

# Greater Miami Tax Institute

## Inbound Taxation: A Summary of U.S. Tax Issues Associated with Foreign Persons Doing Business in the U.S.

August 10, 2016

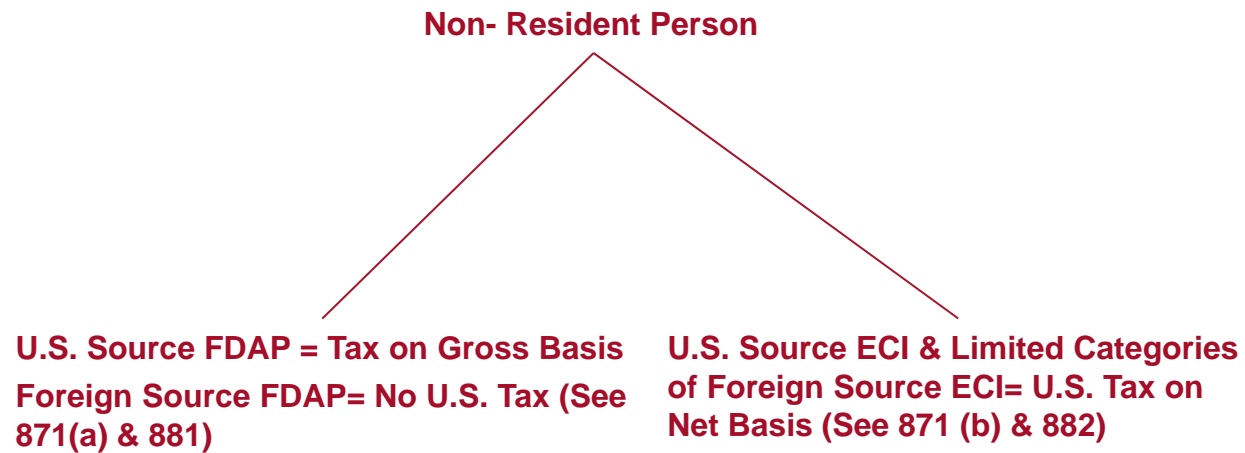
Steven Hadjilogiou, Baker & McKenzie (Miami)

Baker & McKenzie LLP is a member firm of Baker & McKenzie International, a Swiss Verein with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a "partner" means a person who is a partner, or equivalent, in such a law firm. Similarly, reference to an "office" means an office of any such law firm.

© 2016 Baker & McKenzie LLP

# I. Introduction

# I. Introduction



## Key Questions:

- 1) Residency
- 2) Income Classification
- 3) Income Source
- 4) U.S. Trade or business



## U.S. Federal Income Taxation of Foreign Persons

1. Gross investment income, profits and gains of foreign corporations (e.g., dividends, interests, rents and royalties) that are fixed or determinable annual or periodical (“FDAP”) are taxed on a gross basis at 30%.
2. Income Effectively Connected with a U.S. Trade or Business (“USTB”) is taxed on a net basis at graduated income tax rates.
3. There are four levels of activity relevant to the taxability of foreign entities in the U.S.
  - a. Being engaged in a U.S. trade or business -IRC
  - b. Having effectively connected income (“ECI”) -IRC
  - c. Having a permanent establishment in the U.S. -Treaty
  - d. Having business profits attributable to a U.S.PE -Treaty

# Taxation of Foreign Person's Business Income vs. Investment Income

## Business Income

1. Tax income effectively connected with USTB(ECI)
  - a. §871(b) (individuals)
  - b. §882 (corporations)
2. Graduated rates
  - a. §§1 and 11
3. Net-basis taxation
4. File U.S. income tax return
5. Partnership withholds
  - a. §1446 (foreign partners)

## Investment Income

1. Fixed or determinable annual or periodical ("FDAP") income
  - a. §871(a) (individuals)
  - b. §881(a) (corporations)
2. Generally 30% (could be reduced or eliminated by tax treaty)
3. Gross-basis taxation
4. Withholding at source
  - a. §1441(a) (individuals)
  - b. §1442(a) (corporations)
  - c. §1471(a) (FFIs)
  - d. §1472(a) (NFFEs)



## TP ISSUES WITH INBOUND INVESTMENT

- In any case where there's a U.S. Company, U.S. TP rules apply.
  - TP methods apply depending on type of transactions.
- In the U.S., depending on the magnitude or exposure, compliance, planning, and defense should be considered.
- With non-U.S. audit exposures rising, even if small or routine U.S. operations, Companies need to consider implications arising from the U.S.

## II. Source of Income



# Source Rules

- Relevance of Source
  - Factor in US Tax Liability of Foreign Persons
  - For U.S. Taxpayers it is relevant to the calculation of Foreign Tax Credit Limitation (Code Section 904).
- Source Rules found in Code Section 861-865
  - 861: US Source Income
  - 862: Foreign Source Income
  - 863: Partially US and Partially Foreign
  - 864: Definitions and Rules for Allocating Expenses
  - 865: Source of Personal Property Sales

# Interest

- General Rule: Source is dependent on residence of debtor. See 861(a)(1) & 862(a)(1)
  - Payments from US Corporations and US residents are US Source
    - Exception for foreign branch of commercial banking business of US Corporation (i.e., limited exception)
  - Payments from Foreign Corporations and non-residents (including US Citizens residing abroad) are foreign source.
    - Exception: 884(f)(1) provides that interest paid by a US trade or business of a foreign corporation is US sourced. (i.e., broad exception)
  - Residence is determined at time of payment. See Treas. Reg. 1.861-2(a)(2)(i).
- Partnerships
  - Domestic and foreign partnerships engaged in a US trade or business are treated as US resident. 1.861-2(a)(2)
  - However, for foreign partnership predominantly engaged in foreign trade or business, interest is only treated as US source to the extent paid by the US trade or business and allocable to US ECI.

# Dividends

- Dividends from US Corporation are treated as US source.
- Dividends from foreign corporation also treated as US source, unless...
  - less than 25% of the gross income from all sources of the foreign corporation for the 3 year period ending at the end of the taxable year in which dividend is paid is ECI.
  - If greater than 25% ECI, the dividend is treated as US sourced will be a percentage determined by the ratio between the US ECI and total gross income of the corporation. Remainder is foreign sourced.
  - See 861(a)(2)(B)

# Rent and Royalties

- The source of rental and royalty income is determined by the place where the property is located or used. 861(a)(4) & 862(a)(4).
  - The source of royalty income for IP (e.g., patents, copyrights, trade secrets, trademarks) depends on where the rights are used.
- Rev. Rul. 68-443
  - X Corporation (Foreign Corp) licensed rights to Y Corporation (US corporation) to manufacture and sell products using Y's trademark. According to the agreement, Y Corporation manufactured products in US and sold the products in the US exclusively to foreign buyers. An unrelated party owned the rights to the trademark for sales to US buyers. IRS ruled that the marks were used outside the US. Thus, foreign sourced income.
- US Sourced Presumption:
  - Payments received by foreign corporation from domestic film corporation giving domestic corporation exclusive distribution rights to a film in the United States and various other countries were royalties from a license; entire payments were taxable as income from U.S. sources, even though license covered foreign countries as well as United States, because taxpayers presented no basis for apportionment of royalties. *Misbourne Pictures, Ltd. v. Johnson*, 189 F2d 774, 776 (2d Cir. 1951) See also; *Molnar v. Comm'r*, 156 F2d 924 (2d Cir. 1946)

# Personal Services

- The Source of income from the performance of personal services is the place where the services are performed. 861(a)(3) & 862(a)(3).
- Services performed partly in and partly out of the US
  - 1.861-4(b)(1)(i) provides that source is apportioned on “the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.”
  - *Stemkowski v. Comm’r*, 690 F.2d 40 – Canadian hockey player was paid a contract to play hockey for the New York Rangers. A portion of games were played in Canada. Taxpayer argued that his compensation should be apportioned in a ratio equal to total days of performance in the US over total days in the year. However, the court the 2<sup>nd</sup> Circuit held that the proper apportionment is total days of performance in the US over total days of service (i.e., days in the offseason were excluded). Thus, a higher percentage of his income was treated as US sourced. See also Rev. Rul. 87-38.
- Compensation or Royalty Income?
  - German tax resident and world renowned music director and orchestra conductor entered an agreement to receive “royalties” of a percentage of record sales from recordings made of performances that were held in the US. The contract provided that “the recordings once made should be entirely the property of CBS Records...” The court stated that “[b]efore a person can derive income from royalties, it is fundamental that he must have an ownership interest in the property whose licensing or sale gives rise to the income.” The court concluded the taxpayer had no ownership rights in the recording and, thus, received compensation income and not royalties. Royalties would have been tax free under the treaty. On the other hand, compensation income was subject to net taxation in the U.S. (i.e., bad result for the taxpayer). See also *Ingram v. Bowers* and *Karrer v. US*. Cf. Rev. Rul. 74-555
  - Celebrity Endorsement Payments - *Kramer v. Commissioner*, *Goosen* and *Garcia* cases – all involved professional athletes who received compensation for endorse products. In each case, the court apportioned income between royalties and personal services.

# Sale of Property

## – Inventory

- General Rule – Sourced by the situs of the property at the time of the transfer of title.
  - Consider INCO Terms
  - Exception 1: 1.861-7(c): anti-avoidance rule
  - Exception 2: Treated as US source if sale is attributable to an office or other fixed place of business in the US. However, will remain foreign sourced if sold for use or consumption outside the United States and a foreign office or fixed place of business materially participated in sale.

## – Non-Inventory Personal Property

- Source determined by residence of the seller
    - US resident for these limited purposes is
      - a US citizen or a resident alien with no “tax home” in a foreign country,
      - a nonresident alien with a “tax home” in the US, and
      - US corporations, trusts and estates
  - Income may be resourced to the extent of U.S. depreciation recapture
- IP sold on a noncontingent basis is determined based on residence of seller.
- Exception for goodwill, which is sourced in country in which goodwill was generated

### III. Income Effectively Connected with a U.S. Trade or Business

# US Trade or Business

- Net Taxation applies to income that is effectively connected to a US Trade or Business
  - Trade or business within the US is not defined in the Code
    - Generally exists if there are regular, continuous and considerable business activities in the US.
    - On the other hand, isolated or sporadic transactions will not usually be construed as the conduct of a trade or business.
    - No distinction for activities of dependent vs. independent agents.

# Taxation of Effectively Connected Income

1. Taxed on a net-basis at graduated rates (e.g., a U.S. person).
2. An individual or corporation may deduct ordinary and necessary expenses connected with, or allocated and apportioned to, ECI.
3. Every foreign corporation engaged in a U.S. trade or business must file a U.S. income tax return on form 1120-F, even if there is no ECI, no income from U.S. sources or its income is exempt under a tax treaty or Code provision. Treas. Reg. §1.6012-2(g)(1)(i).
  - a. If no tax return is filed, no deductions will be allowed. §874(a) and §882(c)(2).
4. Special rules for determining corporate interest expense attributable to U.S. trade or business based on (i) the value of the Corporation's U.S. assets, (ii) its worldwide debt:asset ratio, and (iii) U.S. booked liabilities. Treas. Reg. §1.882-5.
  - a. Focused on foreign banks with U.S. branches, but applicable to all 1120-F filers that incur interest expense.
  - b. May be overruled by treaty.

# What does ECI Include?

1. Determine source and character of income, gain, or loss.
  - a. All U.S. source FDAP income, gain, or loss
    - i. Asset Use Test
    - ii. Business Activities Test
  - b. All other U.S. source non-FDAP income, regardless of whether or not the income, gain, or loss is derived from the USTB being carried on in the U.S. (known as the “Limited Force-of-Attraction” principle).  
§864(c)(3); Treas. Reg. §1.864-4(b).
  - c. Foreign source income is generally not ECI.
  - d. Certain deferred income
  - e. Special banking rules: Income, gain or loss from stocks or securities
  - f. Foreign Investment Real Property Tax Act (“FIRPTA”) is treated as ECI
    - i. Sale of U.S. real property interest



## U.S. Source Income, Gain, or Loss

U.S. source FDAP income, gain or loss, is treated as ECI if it meets either of the following two tests:

1. Asset use test (income derived from assets used in a USTB); or
2. Business activities test (activities of a USTB are a “material factor” in generating income). Treas. Reg. §1.864-4(c).

Both tests are aimed at ECI treatment for generally “passive”-type income that is, in substance, more like business income (*e.g.*, interest on trade receivables and working capital, dividends for securities dealers, rents and royalties from active leasing or licensing business).

## Asset Use Test

1. Looks to whether income, gain or loss is derived from assets used in or held for use in the conduct of the foreign person's USTB (see next slide).
2. Generally applies in making a determination for passive items where the activities of the USTB do not directly give rise to the realization of the item.
  - a. Focused mostly on interest income and gain/losses from debt and securities resulting from an "active" USTB.
  - b. Stock never satisfies the asset use test (and thus dividends are never ECI under this test), except for portfolio stock investments owned by foreign insurance companies. Treas. Reg. §1.864-4(c)(2)(iii).



## Asset Use Test

1. Ordinarily, an asset will be treated as used in, or held for use in, the conduct of a USTB if it is:
  - a. Held for the principal purposes of promoting the present conduct of the USTB; or
  - b. Acquired and held in the ordinary course of the USTB as, for example, in the case of an account or note receivable, arising from that trade or business; or
  - c. Otherwise held in a direct relationship to the USTB, such as where the asset is needed to meet the present needs of that trade or business (e.g., for operating expenses), and not its anticipated future needs.

Note: This “used or held for use” standard is incorporated for other purposes (e.g., FIRPTA asset testing and DCL foreign branch accounting).

# Business Activities Test

1. The business activities test generally looks to whether the activities of a USTB were a material factor in the realization of the income, gain or loss.
  - a. Ordinarily applies to “passive” items that arise directly from the active conduct of the taxpayer’s USTB.
  - b. Examples of primary significance:
    - i. Dividends/Interest derived by a dealer in stocks or securities;
    - ii. Capital gains or losses derived by an investment company;
    - iii. Royalties derived from patents or similar intangible property in the active conduct of a licensing business; or
    - iv. Service fees derived by an active servicing business.

## Certain Foreign Source Income (“FSI”) as ECI

1. Foreign source income generally not treated as ECI
2. Exceptions to general rule found in IRC §864(c)(4):
  - a. Foreign taxpayer must have an office or other fixed place of business in the United States (“U.S.OFPB”) to which foreign source income, gain or loss is attributable.
  - b. Provision somewhat antiquated (despite a 2004 amendment to include equivalent items) and may not make sense/may be overridden by other provisions (e.g., U.S.-source treatment of income from personal property sales attributable to a U.S. OFPB; trading on own account safe harbor from USTB/ECI status)

## Certain Foreign Source Income as ECI

3. FSI attributable to a U.S. office is ECI if it:
  - a. Consists of rents or royalties for the use of certain intangibles derived in the active conduct of a USTB;
  - b. Consists of dividends or interest, or gains and losses on the sale or exchange of stocks or securities, and is derived in the active conduct of a U.S. banking, financing, or similar business;
  - c. Consists of dividends or interest, or gains and losses on the sale or exchange of stocks or securities, and the foreign corporation's principal business is trading in stocks or securities for its own account; or
  - d. Is derived from the sale of inventory, unless the property is sold for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country participated materially in such sale.
4. Foreign insurance companies engaged in a USTB -FSI that is attributable to its U.S. business is treated as ECI.

## Certain Foreign Source Income as ECI (U.S. OFPB Testing)

1. U.S. office of a dependent agent is attributable to foreign principal. IRC §864(c)(5).
2. U.S. office must be a material factor in the production of the income, gain, or loss. Treas. Reg. §1.864-6.
  - a. U.S. activities provide a significant contribution to, by being an essential economic element in, the realization of the income, gain, or loss.
    - i. Did a U.S. office actively participate in soliciting, negotiating, or performing other activities required to arrange for the transaction; or
    - ii. Did a U.S. office perform significant services incident to the transaction?
3. U.S. office must also regularly carry on activity from which income, gain or loss is derived.



## Certain Deferred Income as ECI (§864(c)(6)-(7))

1. Income recognized in one year, but attributable to disposition of property or performance of services in prior taxable year.
2. Gain from disposition of property withdrawn from USTB and disposed of within 10 years after withdrawal.
  - a. Losses not taken into account.
  - b. Difficult issue for some service providers that move in and out of U.S. project locations.

# IV. Application of Income Tax Treaties

# Treaty Benefits –General Requirements

## 1. Step 1: Qualify as a Tax Resident under the Treaty

- a. Partnerships
- b. Fiscally transparent entities
- c. Tax-exempts
- d. Dual residents
  - i. Tiebreaker rules.
  - ii. Rev. Rul. 2004-76
  - iii. If a company is a dual resident corporation of one of the Contracting States (*e.g.*, the U.K.) and a third state (*e.g.*, the Netherlands), but is treated as a resident of the third state (*e.g.*, the Netherlands) under a treaty between the Contracting State (here, the U.K.) and the third state (here, the Netherlands), the company will not be treated as a resident of the Contracting State (here, the UK).

# Treaty Benefits –General Requirements

**2. Step 2:** Satisfy at least one of the tests in the Limitations on Benefits (“LOB”) article:

- a. “Qualified persons” entitled to all treaty benefits
  - i. resident individuals, governments, publicly traded & subsidiary of publicly traded corporations
  - ii. Entities meeting ownership and base erosion tests
- b. Active Trade or Business Test
- c. Derivative Benefits Test (not all treaties)
- d. Headquarters company test (not common)
- e. Discretionary grant of treaty benefits

# Concept of Permanent Establishment

## – Three Types:

- Fixed Place of Business PE
  - Exception for Preparatory or Auxillary Activities
- Dependent Agent PE
  - A dependent agent who “has and habitually exercises [within the country] an authority to conclude contracts that are binding on the enterprise” may constitute a PE, even if no Fixed Place of Business PE
- Independent Agent PE
  - No PE, provided that independent agent acts in the ordinary course of their business as an independent agent

# V. Examples

## EXAMPLE ONE FACT PATTERN: U.S. PROVIDING SERVICES TO NON-U.S. OPERATIONS

- Non-U.S. parent company with non-US operations
- Formation of US subsidiary with the purpose of performing services for the non-US operations
- Key areas to consider:
  - Identifying and reimbursing costs associated with the service activity; allocation between service recipients?
  - Deterring arm's length mark-up under Treas. Reg. §1.482-9.
  - Does the US subsidiary need access to foreign-owned IP to perform the services? Consider terms of the license to US subsidiary.
  - Ensuring “limited risk” nature of the entity.
  - Ensuring sufficient funding for the entity's operations.
  - Documenting the intercompany arrangement in transfer pricing documentation.

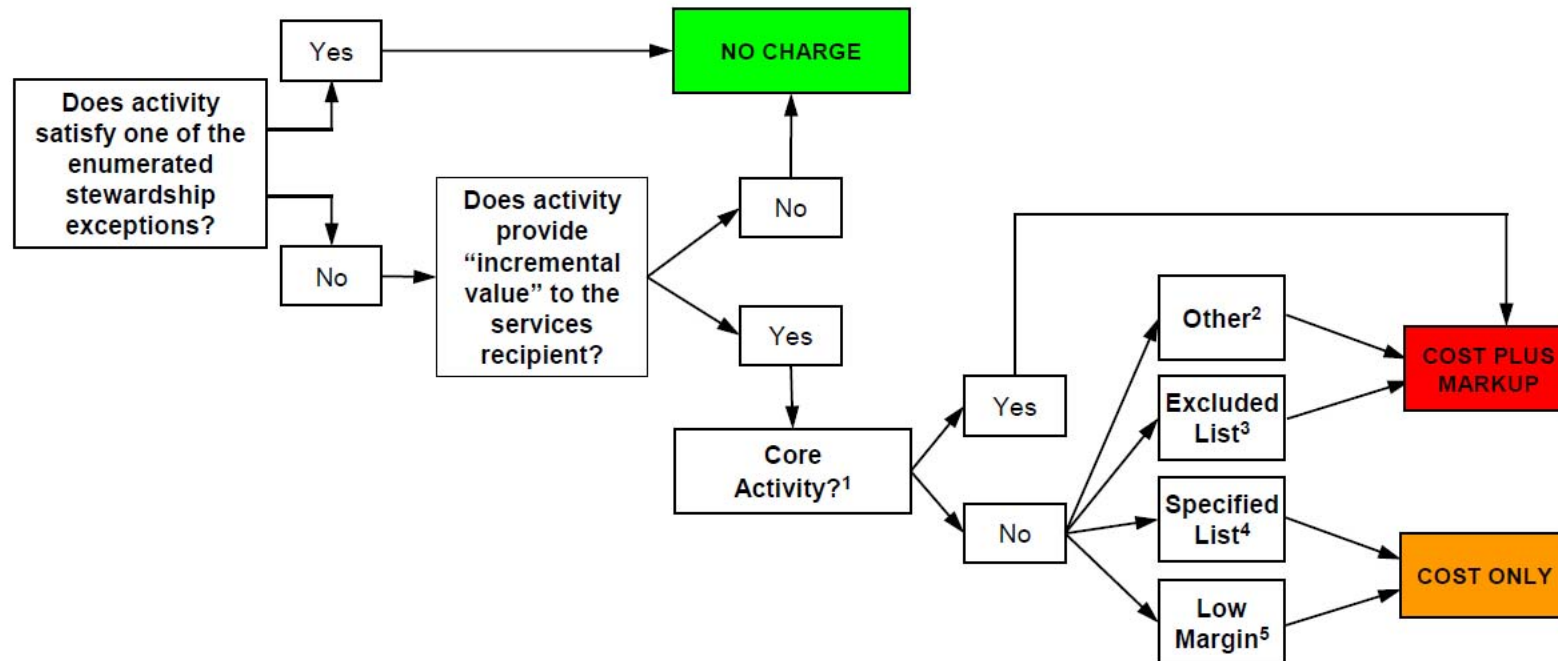
## EXAMPLE TWO FACT PATTERN: U.S. SELLING NON-U.S. MANUFACTURED PRODUCT INTO U.S.

- Non-U.S. parent company with non-US operations
- Formation of US subsidiary or “repurposing” of existing US subsidiary with the purpose of the US subsidiary selling non-US manufactured products into the U.S. (and/or other markets). In this model, the US subsidiary is a “reseller” of a non-US principal, but could also be a service provider of the entity that engages it or of other affiliates in the non-U.S. parents.
- Key areas to consider:
  - Deterring transfer price for products -reseller margin. Documenting the intercompany arrangement in transfer pricing documentation.
  - Isolating costs associated with reseller business vs. other activities (i.e., services) of the US entity
  - Identifying and reimbursing costs associated with the service activity; allocation between service recipients?
  - Does the US subsidiary need access to foreign-owned IP to act as reseller (i.e., license to marketing intangibles).
  - Ensuring sufficient funding for the entity’s operations.

## EXAMPLE THREE FACT PATTERN: U.S. MANUFACTURING PRODUCTS

- Non-U.S. parent company with non-US operations
- Formation of US subsidiary or “repurposing” of existing US subsidiary with the purpose of the US subsidiary manufacturing products in the U.S. In this model, the US subsidiary could also sell the products (into the US market) or to a non-US affiliate.
- Key areas to consider:
  - The entity needs access to the group IP to be able to manufacture the products
  - Does the entity obtain the “inputs” for manufacturing from non-US affiliates?
  - Is the entity a contract manufacturer selling US-manufactured products to another entity in the group? Or, is the entity a local entrepreneur for US and e.g., Latin America or Canada?
  - Isolating costs associated with manufacturing vs. other activities (e.g., services) of the US entity
  - Ensuring sufficient funding for the entity’s operations.

# Services Flowchart



1. Determined by applying the "business judgment rule" as set forth in Treas. Reg. § 1.482-9(b)(5).
2. Non-Core chargeable services that do not fall within any of the following three categories: (1) Excluded List; (2) Specified List; and (3) Low Margin.
3. Services that are not eligible for the Services Cost Method, and which are defined as "excluded activities" in Treas. Reg. § 1.482-9(b)(4).
4. Services that are eligible for the Services Cost Method, and that the Commissioner specifies by revenue procedure. See Rev. Proc. 2007-13, 2007-1 C.B. 295.
5. Services for which the median comparable markup on total services costs is less than or equal to 7%.

# COMPLYING WITH U.S. DOCUMENTATION RULES

- List of 10 Principal Documentation Items –usually in report. Used to support penalty protection, if assessed a penalty.
  - An overview of the taxpayer's business, including economic and legal factors that affect pricing of its property or services. Treas.Reg. §1.6662-6(d)(2)(iii)(B)(1).
  - A description of the taxpayer's organizational structure, including all related parties whose activities are relevant to transfer pricing. Treas.Reg. §1.6662-6(d)(2)(iii)(B)(2).
  - Any document explicitly required by the regulations under section 482(e.g., documentation of non-routine risks, cost sharing agreements, etc.). Treas.Reg. §1.6662-6(d)(2)(iii)(B)(3).
  - A description of the method selected and the reason why it was selected, including an evaluation of whether the regulatory conditions and requirements for application of that method, if any, were met. Treas.Reg. §1.6662-6(d)(2)(iii)(B)(4).
  - A description of the alternative methods that were considered and an explanation of why they were not selected. Treas.Reg. §1.6662-6(d)(2)(iii)(B)(5).
  - A description of the controlled transactions(including terms of sale) and any internal data used to analyze them. Treas.Reg. §1.6662-6(d)(2)(iii)(B)(6).

## COMPLYING WITH U.S. DOCUMENTATION RULES (CONT.)

- A description of the comparables used, how comparability was evaluated and what adjustments were made. Treas.Reg. §1.6662-6(d)(2)(iii)(B)(7).
  - An explanation of the economic analysis and projections relied on in developing the method. Treas.Reg. §1.6662-6(d)(2)(iii)(B)(8).
  - A description or summary of any relevant data that the taxpayer obtains after the end of the year and before filing a tax return, which would help determine if a taxpayer selected and applied a specified method in a reasonable manner. Treas.Reg. §1.6662-6(d)(2)(iii)(B)(9).
  - An index of principal and background documents. and a description of the record keeping system used for cataloging and accessing those documents Treas.Reg. §1.6662-6(d)(2)(iii)(B)(10).
- 
- In practice, increasingly less experienced examination teams on TP audits.
  - TP doc almost always requested at first meeting, though Exam may not involve an economist.
  - Economists often apply theories that do not completely align with Regs.
  - The Exam phase typically ends with a Revenue Agent's Report ("RAR").



**Steven Hadjilogiou**  
**Partner – Baker & McKenzie**  
Miami | United States

T: + 1 305 789 8909  
steven.hadjilogiou@bakermckenzie.com

Steven Hadjilogiou is a partner in the Firm's Tax Practice Group in Miami. He is consistently recognized as a leading tax lawyer by *Chambers USA*, top-rated by *Florida Super Lawyers*, and recognized in *Florida Trend's Legal Elite*.

Mr. Hadjilogiou has written numerous articles and presented on topics related to tax. He was a primary drafter of the amicus curiae brief submitted to the US Supreme Court on behalf of the Florida Bar Tax Section in *Knight v. Commissioner* in 2008. Mr. Hadjilogiou is also an adjunct professor in the University of Miami School of Law's Tax LLM program.

### **Practice Focus**

Mr. Hadjilogiou focuses his practice on tax planning. He has substantial experience advising on transfer pricing, tax-related intellectual property matters, Subpart F and foreign investment in US real property. He has also worked on the taxation of partnerships and corporations, and international corporate reorganizations.

Mr. Hadjilogiou also counsels on state and local tax, inbound and outbound transactional planning, and other corporate and real estate tax issues in several jurisdictions across the world. He has represented various Fortune 500 companies and major privately held businesses in their tax planning and supply chain

### **Professional Associations and Memberships**

- Society of Trust and Estate Practitioners (STEP) - Member
- State Bar of Georgia - Member
- Florida Bar - Federal Tax Division, Co-Chair; International Tax In-Bound Committee, Vice-Chair
- Greater Miami Tax Institute - Secretary/Treasurer
- Florida International Bankers Association (FIBA) - Young Professionals Committee; Member of Steering Committee