed will be paid.¹⁷⁷ Regulations describing the sufficiency of the security have not been issued. It is anticipated that in some cases a closing agreement with the IRS may suffice; in other cases a lien on the property may be required.

Where the tax under FIRPTA conflicts with a treaty obligation of the United States, the treaty obligation will no longer provide benefits after December 31, 1984.¹⁷⁸ Most treaties exempt foreign residents from U.S. tax on capital gains, except for real estate. Under most treaties, real

¹⁶⁹ Id. § 897(c)(4)(B).

¹⁷⁰ Id. § 897(g).

¹⁷¹ Id. § 897(c)(4). If a foreign corporation is organized in a country that has an income tax treaty with the United States, however, and if that treaty contains a nondiscrimination provision, the foreign corporation may elect to be treated as a domestic corporation for purposes of I.R.C. §§ 897 and 6039C. Id. § 897(i). This election affects the planning opportunities of the shareholders of the foreign corporation and also their tax liability. Once the election is made, shareholders may be taxed on all dispositions occurring after June 18, 1980.

¹⁷² Id. § 897(d)(2) (Supp. IV 1980). This section also provides that the nonrecognition provisions in a 12 month liquidation of a foreign corporation are inapplicable to U.S. real property interests.

¹⁷³ Id. § 897(a)(1)(A).

¹⁷⁴ Id.

¹⁷⁵ Id. § 6039C (Supp. IV 1980).

¹⁷⁶ Id. § 6039C(b)(4)(c).

¹⁷⁷ Id. § 6039C(b)(2).

¹⁷⁸ Omnibus Reconciliation Act, Pub. L. No. 96-499, § 1125(c), 94 Stat. 2599, 2690 (1980).

estate gains already may be taxed in the country where the real estate is located.

E. Income Tax Treaties

In November, 1981, the United States had income tax treaties in force with twenty-eight countries, in addition to extensions of treaties with the United Kingdom, Belgium, and the Netherlands to a number of overseas territories or former territories which are now independent countries.¹⁷⁹ Thus, knowledge of the terms of particular treaties and familiarity with the tax systems of the treaty partners of the United States are important when planning a transnational investment.

(1) *Passive Income*. While each treaty is unique to itself, general principles and approaches are embodied in all tax treaties. For most investors, the heart of a treaty is comprised of the articles addressed to capital gains, dividends, interest, and royalties. These last three items are items of passive income which, in the absence of a treaty, are subject to a thirty percent U.S. withholding tax.¹⁸⁰

Income tax treaties generally are intended to reduce the prospect of double taxation of international flows of income. With respect to a particular item of income, the country in which the income arises—the source country—generally undertakes, under specified circumstances, to reduce or eliminate its tax in favor of the tax in the country of residence. The latter country is obligated to relieve double taxation by allowing a credit or by exempting the income. As under internal law, U.S. treaties use the credit mechanism.¹⁸¹

In the normal treaty relationship there are flows of income in both directions. Each country, therefore, will tax income from sources in its country and will provide a credit equal to the tax actually imposed by a treaty country with respect to income of its residents from sources in the other country.¹⁸²

The amount by which tax is reduced or eliminated is dependent generally upon the nature of the item of income and the status of the economic relationship between the two treaty partners. Where one of the countries is a net importer of capital, the withholding tax on a particular item of income may be significant even after the treaty is taken into account.¹⁸³

¹⁷⁹ See Hearings on Ratification of Eleven Tax Treaties Before the Senate Foreign Relations Committee, 97th Cong., 1st Sess. 3 (1981) (statement of John E. Chapoton).

¹⁸⁰ See supra note 16 and accompanying text.

¹⁸¹ See, e.g., Income Tax Treaty, July 25, 1946, United States-United Kingdom, art. 23, 2 Tax Treaties (CCH) ¶ 8103A [hereinafter cited as United States-United Kingdom Income Tax Treaty].

¹⁸² Id.

¹⁸³ The premise underlying a tax treaty is generally reciprocity. Both countries relinquish certain tax jurisdiction and, if the economic relationship is balanced, neither relinquishes more than the other. Usually, the right of the source country to tax dividends, interest, royalties, and capital gains is relinquished. Where one country is a net importer of capital, there may be little

As a general rule, source country withholding tax on a portfolio dividend is fifteen percent.¹⁸⁴ A portfolio dividend is a dividend paid to an individual investor or to a corporation whose ownership interest is less than a specified amount. Dividends paid to a corporate recipient owning more than a specified amount are generally referred to as "direct investment" dividends.¹⁸⁵ The withholding tax on direct investment dividends is generally five percent,¹⁸⁶ although the tax is ten percent under some treaties.¹⁸⁷

Generally, withholding tax on interest is either entirely eliminated¹⁸⁸ or is reduced to ten percent.¹⁸⁹ A similar rule usually is provided for industrial or commercial royalties; the source country tax is either eliminated or reduced.¹⁹⁰ It should be noted that, in comparison to industrial or commercial royalties, mineral royalties generally are subject to full tax in the source country and literary royalties generally are exempt.¹⁹¹

Capital gains other than real estate gains normally are exempt from source country tax. In the U.S.-U.K. Income Tax Treaty, however, the two countries agreed to acknowledge the application of the local tax rules of the source country.¹⁹²

(2) *Business Income*. With respect to business profits, treaties provide

or no reciprocity, as that country has relinquished significantly more tax dollars than has the other country. Therefore, such countries tend to demand significant withholding taxes, even after reduction of the rates by treaty, in order to stem the revenue drain. For example, under the present United States-Canada Income Tax Treaty, *supra* note 108, art. XI, para. 1, the uniform rate of withholding tax on items of passive income is 15%. At one time, the withholding tax on direct investment dividends was reduced to five percent. *Id.* art. XI, para. 2. This additional reduction, however, was terminated at the request of the Canadian Government. Under article X (Dividends) of the proposed United States-Canada Income Tax Treaty which is currently awaiting ratification, direct investment dividends are subject to a 10% withholding tax. 1 Tax Treaties (CCH) ¶ 1310.

¹⁸⁴ See, e.g., Income Tax Treaty, July 11, 1968, United States-France, art. 9 (Dividends), 1 Tax Treaties (CCH) ¶ 2803 [hereinafter cited as United States-France Income Tax Treaty].

¹⁸⁵ In the United States-France Income Tax Treaty the specified percentage of ownership is 25%. *Id.* See also United States-Netherlands Income Tax Treaty, *supra* note 154, art. 7 (Dividends). In the proposed United States-Canada Income Tax Treaty, the specified percentage is 10%. Art. X (Dividends), 1 Tax Treaties (CCH) ¶ 1310. See also United States-United Kingdom Income Tax Treaty, *supra* note 181, art. 10 (Dividends).

¹⁸⁶ See, e.g., Proposed United States-Canada Income Tax Treaty, art. X (Dividends), 1 Tax Treaties (CCH) ¶ 1310.

¹⁸⁷ See, e.g., United States-Canada Income Tax Treaty, *supra* note 154, art. 10 (Dividends).

¹⁸⁸ See, e.g., United States-United Kingdom Income Tax Treaty, *supra* note 181, art. 11 (Interest).

¹⁸⁹ See, e.g., Income Tax Treaty, July 9, 1972, United States-Japan, art. 13, para. (4), 23 U.S.T. 967, T.I.A.S. No. 7345 [hereinafter cited as United States-Japan Income Tax Treaty].

¹⁹⁰ See, e.g., United States-United Kingdom Income Tax Treaty, *supra* note 181, art. 12 (Elimination of Withholding Tax on Royalties); United States-Japan Income Tax Treaty, *supra* note 189, art. 14 (Reduction of Tax Rate Imposed on Royalties).

¹⁹¹ See, e.g., United States-France Income Tax Treaty, *supra* note 184, arts. 5, 12 (dealing with income from real property and royalties, respectively).

¹⁹² United States-United Kingdom Income Tax Treaty, *supra* note 181, art. 13 (Capital Gains).

that a resident of one country who engages in business in the other may be taxed by the host country only to the extent that the nonresident's business venture has made a substantial economic penetration into the host country by virtue of having a "permanent establishment" there.¹⁹³ Thus, not only must the foreign corporation engage in regular or continuous activities in the United States, but it must have a permanence of presence here as well.

The definition of a "permanent establishment" will be somewhat different in each particular treaty. Care should be taken to check time periods where important and to insure that the appropriate treaty will contain the specific provision of the general rules relied upon in planning. Subject to that caveat, the following general statements may be made.

A permanent establishment must exist for the United States to tax a foreign corporation on its industrial or commercial profits. In general, a permanent establishment is defined as a fixed place of business through which a foreign corporation engages in industrial or commercial activity.¹⁹⁴ Certain items are considered to comprise a permanent establishment whereas other items are excluded. The concept of permanent establishment specifically includes a place of management, a branch, an office, a factory, a workshop, and an installation site that is maintained for more than a specified time.¹⁹⁵ In addition, where a person not an agent of an independent status is acting on behalf of a foreign corporation, and that person has and habitually exercises an authority to conclude contracts in the name of that foreign person, a permanent establishment is deemed to exist.¹⁹⁶

On the other hand, the concept of a permanent establishment does not include a fixed place of business through which any or all of certain activities take place. These activities include storage or delivery of goods or merchandise belonging to the business; purchasing goods or merchandise or collecting information for the business; and carrying on any other activity of a preparatory or auxiliary character for the business.¹⁹⁷

In addition, as a general rule, a foreign corporation will not have a permanent establishment merely because it carries on business through a broker, general commission agent or any other agent of an independent status acting in the ordinary course of its business.¹⁹⁸ Similarly, the fact that a foreign corporation controls a U.S. subsidiary will not, of itself,

¹⁹³ See, e.g., United States-France Income Tax Treaty, *supra* note 184, art. 6 (Business Profits).

¹⁹⁴ See, e.g., United States-Japan Income Tax Treaty, *supra* note 189, art. 9.

¹⁹⁵ See, e.g., United States-United Kingdom Income Tax Treaty, *supra* note 181, art. 5 (Permanent Establishment).

¹⁹⁶ See, e.g., *Handfield v. Commissioner*, 23 T.C. 633 (1955), which applies the definition of "permanent establishment" under the protocol to the present United States-Canada Income Tax Treaty, *supra* note 154.

¹⁹⁷ See, e.g., United States-Japan Income Tax Treaty, *supra* note 189, art. 9.

¹⁹⁸ *Id.*

constitute a permanent establishment. A subsidiary that is considered to be a dependent agent, however, could be viewed to be a permanent establishment if the facts warrant.¹⁹⁹

The concept that the activities of a dependent agent such as a subsidiary may constitute a permanent establishment is explained more fully in the commentary of Article 5 of the O.E.C.D. Model Income Tax Convention (O.E.C.D. Model Treaty).²⁰⁰ The commentary of Article 5 explains that only persons having the authority to conclude contracts and who actually exercise that authority can lead to a permanent establishment.²⁰¹ The O.E.C.D. commentary says further that the authority to conclude contracts must cover contracts relating to the operations constituting the business proper of the corporation. Moreover, a dependent person who is authorized to negotiate all elements and details of a contract in a way that is binding on the foreign corporation will constitute a permanent establishment, even if the contract is signed by another person in another country.²⁰²

Finally, the O.E.C.D. commentary provides a reminder that the dependent agent test is merely an alternative test of whether a foreign corporation has a permanent establishment. If it can be shown that a permanent establishment exists within the meaning of the definition of a fixed place of business, it is not necessary to show that the person in charge is one who should fall under the definition of dependent agent with power to bind.²⁰³

(3) *Anti-Abuse Provisions*. Tax planners should bear in mind that it is the current policy in U.S. treaty negotiations and enforcement that only the residents of the treaty country should benefit from the treaty provisions. Newly negotiated U.S. tax treaties²⁰⁴ now generally include anti-abuse provisions designed to prevent residents of third countries from channeling investments into the United States through the treaty country, thereby deriving treaty benefits to which, as the Treasury purports,²⁰⁵ they are not justifiably entitled. These provisions act to deny treaty benefits, such as exemption or reduction of source basis tax in the United States, in such circumstances. Thus, if a resident of a third country establishes a corporation in the treaty country to make his investment in the United States, under appropriate circumstances the anti-abuse

¹⁹⁹ See, e.g., United States-United Kingdom Income Tax Treaty, *supra* note 181, art. 5 (Permanent Establishment).

²⁰⁰ The Organization for Economic Co-operation and Development, O.E.C.D. Model Double Taxation Convention on Income and on Capital, Report of O.E.C.D. Commission on Fiscal Affairs (1977) [hereinafter cited as O.E.C.D. Report]. The Convention is reprinted in 1 Tax Treaties (CCH) ¶ 151.

²⁰¹ O.E.C.D. Report, *supra* note 200, at 66.

²⁰² *Id.* at 67.

²⁰³ *Id.*

²⁰⁴ See, e.g., Protocol Amending the United States-Jamaica Income Tax Convention, July 17, 1981, art. III, 1 Tax Treaties (CCH) ¶ 4387D (revising and strengthening Income Tax Treaty, May 21, 1980, United States-Jamaica, art. 17, 1 Tax Treaties (CCH) ¶ 4386).

²⁰⁵ See *supra* note 179.

provisions would permit the United States to impose its full statutory tax on payments to such a corporation.

The present U.S. Model Treaty²⁰⁶ and the draft proposed model²⁰⁷ both contain anti-abuse provisions. The provisions in the proposed model are tighter than in the present model. It is likely, however, that even after it is made final it will be modified in the course of the negotiation of particular treaties to reflect the U.S. negotiators' perceptions of the potential for abuse in that treaty as well as the needs of the treaty partner. Nonetheless, the policy now in treaty negotiations is to employ anti-abuse provisions wherever necessary, and in the form appropriate to the circumstances, to assure that U.S. tax treaties extend treaty benefits only to the residents of the two countries.

²⁰⁶ See *supra* note 105.

²⁰⁷ See *supra* note 179.

