



Introduction to US International Tax Concepts

November 10, 2020

OVERVIEW OF SESSION

Agenda

- Basic Principles of International Taxation
- “Outbound” Taxation of US Persons on Non-US Activities
- “Inbound” Taxation of Non-US Persons on US Activities
- “Base Erosion” – A Global Concern
- Tax Treaties
- Transfer Pricing & Dispute Resolution

About this Session

- Primer: appropriate for attendees with little or no experience in international tax matters
- Introduction to key concepts in the US federal income taxation of international activities, including:
 - “Worldwide” vs “territorial” taxation
 - “Inbound” vs “outbound” activities
 - “Anti-deferral” regimes
 - FDAP withholding
 - Base erosion
 - Bilateral tax treaties

BASIC PRINCIPLES OF INTERNATIONAL TAXATION

Basic Principles

- Territorial taxation: Tax on all income earned within the country.
- Worldwide taxation: Some countries **also** tax residents of the country based on their worldwide income, regardless of where it is earned. Generally includes foreign tax credit for tax paid to other countries.
- US pre-tax reform:
 - US persons subject to US tax on worldwide income regardless of source
 - Foreign persons subject to US tax on only US-source income
- US post-tax reform: ?

US Tax System Post-Tax Reform

- Post-TCJA the US international tax system has elements of worldwide and territorial system
- Worldwide
 - Current inclusion by US Shareholders of certain earnings of foreign subsidiaries: Global Intangible Low-Taxed Income (GILTI) and Subpart F
 - Current inclusion of foreign branch income
- Territorial
 - Participation exemption (100% dividends-received deduction) for earnings that are not subject to current inclusion
- Anti-base erosion provisions
 - Base erosion and anti-abuse tax (BEAT)

Who is a US Person?

- Any “domestic” corporation (including an insurance company) or partnership is a US person.
 - “Domestic” = “created or organized in the United States or under the law of the United States or of any State”
- An individual is a US person if he or she is a “citizen” or “resident” of the US
 - A non-citizen is a “resident” if:
 - “Lawfully admitted permanent resident” under US immigration law;
 - Meets a “substantial presence test,” which generally requires that the individual have spent a certain number of days in the US in the past year or years; or
 - Makes a “first-year” election, which allows some non-citizens to elect to be a resident in the year before they meet the substantial presence test.

“OUTBOUND:”

TAXATION OF US PERSONS ON NON-US ACTIVITIES

What is an “Outbound” Transaction?

- US person earning income outside the US
- General Rule: income from “outbound” transactions is subject to US tax.
 - US persons are subject to US tax on their worldwide income.
 - But: not on income earned by a foreign corporation that is owned by a US person, because the foreign corporation is a separate entity with its own residence.
- However, certain special provisions modify this general rule:
 - Subpart F and PFIC Anti-Deferral Regimes
 - Foreign Tax Credit (FTC)
- Also, several aspects of Tax Reform affect the general rule:
 - Base Erosion and Anti-Abuse Tax (BEAT)
 - Section 245A Dividends Received Deduction (DRD) for foreign dividends
 - Tax on Global Intangible Low-Taxed Income (GILTI)
 - Tax Cuts and Jobs Act “Deemed Repatriation” or “Transition Tax”

Deferral vs. Anti-Deferral

Pre-Tax Reform: Deferral vs. Anti-deferral

- Generally, if a US person owned a corporation that earns income, the person was not taxed on the income of the corporation until the person received a distribution or disposed of its stock.
- US taxpayers could *defer* US taxes by channeling foreign-source income through a foreign corporation, ideally located in a low-tax jurisdiction.
 - Instead of paying tax when the income is earned, the taxpayer pays later, when the income is “repatriated.”
- “Subpart F” and the “PFIC” rules are “*anti-deferral*” regimes intended to prevent this outcome via:
 - Tax on US Shareholders of CFCs
 - Tax on US holders of PFICs
 - Tax on US shareholders of insurance CFCs that earn RPII

Territorial vs. Territorial-Lite

Post-Tax Reform: Territorial vs. Territorial-Lite

- Territorial regime? – Dividends Received Deduction (“DRD”)
 - A US corporation that is a “US Shareholder” of a foreign corporation is entitled to a new, 100% dividends-received deduction for dividends from the foreign corporation of earnings that have not been previously taxed.
 - This introduces “territoriality” to the US’s otherwise expanded system of worldwide taxation.
- Reality is Territorial-Lite – Entitled to DRD except certain items (not a complete list)
 - Subpart F regime continues
 - New Type of Subpart F Inclusion: Global Intangible Low-Taxed Income (GILTI)
 - Deemed repatriation of previously deferred earnings
 - Section 956 remains?

Controlled Foreign Corporation (CFC)

- A CFC is a foreign corporation that meets a stock ownership test: *more than 50% of the vote or value* of the corporation's stock is owned by "US Shareholders."
 - A **US Shareholder** is any US person that owns *10% of the vote or value of all classes of stock*, directly, indirectly or constructively.
 - Example: A foreign corporation that is owned by 11 US persons, each owning 9.09% of the sole class of shares that have proportionate vote and value is not a CFC (absent any connection among any of the US persons).
 - The "vote prong" looks to the "reality," not just the formality, of voting power.
 - E.g., whether US Shareholders have the power to elect, appoint, or replace a majority of the board of directors (or elect half the board and cast a tie-breaking vote).
 - Also: the Service may disregard nominal ownership if the shareholders have express or implied agreements about voting.
- Annual determination: a foreign corporation may be a CFC one year, but not the next.

Tax on Subpart F Income

- If a CFC earns “Subpart F income,” the income passes through to the CFC’s US Shareholders on a pro rata basis, resulting in current US tax on the US Shareholders.
- **Subpart F income** includes (this is not a complete list!):
 - *Passive income*: dividends, interest, rents, royalties, income from commodity and currency transactions and notional principal contracts
 - *Insurance income*
- **Subpart F income** does **not** include (also not a complete list):
 - Active financing income
 - Exempt insurance income
 - Income from services performed for unrelated persons
 - Active rents/royalties received from unrelated persons

Subpart F Application to Insurance Companies

- Special ownership threshold: For purposes of including Subpart F insurance income, a foreign corporation is a CFC if more than 25%, rather than 50%, of its stock is owned by US Shareholders.
- Generally, income from insurance or reinsurance that would be taxed under subchapter L if the corporation were a domestic insurance company.
 - Exemption for “exempt insurance income,” which includes some income of foreign insurance companies in connection with in-country risks.
- 954(i) – Mechanical computation to exclude certain investment income associated with insurance reserves
- 952 election – Election to determine subpart F income without application of the same country exemption.

RPII: A Flavor of Subpart F Income

- RPII = Related Person Insurance Income
- Section 953(c)(2): insurance income attributable to a policy of insurance or reinsurance with respect to which the person (directly or indirectly) insured is a United States shareholder in the foreign corporation or a related person to such a shareholder.
- Here, “United States shareholder” means ANY direct or indirect US shareholder
- Consequence: a RPII Shareholder has (i) phantom income (i.e., loss of deferral), and (ii) possible excess inclusion because the “pro rata” share is determined as if the RPII were distributed proportionately only to US persons (subject to the shareholder’s pro rata share of E&P).
- Exceptions are available:
 - No inclusion if less than 20% of vote/value is owned by persons who are (directly or indirectly) insured or reinsured or who are related persons to any such person;
 - No inclusion if RPII represents less than 20% of the insurance income of the foreign corporation

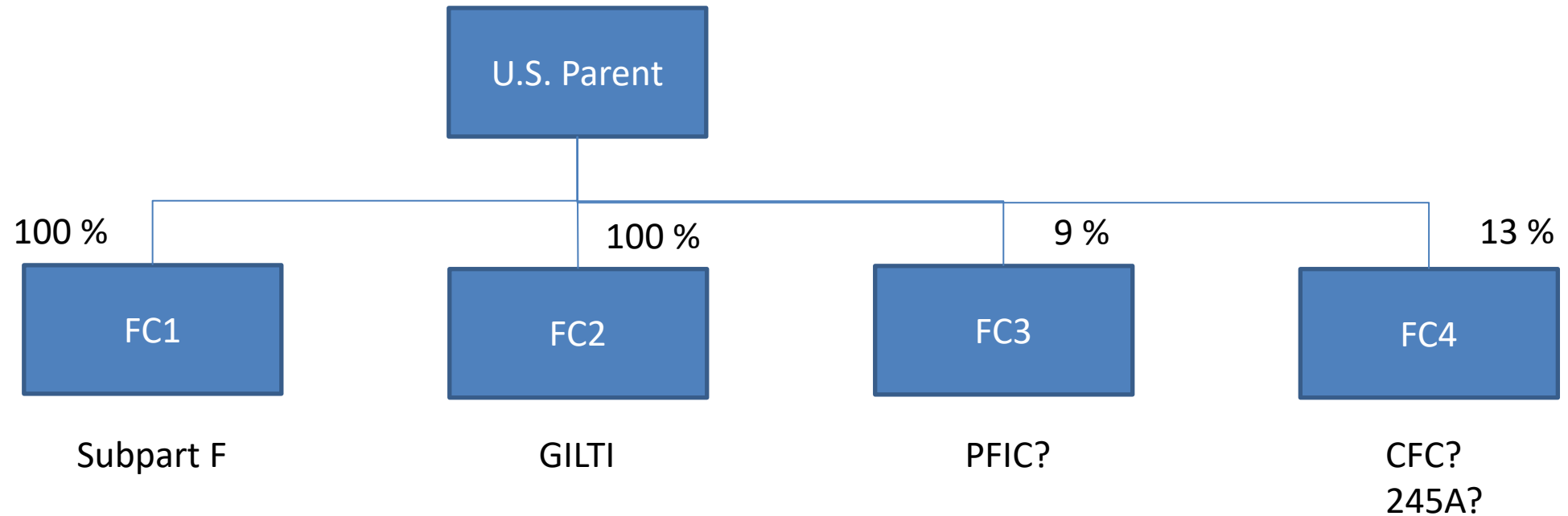
GILTI: A New Kind of Subpart F Inclusion

- US Shareholders of CFCs that earn no “Subpart F income” may still be required to include a portion of the CFC’s income in their current tax return (regardless of whether they have received a distribution) under the “GILTI” rules (Global Intangible Low-Taxed Income).
- Unlike Subpart F income, GILTI is calculated at the taxpayer level, considering all CFCs in which the taxpayer qualifies as a US Shareholder
- Don’t let the name fool you!
 - GILTI includes all income (other than Subpart F income and certain other amounts) that exceeds a 10% return on the adjusted tax basis of tangible property of the CFC.
 - Example: US Shareholder owns 100% of CFC, which operates a consulting business. CFC earns \$100 of income in year 1. CFC owns furniture and fixtures with adjusted tax basis of \$20 but no other tangible assets.
 - QBAI: \$20
 - Net deemed tangible income return: $10\% * \$20 = \2
 - **GILTI = \$100 - \$2 = \$98**
 - But a 50% deduction is available if US Shareholder is a corporation
- Computation of GILTI requires determination of taxable income at a CFC level as though such entity were a U.S. entity. There are numerous insurance-specific adjustments that may be needed to determine taxable income.

Passive Foreign Investment Companies

- Another anti-deferral measure meant to address US persons deferring US tax on *passive investment income* through foreign corporations.
- A PFIC is any foreign corporation meeting one of two tests:
 - **Income test:** 75% or more of gross income for the taxable year is “passive income” (generally including dividends, interest, royalties, rents, etc.).
 - **Asset test:** 50% or more of assets are “passive assets” (i.e., assets producing passive income).
- A US person that owns a PFIC (in any amount) may either:
 - elect to treat the PFIC as a “qualified electing fund” (QEF), which requires the US person to include in current year income their pro rata share of the PFIC’s ordinary earnings and net capital gain for the year;
 - if the PFIC is publicly-traded, elect to “mark to market” the stock annually; or
 - upon receiving an “**excess distribution**” or any gain on dispositions, pay current tax on the distribution or gain at the *highest ordinary rate* (rather than preferential dividend or capital gains rates) plus interest on taxes deemed deferred from previous years.
- Insurance Exception – Passive income does not include investment income derived in the active conduct of insurance business.

Potential Current Year Taxation: Summary Scenarios



“INBOUND”:

TAXATION OF NON-US PERSONS ON US ACTIVITIES

“Inbound” Transactions

- General rule: Foreign persons are subject to US tax only on income earned from US sources or from the conduct of a US trade or business.
- Foreign persons engaged in a trade or business in the US must file tax returns and pay net income tax on their “**effectively connected income**” (ECI) at the same rates applicable to US persons.
- Foreign persons generally pay a flat rate 30% gross income tax on their US-source, **fixed or determinable, and annual or periodical gains, profits and income (FDAP income)** that is not ECI.
- Foreign persons from countries that have entered into tax treaties with the US may enjoy:
 - Relief from net income tax on income associated with a trade or business in the US, unless that income is attributable to a permanent establishment.
 - Zero or reduced withholding tax rates on FDAP income.

FDAP Income

- Foreign persons are taxed at a flat rate of 30%, *without allowance for deductions*, on their US-source “fixed or determinable, annual or periodical gains, profits, and income” that is not ECI.
- **FDAP** is broad and generally includes all passive income (interest, OID, dividends and other corporate distributions, rents and royalties).
- FDAP generally does *not* include gains from dispositions of property.
- The tax on FDAP is generally satisfied through a **withholding tax**, meaning that the domestic payor must *withhold* 30% of the payment to the foreign payee and remit that amount to the government.
 - A flat-rate gross-basis withholding tax system makes collection from foreign taxpayers simpler.

How is income “sourced”?

- The source rules (§§ 861-865 and other sections), are complex, and may be supplemented by treaties. The following are general rules (subject to exceptions):
 - *Interest income* is sourced based on debtor’s residence or place of incorporation.
 - *Dividend income* is sourced based on the payor’s place of incorporation.
 - *Compensation for personal services* is sourced based on the place where the services were performed.
 - *Rental income and royalties* are sourced by the location or place of use of the leased property.
 - *Insurance underwriting income* is sourced based on the location of the risks insured.
 - Income from a *notional principal contract* is sourced by reference to the payee.
 - In the absence of a clear rule, income sourced by analogy.

US Trade or Business

- A non-US person that is engaged in a “trade or business” in the US is subject to net income tax on its ECI. Determination has few bright lines and is based on facts and circumstances:
 - “Regular, continuous and considerable” or “sustained” activity
 - “Trade or business” vs. activity as an investor
 - Statutory “safe harbors” protect investment activity (i.e., trading for your own account)
 - Lending activity vs. purchase of a debt obligation
 - Performance of personal services
- Activities taken into account:
 - Activity undertaken by the nonresident individual or foreign corporation (through its employees)
 - Activity of an “agent” of the non-US person
 - Activity of a partnership in which the non-US person is a partner
 - Activity of a trust or estate of which the non-US person is a beneficiary

Effectively Connected Income (ECI)

- A non-US person that is engaged in a “trade or business” in the US is subject to US federal income tax on income that is “effectively connected” with that trade or business: ECI.
 - In general, US-source FDAP and capital gains are ECI if one of two tests are met:
 - **Asset-use test:** The income is derived from assets used in or held for use in the US trade or business.
 - **Business-activities test:** The activities of the US trade or business were a material factor in the realization of the income.
 - All other US-source income is treated as ECI.
 - Foreign-source income is treated as ECI only if it is attributable to an office or other fixed place of business in the US and certain other requirements are met.
 - For insurance companies:
 - Minimum effectively connected net investment income: a portion of net investment income is automatically treated as ECI
 - Foreign source income attributable to US business is treated as ECI

“BASE EROSION:” A GLOBAL CONCERN

Tax on Certain Outbound Transactions: BEAT

- What if a taxpayer erodes US profits by making deductible payments to an offshore affiliate in a low-tax jurisdiction?
 - “**Base erosion**” is a term to describe this reduction in a country’s tax base.
 - The Code contains several provisions designed to prevent base erosion, including “interest stripping” limitations and transfer-pricing rules.
- New with Tax Reform: the “**Base Erosion and Anti-abuse Tax**” or “**BEAT**”
 - a *minimum* tax on certain large corporations that pay related foreign persons.
 - “Related” is broadly defined and includes (i) a 25% owner of the taxpayer (including constructively), (ii) persons related under sections 267(b) or 707(b)(1) to the taxpayer or one of its 25% owners, and (iii) persons related under § 482, including those owned or controlled directly or indirectly by the same interests.
- Based on “**base erosion tax benefits:**” generally, deductions or reductions in gross receipts arising from “base erosion payments,” which include
 - Deductible payments to a “related foreign person,” except for the cost component of certain services;
 - Purchases of depreciable or amortizable property from a “related foreign person;”
 - Certain premiums and other consideration paid to a “related foreign person” for insurance or reinsurance.

BEAT: Applicable Taxpayer

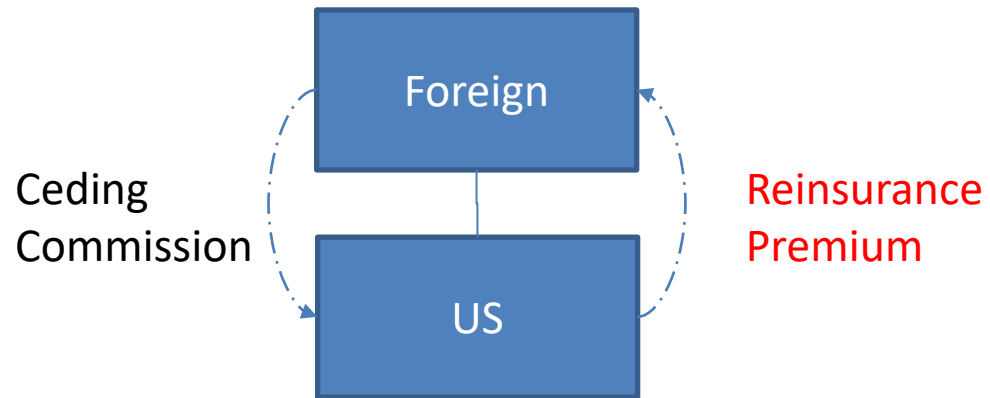
- BEAT only applies to “applicable taxpayers,” which includes any taxpayer that is:
 - A corporation (including an insurance company);
 - With average annual gross receipts of at least \$500 million for the preceding three years, calculated on a group-wide basis; and
 - With a “base erosion percentage” of 3% or more.

$$\text{Base erosion percentage} = \frac{\text{Base Erosion Tax Benefits}}{(\text{All Deductions}) + (\text{All Base Erosion Tax Benefits That Are Not Deductions})}$$

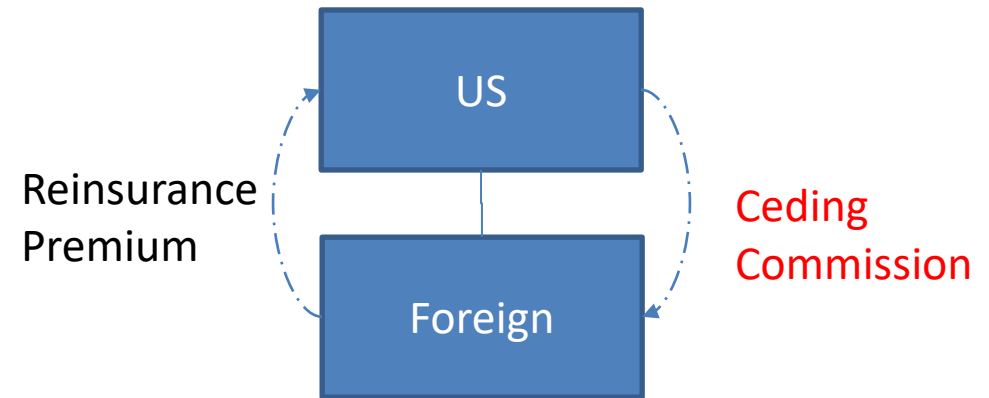
- Because foreign persons can be U.S. taxpayers, they can potentially be subject to BEAT.

BEAT Illustration

Inbound



Outbound



OECD BEPS Projects – Digitalization of the Economy

Globally, focus has intensified on payments that erode the tax base of a jurisdiction

Overview of Developments

- The OECD two-pillar approach to address the tax challenges arising from the digitalization of the economy involves the following proposals:
 - **Pillar 1:** proposals for a redesign of the international transfer pricing framework, including proposals for the introduction of a new taxing right that would allocate a share of MNEs residual profits to market jurisdictions based on a formulaic approach. Insurance excluded.
 - **Pillar 2:** the so-called “Global Base Erosion (“GloBE”)” proposal, which consists of various measures that aim to introduce a global minimum tax, amongst others, through the introduction of global GILTI and BEAT type rules.
- More than 135 countries are currently working together on developing the proposals with the aim to reach a consensus-based solution by the end of 2020.

TAX TREATIES

Income Tax Treaties: Generally

- Bilateral income tax treaties provide for adjustments between the income tax systems of two countries to reduce barriers to international trade, prevent discriminatory tax treatment, and permit reciprocal administration.
 - The US has income tax treaties with 58 countries.
- Income tax treaties typically provide benefits only to “**residents**” of the treaty country. The concept of residence can vary based on the terms of the treaty and the laws of the foreign country. For example, residence in some cases looks to a corporation’s country of incorporation, and in others to the locus of management.
- US treaties typically require that a resident satisfy other requirements under a “Limitation on Benefits” article to benefit under the treaty
- Some of the primary benefits to residents of the treaty country are:
 - Reduction in **rates of tax on FDAP income**;
 - **Exemption for business profits** unless attributable to a “permanent establishment;” and
 - **Uncommon:** Exemption from federal excise tax on insurance.

Withholding Tax Rates

- Treaties reduce the rate of tax on US-source FDAP income paid to residents of the treaty country if not attributable to a PE in the US:
 - *Dividends*: typically taxed at 15% or less; recent treaties may provide for exemption for dividends from controlled subsidiaries
 - *Interest*: often exempted or taxed at 15% or less.
 - *Royalties*: typically exempted or taxed at 15% or less
 - *Rents*: typically exempted as business profits, except for the rental of US real property.
- Consider potential application of anti-conduit rules in arrangements involving back-to-back payments

Business Profits

- Treaties typically exempt from US taxation “business profits” earned in the US by residents of the treaty country, unless the business profits are attributable to a “permanent establishment.”
- **Business profits** generally include income derived from any trade or business.

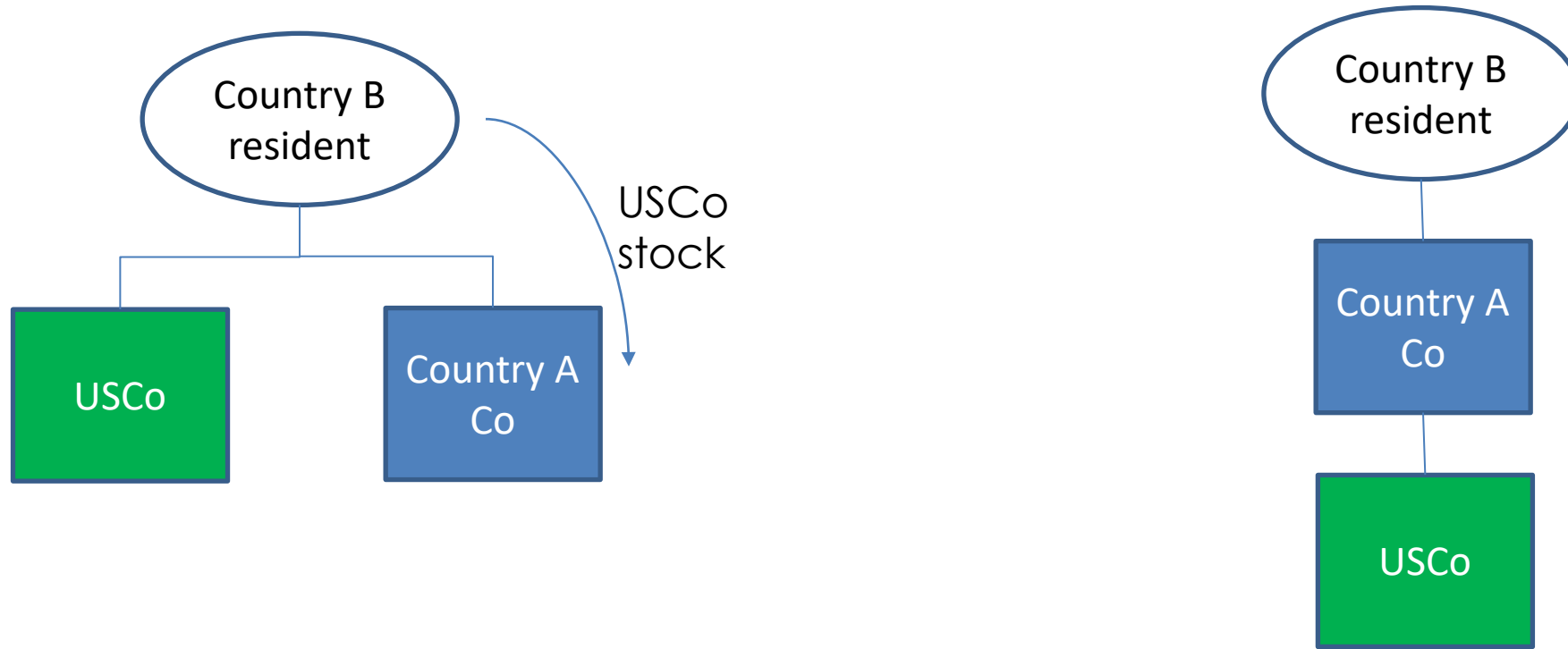
Permanent Establishment

- **Permanent establishment** is typically defined as a “fixed place of business” through which a business is wholly or partly carried on.
 - A permanent establishment typically includes a branch of the business, an office, and a factory.
 - A treaty may contain safe harbors for certain activities such as the use of facilities solely for storage or maintenance of a fixed place of business solely for purchasing goods, etc.
 - If a dependent agent has and habitually exercises in the US the authority to conclude contracts binding on a foreign principal, then the agent’s activities typically create a US permanent establishment for the foreign principal.
 - The concept of permanent establishment is generally more narrow than that of a “US trade or business.” Thus, a resident of a treaty country generally must have a more extensive presence in the US in order to be taxed on ECI than a resident of a non-treaty country.

Exemption from Insurance Excise Tax

- A treaty may exempt foreign residents from the insurance excise tax under section 4371 on premiums paid to a foreign reinsurer that is a resident of the treaty country.
- However, the treaty may specify that the benefit does not apply where the foreign reinsurer reinsures the risk to a third party that is not a resident of a country with a treaty.
- Example: US-UK Tax Treaty

Limitation on Benefits



- **Issue:** When the US enters a treaty with Country A, persons from Country B may attempt to shift income to a corporation formed in Country A, or establish residence in Country A, to obtain the benefits of that country's treaties with the US. This is sometimes called "**treaty shopping.**"

Limitation on Benefits (cont'd)

- Treaties contain “limitation on benefits” or “LOB” articles to address treaty shopping by denying treaty benefits to corporations formed in the treaty country but largely owned by residents of a third country unless attributable to a trade or business activity conducted in the treaty country.
- Limitation on benefits provisions are highly mechanical and technical and typically limit treaty benefits to:
 - Regularly traded companies (and subsidiaries)
 - Active trade or business
 - Ownership/base erosion
 - Derivative benefits
 - Discretionary relief
- Specific treaty benefits may have stricter LOB requirements (*e.g.*, zero rates on dividends)
- The Code also contains certain anti-treaty-shopping provisions, and the Service and courts may use general tax doctrines preventing “sham” transactions or transactions with “no economic or business purpose.”

TRANSFER PRICING AND DISPUTE RESOLUTION

Allocation of Profits



- Assume USCo and UKCo are under common control
- US-initiated adjustment: what if US IRS allocates \$20 income from UKCo to USCo?
 - USCo pays additional US tax on additional income
 - But UKCo already paid UK tax on this income
- Foreign-initiated adjustment: what if HMRC allocates \$20 income from USCo to UKCO?
- Double taxation may result
 - No requirement under domestic law to give effect to another country's transfer pricing adjustment
 - Restrictions on availability of U.S. foreign tax credit unless taxpayer "exhausts all practical and effective remedies"

Competent Authority Overview

- All U.S. treaties contain a Mutual Agreement Procedure (“MAP”) Article
 - Taxpayer may bring case to competent authority where it believes that the actions of one or both of the Contracting States result in taxation not in accordance with the treaty (e.g., double taxation)
 - The competent authorities endeavor to resolve the case by mutual agreement
- Types of Competent Authority cases
 - Cases arising under business profits and associated enterprises articles (transfer pricing)
 - Handled by IRS Advance Pricing and Mutual Agreement (“APMA”) Office
 - Cases arising under all other articles (residence, limitation on benefits, dividends, interest, royalties)
 - Handled by IRS Treaty Assistance and Interpretation Team (“TAIT”)

Competent Authority Process

- Protective Measures
 - Limitation periods in domestic law and treaties
- Informal Consultations and Pre-Filing Conferences
 - Recommended for large and complex cases; mandatory in the case of taxpayer-initiated adjustments
- Written Request (Rev. Proc. 2015-40)
- Time for Filing MAP Request
 - U.S.-initiated adjustment: typically file upon issuance of RAR or NOPA
 - Foreign-initiated adjustment: typically advisable to file as soon as foreign country proposes specific adjustment
- Processing the Request
 - Acceptance (or rejection)
 - Suspension of domestic law proceedings
 - Position papers and government-to-government negotiations
 - Agreement
- Taxpayer Acceptance and Implementation
- Rolling the Agreement Forward (ACAP)

Competent Authority Arbitration

- Traditional Competent Authority procedure can result in protracted negotiations and may not result in an agreement
- Mandatory arbitration is a significant policy development in U.S. tax treaties
 - Arbitration is in place in a handful of U.S. treaties (*e.g.*, Canada, Germany, Belgium)
 - Arbitration commences 2 years after case is brought to competent authorities
 - 2016 U.S. Model Treaty includes a mandatory binding arbitration provision
 - BEPS Multilateral Instrument (2016) includes provisions for mandatory binding arbitration (which countries may decide to adopt on a bilateral basis)