Chapter 6 Federal International Issues Overview

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Training Objectives:

This chapter introduces you to the U.S. system of taxation of international transactions and investments, and describes in general terms the relationship of that system to the water's-edge system. Included in this material are introductions to areas such as section 482 pricing, Subpart F, U.S. possessions corporations, foreign sales corporations, and section 367 transfers which are the subjects of detailed chapters in the text which follows, and for which you will find direct applications in your audits of water's-edge tax returns. Also included are background materials on tax treaties, the foreign tax credit, and income and deduction source concepts. This additional material is provided so that you can gain an overall understanding of the federal system, and so that you will know how the individual federal provisions you will be applying fit in to the larger federal scheme for dealing with international transactions and investments.

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Section 6.1 Introduction To The Federal International Issues Overview

Contents:

a. The Nature and Limitations of U.S. Taxing Jurisdiction
b. Jurisdiction as to U.S. Corporations
c. Jurisdiction as to Foreign Corporations
d. "Indirect" Jurisdiction
e. Summary

References:

IRC §11
IRC §61
IRC §864(c)(4)(B)
IRC §881
IRC §882
IRC §951
IRC §1442

Training Objectives:

At the conclusion of your classroom work on this chapter you should be able to describe the taxing jurisdiction of the United States as it applies to U.S.-based and foreign-based multinational corporations.

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a. The Nature And Limitations Of U.S. Taxing Jurisdiction

As discussed in Chapter 1(d), Water's-Edge Manual, there is a basic difference between the nature of the taxing jurisdiction of the United States and that of the state of California. As to the income of multijurisdictional corporate business enterprises, California may only tax that which is derived from California sources.[1] This limitation is founded in the Commerce and Due Process Clauses of the U.S. constitution.[2]

The government of the United States, however, suffers no such constitutional limitations.[3] In the international context the only significant limitations on U.S. jurisdiction to tax are self-imposed by Congress in furtherance of tax, foreign relations, or international trade policy considerations. There are no provisions of international law or the U.S. constitution which in any way limit the worldwide jurisdiction to tax the income of U.S. citizens or residents, or that derived from property having some connection with the U.S.[4]

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Thus the United States even asserts the right to tax certain types of income of foreign corporations derived from foreign sources, where such income is connected with the operation of a U.S. trade or business. [5]

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b. Jurisdiction As To U.S. Corporations

Congress is not shy in asserting the right to tax the income of entities incorporated in the United States. All is enough. There is no exclusion from taxation for income derived from sources outside the U.S.[6]

Example 1:

Corporation A was incorporated under the laws of the state of California. All of its property, officers, and employees are located in foreign countries. All of its business is conducted in foreign countries. It conducts no business in, and transacts no business with any other person in, the United States.

All of Corporation A's income is subject to the U.S. federal income tax.

Many foreign countries, however, assert taxation on the basis of source (indeed, the United States does so; see Section 6.1(c), Water's-Edge Manual).

Example 2:

Corporation A described in the immediately preceding example conducts all of its business and derives all of its income from sources in the United Kingdom (U.K.). The U.K. therefore asserts taxing jurisdiction over all of A's income.

Where both the United States, as the country of incorporation, and a foreign country, as the geographic source of income, assert the right to tax income, international double taxation arises. Taking our preceding examples together, Corporation A's income is taxable in its entirety by both the United States and the United Kingdom. Where this occurs the United States in effect cedes all or part of its jurisdiction to tax the income of its corporate citizen to the country with source-based jurisdiction. This is accomplished by means of the foreign tax credit. In our Example 2 with Corporation A, a credit would be available against A's U.S. tax liability for the income taxes paid to the U.K.[7]

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c. Jurisdiction As To Foreign Corporations

Congress is more circumspect with respect to entities incorporated in foreign countries, asserting jurisdiction to tax only income with some connection with the United States. As you might expect, the methods of applying the tax under this theory of jurisdiction are quite a bit more complicated than that which applies in the case of U.S. incorporated entities.

In asserting source-based jurisdiction to tax the income of foreign corporations the United States does not operate under a "minimum connection" -- or "nexus" -- limitation such as that applicable to the states (see above; note [2]). As indicated above, such limitations as apply are self-imposed, and they reflect consideration of a broad range of international policy considerations.

A number of specialized provisions apply under federal law in delimiting jurisdiction to tax the income of foreign corporations. Most of these are the subject of separate treatment in this or later chapters of your text. For our present purpose we will merely sketch an outline of the treatment of items based on distinctions between countries of incorporation, types of income, and whether the income is related to U.S. business operations. It may not be quite accurate to even speak of these rules in terms of "jurisdiction" inasmuch as that term implies the scope of the authority of the U.S. to tax, and we are dealing here with self-imposed limitations. However, and with apologies to purists, it seems best to start our discussion of how the U.S. taxes income of foreign entities by defining the limits of the jurisdictional claims which have been made by the U.S., even if we can not precisely define the limiting or restraining influences, and even if such influences are not, strictly speaking, compelling.

In general, the United States asserts jurisdiction to tax only that income of a foreign corporation which is "effectively connected with the conduct of a trade or business within the United States" (generally referred to as "effectively connected

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income," or "ECI").[8] This not very simple concept is discussed briefly in the next section and is the subject of Chapter 8, Water's-Edge Manual.

U.S. jurisdiction to tax ECI is, however, ceded to the country of incorporation in certain instances. The most common method of doing so is by means of tax treaties with foreign governments. Tax treaties are the subject of Section 6.2, Water's-Edge Manual of this chapter, and they are referred to in Chapter 8, Water's-Edge Manual.[9]

Source-based jurisdiction is not limited to ECI, however. Certain types of income from U.S. investments and activities which do not rise to the level of being a "trade or business within the United States" are subject to tax under IRC section 881. This is not the normal income tax, but a special 30 percent tax which is generally collected by means of withholding by the payer of the income.[10] Tax treaties are, again, a significant factor when it comes to this type of income; however, rather than operating to cede jurisdiction to the country of residence of the payee, treaty provisions in this area generally merely reduce the applicable tax rate to something less than the statutory rate of 30 percent.[11]

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d. "Indirect" Jurisdiction

The long arm of tax jurisdiction of the United States extends even to the earnings of foreign incorporated entities which are controlled by U.S. shareholders. As you will see in Section 6.6, Water's-Edge Manual, and in Chapter 9, Water's-Edge Manual, the U.S. imposes an income tax on U.S. shareholders with respect to certain types of income of their controlled foreign corporations. This is accomplished by means of the fiction of a so-called "deemed dividend" pursuant to the Subpart F provisions.[12] Although this can be viewed as simply a definition of a special type of income, or as merely an acceleration of tax on amounts which would be included in the shareholder's taxable income at some later date when actually distributed, it seems equally valid to view it as an extension of U.S. tax jurisdiction into a foreign country -- subjecting the foreign source earnings of a foreign corporation to tax via indirect means.

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e. Summary

You were introduced to a number of new terms in the foregoing discussion. All of these will be subject to extensive discussions in the text which follows. At this stage you may find this discussion of U.S. tax jurisdiction difficult to digest. The following chart may help you to put some of these concepts into perspective; you may wish to refer back to it as you study foreign tax credits, treaties, ECI, and other subjects in your subsequent lessons.

	U.S. Tax Jurisdiction Over Income From Sources	
Over These Entities	In the U.S.	Outside the U.S.
U.S. incorporated	All	All; subject to foreign tax credit
Foreign incorporated – ECI	All; subject to treaty	All; subject to treaty
Foreign incorporated – not ECI	Some; subject to treaty	None
Foreign incorporated – subsidiary of U.S. corp	ECI rules apply; see above	Subpart F income taxed to stockholder

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Footnotes

1. Rev. and Tax. Code section 25101.
2. Mobil Oil Corporation v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980). ASARCO, Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982).
3. The Due Process Clause does apply to limit the taxing power of the United States, but only in exceptional circumstances. See Mertens, Federal Law of Income Taxation, sections 4.01 and 4.06. It does not, however, operate generally to restrict U.S. tax jurisdiction as to income derived from sources outside the United States. For the contrast between the application of the Due Process Clause to the taxing power of the U.S. and to the states, see United States v. Bennett, 232 U.S. 299 (1914).
4. Mertens, supra, sections 4.01 et seq., and Rufus von Thulen Rhoades and Marshall J. Langer, Income Taxation of Foreign Related Transactions, Matthew Bender, 1990, section 1.11.
5. IRC section 864(c)(4)(B). See Section 6.1, Water's-Edge Manual, and Chapter 8, Water's-Edge Manual.
6. IRC sections 11 and 61.
7. See Chapter 1(d), Water's-Edge Manual, and Section 6.3, Water's-Edge Manual. For a brief discussion of the foreign tax credit as a means of ceding jurisdiction based on source, see Michael J. McIntyre, The International Income Tax Rules of the United States, Butterworth Legal Publishers, 1989, pp. 1-3 and -4 (note, however, that the distinctions drawn there on the basis of "residence jurisdiction" have no --or at least different --application to corporations, which generally are deemed residents of the place of incorporation).
8. IRC section 882(a)(1).
9. Omitted from this discussion has been any mention of the branch profits tax imposed under IRC section 884. This is imposed with respect to the "dividend equivalent amount" of a branch of a foreign corporation operating in the U.S. It is only imposed with respect to a portion of ECI so, in essence, its imposition does not represent any extension of U.S. tax jurisdiction beyond that which is otherwise asserted with respect to foreign corporations operating in the U.S. The branch profits tax rate is 30 percent, subject to reduction by treaty.
10. IRC section 1442.
11. See, for example, the 1981 U.S. Model Income Tax Treaty, Article 10, providing a general rate of 15 percent applicable to dividends.

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12. IRC section 951, et seq.

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Section 6.2 U.S. Tax Treaties

Contents:

a. Nature of Tax Treaties; Source and Scope of Authority
b. U.S. Tax Treaties and California Law
c. Permanent Establishment and ECI
d. Tax Rate Reductions Under IRC Sections 881 and 884
e. Planning and Anti-Planning Issues

References:

California Code of Regulations Section 25110(d)(2)(G)

Training Objectives:

This section provides a basic overview of U.S. tax treaties and the application of these treaties under the water's-edge law.

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a. Nature Of Tax Treaties; Source And Scope Of Authority

The United States government has entered into tax treaties, or "tax conventions," with numerous foreign countries. These treaties have a pervasive influence on the manner of taxation imposed by the United States on foreign corporations engaged in business or investment activity in the U.S. As noted in our discussion of U.S. taxing jurisdiction in the introduction of this chapter, treaties can be viewed as devices for ceding jurisdiction to tax to the country of incorporation. This concept and its application is discussed in more detail below in relation to the "permanent establishment" rules. Also as noted in the introduction, treaties may operate to reduce tax rates applied to certain types of income not related to U.S. business operations. This application is discussed below as well.

Tax treaties are generally entered into for the purpose of avoiding international double taxation. As discussed earlier in this chapter, and in Chapter 1(d), Water's-Edge Manual, international double taxation arises from competing claims of governments to tax the same income. Since the United States asserts jurisdiction to tax the worldwide income of entities incorporated in this country, and also source-based jurisdiction with respect to income earned here by foreign incorporated entities, international double taxation can arise whenever a U.S. corporation earns income in a foreign country, or where a foreign country asserts residence-based jurisdiction to tax U.S. source income. It can also arise where only source-based jurisdiction is asserted by both countries, but where definitions of source of income are not in harmony. Finally, double taxation can arise where a corporation is deemed to be a resident of both concerned countries.

With respect to taxes imposed by the United States, tax treaties are of primary importance from the standpoint of businesses and investments in the U.S. of foreign corporations. Benefits available to U.S. corporations under tax treaties generally are of a reciprocal nature, providing to those corporations benefits in the foreign country of the same nature as those provided to foreign-resident companies by the U.S. Moreover, the principal means by which the U.S. seeks to avoid international double taxation of U.S. corporations is through the unilateral granting of the foreign tax credit (i.e., the credit is available in respect of taxes imposed by foreign governments which do not have a tax treaty with the U.S.).

U.S. tax treaties are negotiated by representatives of the Treasury Department, and following signature by the President are referred to the U.S. Senate for

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advice and consent, pursuant to the constitutional procedure applicable to all treaties.[1] Currently the United States has treaties in force with 57 foreign countries.[2] Treaties can be unilaterally terminated by either party. For example, the U.S. notified the Netherlands Antilles in mid-1987 that their treaty would be substantially terminated in January, 1988.[3]

The relationship of U.S. tax treaty provisions to those of the Internal Revenue Code is rather complicated. As a general rule, treaty provisions take precedence over the statutory law.[4] In other words, the treaty overrides the Code. However, there are numerous exceptions to this general rule in instances where statutes are passed after treaties are ratified, and where Congress specifically provides that the statute will take precedence.[5] Careful research may be required to determine the applicability of a particular treaty provision.

Almost all U.S. tax treaties are based on one of a number of "model treaties." A model treaty is a starting point for negotiations between the two countries, and the model currently used by Treasury reflects U.S. policy in respect of treaty provisions.[6]

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Treaties generally govern the tax treatment by one country of the residents or citizens of the other. In other words, they are mutually beneficial: benefits extended to residents of a foreign country by the U.S. are compensated for by benefits extended to U.S. residents by the foreign country. The most important benefits are the liberalization of requirements for nexus for taxation through the permanent establishment rules, and the reduction in tax rates applicable to investment income. Treaties also afford important means for mutual cooperation between governments in furtherance of effective tax administration. They provide for resolution of disputes through the respective governments' "competent authorities," an aspect of treaties which you will study in connection with IRC section 482 allocations in Chapter 17, Water's-Edge Manual. In addition, treaty provisions may facilitate exchanges of information between governments and the carrying out of joint audit projects.

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b. U.S. Tax Treaties And California Law

Later in this text you will be studying the application of tax treaties under the water's-edge law in some detail. See Chapter 8, Water's-Edge Manual. Tax treaties have important affects on water's-edge combined reports. For income years beginning before January 1, 1992, under the water's-edge regulations, treaty provisions are applicable to foreign banks and corporations operating in the United States, to the extent that they limit the definition of effectively connected income (ECI; see preceding section of this text) for federal purposes.[7] Therefore, the auditor will need to understand treaty provisions to determine if a foreign bank or corporation has a taxable presence in the U.S. under relevant tax treaties, and thus has income and factors subject to inclusion in a water's-edge combined report.

For income years beginning on or after January 1, 1992, under water's-edge regulations, treaty provisions are *not* applicable to the extent they limit the definition of ECI for federal purposes.[8] Therefore, the auditor will need to be alert for situations where a foreign bank or corporation is immune from federal tax because of tax treaty provisions, but nonetheless has ECI under the IRC which is subject to inclusion in a water's-edge combined report.

You should keep in mind, however, that tax treaties between the United States and foreign governments have only limited application to California tax returns. Their application in a water's-edge context is strictly limited to their relation to the ECI concept. The fact that a treaty grants to a foreign corporation what is in effect an exemption from U.S. income tax does not mean that such entity is exempt from the California franchise tax.

Example 1:

Corporation A was formed under the laws of Country X. Corporation A is engaged in certain business operations in the state of California, and is "doing business" in California within the meaning of Rev. and Tax. Code section 23101.

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Country X has a tax treaty with the United States. Corporation A's activity in California is such that, under the treaty, Corporation A is effectively exempt from U.S. income taxes.

Although for purposes of the water's-edge combined report for income years beginning before January 1, 1992, Corporation A will recognize the treaty provisions to determine its water's-edge includible income and factors, and such would be zero, Corporation A remains subject to the franchise tax and must file a California tax return and remit the minimum tax.

U.S. tax treaties with foreign countries do not expressly limit state-level taxation, and they have applied in California in the past only to the extent required under legislation enacted in this state.[9] The thing to remember is that exemption from U.S. taxation under a treaty does not translate into immunity from California taxation, even under water's-edge.

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c. Permanent Establishment And ECI

The most important affects of treaties for U.S. taxation purposes, as well as for California water's-edge purposes, are derived from the concept of "permanent establishment," or "P.E."[10]

As will be discussed in more detail in Chapter 8, Water's-Edge Manual for federal purposes the first step to determining the U.S. taxable income of a foreign corporation is to determine whether that corporation is engaged in a "trade or business" within the U.S. The second step is to determine the ECI related to that trade or business.[11] What is important about P.E. is that, under a tax treaty, it does not matter whether the foreign corporation has a "trade or business" in the U.S.; rather, the important question is whether the foreign corporation has a "permanent establishment" here. These terms will be explored in some detail in Chapter 8, Water's-Edge Manual. For now you should simply keep in mind that more substantial connections with the U.S. are generally required for a P.E. than for a "trade or business." In other words, some activities in the U.S. which would be regarded as constituting a "trade or business" might be insufficient to constitute a "permanent establishment."

Example 2:

Corporation A was formed under the laws of Country X, which has a tax treaty with the U.S. Corporation B was formed under the laws of Country Y, which does not have a tax treaty with the U.S. Both A and B import goods to U.S. and both maintain storage facilities for inventory here. Other than these storage facilities, neither has a fixed place of business in the United States.

Both Corporation A and Corporation B would be regarded as engaged in a trade or business in the U.S. However, since Corporation A is a resident of a treaty country, it is necessary to look to the terms of the treaty to determine if Corporation A has a P.E. in the U.S. Under the terms of the tax treaty with Country X, simply maintaining storage facilities in the U.S. do not give rise to a

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P.E. (indeed, such would be true of virtually all, if not all, tax treaties). Thus, because Corporation A has no P.E., it has no U.S. tax liability. Since Corporation B is a resident of a non-treaty country, it is taxable by the U.S. on the income from its U.S. trade or business.[12]

One difficulty with the permanent establishment concept is that "permanent establishment" is not uniformly defined. What constitutes a P.E. under one U.S. tax treaty may not do so under another. When dealing with a P.E. issue under a treaty in a water's-edge audit you will have to research and understand the particular treaty provisions that you must apply. You can not assume that the definition of P.E. is that provided in a model treaty. In addition, treaties often include provisions which, in effect, redefine the source of income. That is, income which would be considered as from U.S. sources under the statutes and regulations may, under a treaty, be considered to have been derived from sources in a foreign country. This in turn will affect the determination of net income derived from the permanent establishment and thus subject to tax by the United States, and so includible in a California water's-edge combined report. See Chapter 8, Water's-Edge Manual.

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d. Tax Rate Reductions Under IRC Sections 881 And 884

Another important effect of U.S. tax treaties generally is the reduction in the tax rate applicable to investment and certain other kinds of income not related to a U.S. trade or business. This is not important from the standpoint of water's-edge tax returns, and we will just briefly describe the nature of the relief available under treaties.

As discussed in the introduction of this chapter, the United States asserts jurisdiction to tax some, but not all, U.S. source income of foreign corporations even if they are not engaged in a trade or business in the U.S. The United States also collects a "branch profits tax" in respect of the "dividend equivalent" of earnings of foreign corporations which are engaged in a trade or business in the U.S. This is in addition to the regular U.S. income tax on ECI (or net income from a P.E., if a treaty applies). The tax rate generally applicable to both of these types of income is 30 percent.[13]

U.S. tax treaties generally provide reduced rates of tax on these types of income. The 1981 U.S. Model Income Tax Treaty provides for a general rate of 15 percent on dividends (Article 10).

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e. Planning And Anti-Planning Issues

As you might expect, tax treaties are regarded by corporate tax planners as a very significant feature of the international tax landscape, and the provisions of treaties and the threats and opportunities that they present must be taken into account. Keep in mind that not only does the United States enter into tax treaties with foreign governments, but such foreign governments have treaties among themselves.

From a strictly water's-edge standpoint, the most important planning issue involving tax treaties has to do with the permanent establishment rules. It may be critical that a foreign corporate resident of a treaty country confine its U.S. activities in such a way that it avoids having those activities meet the threshold requirements for a permanent establishment in this country: if it does not have a P.E., it pays no tax, if it does have a P.E., it pays U.S. tax on its net business income. As you will see in Chapter 8, Water's-Edge Manual, this becomes a significant water's-edge issue as well. For income years beginning before January 1, 1992, if the auditor can discover that there is in fact a P.E. where the taxpayer has claimed that there is not, he or she may have a significant adjustment to the California water's-edge tax return. Similarly, for income years beginning on or after January 1, 1992, if the auditor can discover situations where the taxpayer erroneously assumed that tax treaty immunity also applies for state purposes, he or she may have a significant adjustment to the water's-edge return.

The worldwide network of treaty relationships presents important tax planning opportunities. For example, if a corporate resident of a non-treaty country desires to do business in the U.S. it may choose to do so through a subsidiary formed in a third (foreign) country which does have a treaty with the U.S. In this way it can take advantage of the P.E. rules, and it may eliminate any potential U.S. income tax. Similarly, a U.S.-based multinational desiring to do business in a non-treaty country may form a subsidiary in another country which does have a treaty with the first in order to take advantage of treaty provisions between the two foreign countries. An example of such "treaty shopping" well-known to Franchise Tax Board auditors was the pre-1984 use by U.S.-based multinationals of finance subsidiaries formed in the Netherlands Antilles. The applicable treaty provisions enabled these companies to issue debt securities in

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Europe without having the creditors be subject to U.S. tax, which would have been due if the U.S. company had issued the securities directly.

For the auditor, "treaty shopping" issues may be a temptation. All such arrangements have about them a sense of the artificial, and the contrived. The question that arises is whether there is more form than substance involved. Nonetheless, it is probably safe to say that most treaty shopping arrangements will pass scrutiny. The alert auditor may, however, discover from time to time an instance where the planner's scheme was misconceived or ineptly executed. Adjustments may be possible if you can redefine the residence of a foreign corporation from a treaty country to a non-treaty country, or from a non-treaty country to a treaty country, or from a foreign country to the U.S., or from the U.S. to a foreign country.[14] See Chapter 8, Water's-Edge Manual.

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Footnotes

1. U.S. Constitution, Art. II, section 2, clause 2.
2. Rufus von Thulen Rhodes and Marshall J. Langer, Income Taxation of Foreign Related Transactions, Matthew Bender, 1995, section 16.11.
3. Income Taxation of Foreign Related Transactions, supra, section 16.11, p. 16-48, note 11.
4. The supremacy clause of the U.S. constitution provides that "...all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land...". See also IRC section 894, which provides that the provisions of the IRC shall be applied with due regard to any treaty obligation which applies to the taxpayer. However, IRC section 7852(d)(1) provides that "...neither the treaty nor the law shall have preferential status by reason of its being a treaty or law."
5. For a general discussion, see Rufus von Thulen Rhoades and Marshall J. Langer, Income Taxation of Foreign Related Transactions, Matthew Bender, 1995, chapter 9B.
6. See the 1977 U.S. Model and the 1981 Draft U.S. Model. It is believed that Treasury generally uses the 1981 Draft in negotiations, notwithstanding that it has never been finalized. In 1992 the Treasury announced that it plans to review and revise the Draft U.S. Model.
7. 18 CCR section 25110(d)(2)(G)(ii)(I).
8. 18 CCR section 25110(d)(2)(G)(i)(I).
9. See Rev. and Tax. Code section 24320 regarding a California tax exemption available to foreign sea and air carriers under treaties and other intergovernmental agreements, in which regard see Pacific Coast Shipping Company v. Franchise Tax Board, 167 Cal. App. 3d 312 (1985). Except for this statutory exception, the California State Board of Equalization and the courts have systematically rejected the idea that U.S. tax treaties are to influence applications of the California franchise tax, or even to afford access to the federal courts for jurisdiction of disputes involving the tax. See Container Corporation v. Franchise Tax Board, 463 U.S. 159 (1983), EMI Limited v. William Bennett, et al., 738 F.2d 994 (1984), and Appeal of Capitol Industries-EMI, Inc., Cal. St. Bd. of Equal., October 31, 1989. For analogous rejections of the same concept in respect of the California personal income tax, see Appeal of M. T. de Mey van Streefkerk, Cal. St. Bd. of Equal., November 6, 1985, and Appeal of Franklin J. Kosdon, Cal. St. Bd. of Equal., June 29, 1982.
10. See, for example, 1981 U.S. Model Income Tax Treaty, Article 5.

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11. IRC section 882.
12. See 1981 U.S. Model Income Tax Treaty, Article 5. See Chapter 8, Water's-Edge Manual
13. IRC sections 881 and 884.
14. For an example of an IRS success story, see Ingemar Johansson v. United States, 336 F.2d 809 (5th Circuit, 1964), 64-2 USTC 9743. For a failure, see Perry R. Bass v. Commissioner, 50 T.C. 595 (1968).

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Section 6.3 The Foreign Tax Credit

Contents:

a. Importance of the Foreign Tax Credit
b. The Credit in General
c. The Direct and Indirect Foreign Tax Credits
d. Baskets and Such -- Limitations on the F.T.C.

References:

IRC Sections 901 - 908
IRC Section 960

Training Objectives:

At the end of this section the auditor should be able to:
1. Describe the nature and purpose of the federal foreign tax credit provisions.
2. Describe generally the manner of computation of the direct foreign tax credit and the indirect foreign tax credit.
3. Describe generally what is meant by "baskets," and be able to describe the general and other limitations on the foreign tax credit.

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a. The Importance Of The Foreign Tax Credit

As every California schoolboy (or girl) knows, the three most important principles of real estate investment are (1) Location, (2) Location, and (3) Location. Similarly, for U.S.-based multinational corporations, the three most important international tax considerations are (1) The Foreign Tax Credit, (2) The Foreign Tax Credit, and (3) The Foreign Tax Credit.

For the U.S. multinational, the importance of the foreign tax credit (F.T.C.) can not be overestimated. Its influence on their worldwide tax planning is pervasive, and all-important. There is no international tax issue which can be considered without taking the F.T.C. into account. This includes determinations of the source of income and deductions, intercompany pricing arrangements, Subpart F considerations, and so on. The availability of the F.T.C., or lack thereof, can have a significant affect on a company's bottom line; it is the difference between paying significant national-level income taxes to one country instead of two.

Example 1:

Corporation A, a U.S.-based multinational, earns $1,000,000 in pre-tax net income in West Germany. The U.S. taxes this income at 34 percent, and the West German government taxes it at 56 percent. If Corporation A can not credit its German taxes against its U.S. taxes its after-tax net income will be just 10 percent of $1,000,000, or $100,000; its effective tax rate will be 90 percent (56 + 34). If it can credit the German tax against the U.S. tax, then it will wipe out what would otherwise be a $340,000 U.S. tax liability, and increase its after-tax earnings accordingly.

With new limitations imposed under the Tax Reform Act of 1986 (see below), the F.T.C. has become more important than ever to U.S. multinationals. A great many U.S. multinationals presently have significant stocks of "excess credits" --foreign taxes paid but not creditable because of the limitations. Significant business and investment decisions turn on whether such excess credit positions will be aggravated or relieved; a primary aim of corporate tax planners nowadays is to find ways to reduce -- to use -- excess credits.

Despite the importance of the F.T.C. for federal purposes, it is of little direct importance for purposes relating to California water's-edge tax returns. The

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credit provisions of federal law are worthy of your consideration, however, because an understanding of them will aid you in analyzing international tax issues generally, and will help to explain the reasons for some of the tax planning decisions reflected in water's-edge tax returns of U.S.-based multinationals. It may also prove to be important for you to understand the basics of the credit for the purpose of determining the scope of your audit. RTC §25114 and its regulations may limit the scope of your audit where the Internal Revenue Service has examined an international issue in detail. The Service, however, may not examine an issue, such as a possible Subpart F income determination, where the availability of a foreign tax credit would mitigate the effects of the principal audit adjustment. Your §25114 considerations will be addressed in later chapters of this text.

What follows is a very brief summary of the basics of the foreign tax credit rules.

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b. The Foreign Tax Credit In General

The principal goal of the federal foreign tax credit rules is the avoidance of international double taxation which would otherwise result from the U.S. asserting residence-based jurisdiction while a foreign government asserts source-based jurisdiction over the same income. Refer back to the example above. The U.S. asserts tax jurisdiction because the earner of the income is a U.S. corporation; West Germany asserts tax jurisdiction because the income was earned in West Germany. Although the foreign tax credit has application in other situations, this is the one of primary importance.[1] The credit allowed by the U.S. is designed to eliminate double taxation by the U.S.; it is not meant to eliminate double taxation by the foreign government. In other words, the U.S. allows a credit for the foreign taxes paid, but only to the extent that U.S. taxes were imposed on the foreign source income.

Example 2:

In example 1, Corporation A incurred pre-credit tax liabilities as follows:

West Germany	$ 560,000
U.S.	340,000
Total	$ 900,000

In granting relief from double taxation, the U.S. will permit a credit for the West German tax only to the extent that the U.S. imposed a tax. That is:

U.S. pre-credit tax liability	$340,000
Less: German tax to extent U.S. imposed a tax	340,000
U.S. post-credit tax liability	$ 0

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Put another way, the U.S. will not credit the taxpayer with the full amount of the West German tax in order to generate an overpayment on the U.S. return. Of course, if the effective tax rate in the foreign country is less than the U.S. effective rate, the taxpayer will end up paying a total tax liability at the U.S. effective rate.

Example 3:

Same facts as example 2 except that the West German tax rate is 20 percent. Accordingly,

U.S. pre-credit tax liability	$340,000
Less: German tax to extent U.S. imposed a tax	200,000
U.S. post-credit tax liability	$140,000

U.S. pre-credit tax liability	$340,000
Less: German tax to extent U.S. imposed a tax	200,000
U.S. post-credit tax liability	$140,000

Taking these examples together, you can see that the combined effective tax rate after the granting of the U.S. foreign tax credit will always be the larger of the effective rate in the U.S. or the foreign country.

A taxpayer can elect to deduct the foreign taxes which it pays in computing U.S. taxable income, rather than claiming a credit for these amounts.[2] Since eligible foreign taxes are creditable in full to reduce the U.S. tax liability, the deduction route is preferable only in rare circumstances. For example, if the taxpayer has no U.S. tax liability because it incurred current losses, and if the net operating loss carryover is of potentially greater future value than a carryover of the foreign tax credit (see below), deduction may be preferable.[3] Another instance is where

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the foreign country asserts jurisdiction over income that is considered under U.S. rules to be sourced in this country (that is, there is a conflict of the source of income definitions used by the U.S. and the foreign country). As you will see below in the discussion of limitations on the credit, the U.S. would allow no credit in this circumstance, and therefore the taxpayer should much prefer a deduction worth something to a credit worth nothing.

Where creditable foreign taxes can not all be used in the current year, the taxpayer must carry them back to apply, if possible, to the second preceding year and then to the immediately preceding year. If the excess credits are still not used up, they are to be carried forward to the first subsequent year, then to the second, third, fourth, and fifth succeeding years, in that order.[4] This rather simple concept is transformed in practice into a nightmare of tedium because it must be coordinated with the limitation rules discussed (in very simple terms) below, and there must be effected a transition owing to the very significant changes in the limitation rules and the U.S. effective tax rate under the Tax Reform Act of 1986.[5]

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c. The Direct And Indirect Foreign Tax Credits

The foreign tax credit is available with respect to taxes paid directly by a U.S. corporation which incurs the tax liability with the foreign government.[6] In this case the taxpayer is said to claim a "direct credit." All of the foregoing general considerations are applicable to the direct credit.

The foreign tax credit is also available with respect to taxes paid and incurred by foreign subsidiaries of U.S. parent corporations. In this case the taxpayer is said to claim a "deemed paid credit," or an "indirect credit."[7] All of the foregoing general considerations are applicable to the indirect credit, except the optional deduction: since the tax cost or expense is not directly incurred by the parent corporation, no deduction is allowable.[8] Only by means of the special foreign tax credit rules can the parent obtain a U.S. tax benefit from the foreign taxes incurred by its subsidiary.

The direct credit is fairly straightforward in application. The payer of the foreign tax liability claims a credit for the amount paid against its U.S. tax liability, subject to the limitations discussed below.

The indirect credit is far more complicated in application.

Naturally, the only reason to allow an indirect credit is to alleviate international double taxation. Where a foreign subsidiary earns the income in a foreign country, such foreign subsidiary is obviously not subject to tax by the U.S. (see introduction section of this chapter). The only danger of double taxation arises where the foreign subsidiary's earnings are taxed in the U.S., and that can only occur when those earnings are distributed, or deemed to have been distributed under the Subpart F provisions (see Section 6.6, Water's-Edge Manual, and Chapter 9, Water's-Edge Manual).

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Example 4:

Corporation P, a U.S. corporation, owns one hundred percent of the stock of Corporation FS which was formed under the laws of West Germany. During the current year FS had pre-tax earnings of 100 from sources in West Germany and incurred German income taxes of 56. FS's earnings would only be subject to international double taxation if FS made a distribution out of current year earnings and profits to Corporation P.

What to do when FS has made a distribution, however? Obviously this presents a somewhat complicated problem if one seeks to avoid international double taxation. From our examples in the general discussion above, you will have noted that our point of reference for measuring the potential for double taxation was the total income subject to tax in both jurisdictions. Inasmuch as only after-tax income -- earnings and profits --are available for distribution, however, this natural point of reference is not readily available; that is, absent some special provision, the U.S. in example 4 above would tax only the dividend amount, not the entire earnings subject to the West German tax. To achieve rough equivalence of effect of the direct and indirect credits, the distribution from the foreign subsidiary must be "grossed-up."[9]

Example 5:

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Assume the same facts as in example 4. Further assume that FS distributed to P as a dividend all of its after-tax earnings. The dividend is "grossed-up" and the indirect credit applies as follows.

Dividend received by P	$ 44
Plus: Foreign income tax paid by FS with respect to the earnings from which the dividend was paid (the gross-up)	56
U.S. taxable income of P	100
P's pre-credit U.S. tax liability, @ 34%	34
Less: Indirect credit for German taxes incurred by FS with respect to gross-up dividend amount, to extent of U.S. tax thereon (total of 56, limited to 34)	34
P's post-credit U.S. tax liability	$ 0

As you can see, the result of the gross-up procedure is the same as that achieved in the case of the direct credit example under Section 6.3(b), Water's-Edge Manual.

The fact that the payer of the foreign tax is a subsidiary corporation makes application of the theory underlying the indirect credit quite complicated. There are special rules dealing with a range of problems that arise in this context. Following are very brief summaries of some of them.

1. To be eligible for the indirect credit the U.S. stockholder must hold at least a certain minimum amount of stock in the foreign subsidiary. The amount is ten percent in the case of a first tier subsidiary, and five percent in the case of indirect holdings in a second or third tier subsidiary. Fourth and lower tier subsidiaries do not qualify.[10]
2. Distributions flowing from second and third tier subsidiaries to the first tier subsidiary, and thence to the U.S. parent, carry with them foreign taxes incurred by two or more of the subsidiaries in the chain. Procedures are

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prescribed for computing the credits carried up through the chain to the parent.[11]

3. Credit is available to the U.S. stockholder only in proportion to the earnings actually distributed to it. Thus a stockholder which owns less than 100 percent of the stock of the subsidiary will only be entitled to a credit proportionate to its ownership share (as reflected by its dividend share). In addition, where less than 100 percent of the earnings and profits are distributed (as is usually the case), credit is available only with respect to the portion of earnings and profits which is actually distributed.[12]
4. Distributions in a given year often include earnings and profits from two or more periods. For all post-1986 years, including the current year, earnings and profits are combined in a single "pool," and distributions are treated as coming out of this pool -- no distinction is made on the basis of the separate income year of the foreign subsidiary. Similarly, the foreign taxes associated with such earnings and profits are pooled.[13]
5. For purposes of the indirect credit taxpayers obviously must be able to compute the earnings and profits of the foreign subsidiary. Moreover, the foreign subsidiary has probably kept its accounts in a currency other than U.S. dollars, paid its foreign taxes in a currency other than U.S. dollars, and may even have made its distribution in other than U.S. dollars. Rules are prescribed for how to compute earnings and profits (you must use U.S. tax accounting rules) and how to make the appropriate translations into U.S. dollars.[14] These earnings and profits and currency translation rules are important to California water's-edge tax returns as well, and are the subjects of Chapters 9, Water's-Edge Manual, Chapter 10, Water's-Edge Manual and Chapter 11, Water's-Edge Manual.

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d. Baskets And Such -- Limitations On The F.T.C.

The most complicated -- and most important -- feature of the foreign tax credit rules is the limitation of relief to foreign source income which has actually been subject to double taxation. Without such a limitation the United States might actually cede tax jurisdiction over U.S. source income of a U.S. corporation to a foreign government.

Example 6:

Corporation A, a U.S.-based multinational, had income from the following sources:

U.S. source income	$100
Foreign source income	100
Total income	$200

U.S. source income	$100
Foreign source income	100
Total income	$200

A's pre-credit U.S. tax liability, at 34 percent, is $ 68. The foreign source income is subject to foreign income tax at the rate of 70 percent, resulting in a foreign tax liability of $ 70.

If the foreign tax credit were granted without regard to source of income, a credit of $ 70 would completely wipe-out the U.S. tax of $ 68. In that case, the U.S. would, in effect, give up the right to tax the U.S. source income. If, on the other hand, the availability of the credit were limited to the U.S. tax with respect to the foreign source income, the U.S. would retain jurisdiction to tax the U.S. source income at 34 percent:

Pre-credit U.S. tax liability @ 34%	$ 68
Less: Foreign income tax on foreign source income, limited to the U.S. tax on such income ($70, limited to $34)	34

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Post-credit U.S. tax liability	$ 34

This basic and easily understood policy is carried out under a set of exceedingly complicated rules. The main purpose of these rules is the avoidance of averaging, or "blending," of high-tax foreign income with low-tax foreign income.

Example 7:

Corporation B has the following income and tax liabilities:

	IncomeAmount	ApplicableTax Rates	TaxLiability
U.S. Source Income	$ 100	34%	$ 102
U.K. source income from mfg operations	100	65%	65
Cayman Island source interest income	100	0%	0
Total	$ 300		$ 167

If the U.K. manufacturing and Cayman interest incomes were lumped together, and were the foreign tax credit granted by the U.S. with respect to the aggregate foreign source income and tax, then the full amount of the U.K. tax would be creditable. That is, $65 tax on total foreign source income of $200 is less than the U.S. tax on such income, and no limitation would apply. If, however, the U.K. tax were restricted to be associated with the U.K. source manufacturing income, then the effective foreign tax rate on such income could be seen to exceed that of the U.S., and the credit would be limited to the U.S. tax on such income, just $34 instead of the full $ 65.

That is what the foreign tax credit limitation provisions do (or attempt to do): they restrict the availability of the credit to foreign source income actually subject to double taxation.

The limitation is accomplished by means of the following formula:[15]

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Limitation Amount	=	U.S. Pre-credit tax	X	Applicable Foreign Source Income / U.S. Taxable Income (i.e., "worldwide income")

This limitation amount is compared to the actual foreign taxes paid with respect to the applicable foreign source income, and the actual credit is the smaller of these two amounts.[16] You can see that application of this formula is also the means by which the credit is limited in terms of the effective U.S. tax rate, as we have been discussing.

By using the term "applicable foreign source income" in the above fraction we have indicated that foreign source income is subject to classification in order to avoid the averaging or blending problem mentioned above. Thus each separate classification of foreign source income requires a separate application of the limitation formula.[17]

Foreign source income is not, however, classified by country; rather, foreign source income is classified by type. Referring back to example 7, the distinction is drawn based on the difference between income from manufacturing operations and interest income, not on the basis that some of the income was derived from U.K. sources and some from Cayman Island sources. Thus if the income from both countries had been interest income it would have been lumped together and subjected to a single limitation formula. On the other hand, if both the interest income and the manufacturing income had been derived from U.K. sources, separate limitation formulas would apply.

Where the limitation amount is less than the foreign taxes incurred, an excess credit position arises and the excess is subject to the carryover and carryback rules referred to above.[18] Complex special rules are prescribed for dealing with

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foreign source losses and for "looking through" a chain of entities (controlled foreign corporations) to ascertain the true type of foreign source income.[19]

The Internal Revenue Code prescribes the classification of foreign source income for purposes of the limitation into ten separate categories. As indicated above, the purpose is to classify income according to whether it is generally subject to high or low rates of tax, in order to minimize blending high tax income with low tax income. IRC section 904(d)(1) provides for nine categories or classifications of foreign source income:

(A) Passive income,
(B) High withholding tax interest,
(C) Financial services income,
(D) Shipping income,
(E) Dividends from less than majority-owned foreign corporations,
(F) Dividends from a domestic international sales corporation (DISC),
(G) Foreign trade income of a foreign sales corporation (FSC),
(H) Dividends from a FSC, and
(I) All other income

Class (I), all other income, includes all foreign source income which cannot be classified in one of the other "baskets." The limitation formula applicable to this catch-all basket is usually referred to as the "general limitation." In addition to these nine baskets, "passive income," is subject to classification according to a "high tax kick-out rule," whereby passive income subject to a high foreign tax rate is reclassified to the general limitation basket.[20] A tenth basket is in effect added by IRC section 907(a) for foreign oil and gas extraction income, as defined at section 907(c)(1). The section 904 baskets are defined at 904(d)(2).

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Footnotes

1. Under IRC section 906 a foreign corporation with income from foreign sources which is effectively connected with a U.S. trade or business may be entitled to a foreign tax credit for taxes paid on such income to a foreign government.
2. IRC section 901(a). Note that foreign income taxes are generally deductible under IRC section 164(a)(3), but not if the credit is claimed, per section 275(a)(4)(A).
3. A net operating loss may be carried forward for up to fifteen years under IRC section 172(b)(1)(A), while a foreign tax credit may only be carried forward up to five years under IRC section 904(c).
4. IRC section 904(c).
5. Masochists may consult Treas. Reg. section 1.904-2 and move from there to the transition rules of section 1205 of the Tax Reform Act of 1986. Rather more accessible is the explanation in Rufus von Thulen Rhoades and Marshall J. Langer, Income Taxation of Foreign Related Transactions, Matthew Bender, 1995, section 5.04.
6. IRC section 901(a) and (b)(1).
7. IRC sections 901(a) and 902.
8. IRC section 164.
9. IRC section 78. The theoretical basis for the indirect credit has been stated to be that "... it should be no more or less advantageous to operate overseas through a subsidiary than it is through a branch." Rhoades and Langer, supra, section 5.06[1]. As the indirect credit rules do not quite achieve this equality of treatment, another commentator has suggested that the credit's "... limited purpose is to equalize the U.S. tax imposed on the foreign source taxable income of a U.S. corporation earned through a branch with the U.S. tax imposed on an equal amount of taxable income earned through a foreign affiliate and distributed by that affiliate to the U.S. corporation." Michael J. McIntyre, The International Income Tax Rules of the United States, Butterworth Legal Publishers, 1989, p. 4-27. In any event, the obvious purpose of the gross-up is to achieve a rough equivalence of the effects of the indirect credit to those of the direct credit.
10. IRC section 902(a) and (b).
11. Treas. Reg. section 1.902-1(c)(2) and (d)(2).
12. IRC section 902(a).
13. IRC section 902(c)(1) and (2).
14. IRC section 902(c)(1), which references section 964(a) and 986.

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15. IRC section 904(a).
16. Ibid.
17. IRC section 904(d)(1).
18. IRC section 904(c).
19. IRC section 904(f) and (d)(3), respectively.
20. IRC section 904(d)(2)(A)(iii)(III).

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Section 6.4 Sources Of Income And Deductions (The Federal Meaning Of "Allocation" And "Apportionment")

Contents:

a. Nature and Importance of the Source Rules
b. Source Rules for Gross Income
c. Source Rules for Deductions

References:

IRC §§861 through 865

Training Objectives:

At the end of this section you will be able explain the concepts of U.S. and foreign source income under the IRC. You should be able to identify and describe the federal treatment of common types of income and deductions, and to describe how the federal concept of source of income differs from the California concept of source of income.

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a. The Nature And Importance Of The Source Rules

In this and in the preceding chapter we have made the point several times that the federal source of income concept is something quite different from the concept of source of income which applies in the context of multijurisdictional apportionment and allocation for California franchise tax purposes. In our preceding discussions of the tax jurisdiction of the United States, the foreign tax credit, and tax treaties we have made frequent references to the "source" of income, and you may well have gathered from these that source determinations are of great importance under the international tax rules of the United States. Let's turn now to the specific federal rules governing the determination of the source of income and deductions.[1]

One very important concept for you to keep in mind is that the federal source rules have nothing to do with determining the taxable income of U.S. corporations. As we have noted before, the United States asserts jurisdiction to tax the worldwide income -- income from sources within and without the United States -- of a U.S. corporation. Determining the sources of such an entity's income will not affect its U.S. taxable income; but the source determination will affect its foreign tax credit. On the other hand, the source rules do affect the determination of U.S. taxable income of foreign corporations.

The statutory and regulatory scheme under the Internal Revenue Code treats the determination of net income from U.S. or other sources as a two-step process. First, items of gross income are assigned to a particular source. Second, the

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deductions related to such classifications of gross income are assigned, and are then subtracted from the applicable gross income to determine net income from a particular source.[2] The resulting net income amount is used, for example, as the numerator of the fraction in the indirect foreign tax credit limitation formula for a particular income basket, as discussed in the preceding section of text. Determinations of the source of net income are made for a variety of purposes under so-called "operative" provisions of the IRC.[3] Two of these operative provisions which we have discussed are the foreign tax credit limitation and the determination of income effectively connected with the conduct of a U.S. trade or business, but there are a number of others. One difficulty with the application of the source rules is that they do not apply uniformly for purposes of all of the operative sections. That is, an item of gross income or deduction which is regarded as being from U.S. sources for purposes of the application of one operative section may be regarded as being from foreign sources for purposes of the application of another operative section.

In your audits of California water's-edge tax returns the federal source of income and deduction rules will be of most importance in the determination of apportionable income of certain foreign-nation banks and corporations with branches in the United States.[4] Under the water's-edge regulations, the

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determination of the income and factors of these entities to be included in a water's-edge combined report must be made according to the federal rules for determining the income attributable to U.S. sources, either from a U.S. trade or business (ECI) or from U.S. investments.[5] As discussed in Section 6.1, Water's-Edge Manual, the permanent establishment rules under U.S. tax treaties may override federal ECI rules, for federal purposes and for California water's-edge purposes for years beginning before January 1, 1992. In either case, the federal source of income and deduction rules are extremely important in the determination of the federal taxable --and thus California water's-edge apportionable -- net incomes of these branch operations. Your application of these detailed rules will be the subject of Chapter 8, Water's-Edge Manual. The following discussion should serve as a brief introduction to the nature of the federal rules for determining the sources of income and deductions.

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b. Source Rules For Gross Income

As stated above, the first step in determining the net income attributable to a particular source is to determine the gross income from that source. The source rules assign gross income to a particular geographic location. To apply the rules, an item of gross income must first be classified according to type; then rules governing the assignment to location for that particular type of income are applied to determine the income's source.[6] Income from sources without the United States ("foreign source income") is generally defined by exception. That is, foreign source income in a particular classification is all such income except that which is from U.S. sources as determined under IRC §861(a). Section 862(a)(1) states, for example, that foreign source interest income is "interest other than that derived from sources within the United States ... " Similar language applies to the other classifications of gross income.

It is difficult and perhaps naive to attempt to generalize about the nature of the federal rules for making geographic assignments of classes of gross income. At the risk of misleading the reader we can, however, offer a few observations. First, logically, there must be some sort of economic or business nexus between the income and the geographic source to which it is assigned. Second, in most instances where there is some such nexus between two (or more) locations and the income, the income is assigned to that location whose nexus is more substantial than the other's. For income derived from tangible property, the source is the location of that property. Intangible property obviously presents special problems here, which are resolved in different ways for different classes of income. For income derived from transactions such as sales of goods or the performance of services, the location of the transaction is the critical factor.

Following are very brief summaries of the source rules applicable to specific classes of gross income.

1) **Interest income**. The general rule is that interest income has its source at the residence of the borrower. Thus interest received from a U.S. incorporated entity has its source in the U.S., regardless of the residence of the payee, the place of the transaction, the location or nature of use of the

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funds, or any other factor.[7] There are a number of exceptions to this general rule, the most important of which is for interest from a deposit with a foreign branch of a U.S. bank, which has its source in the foreign country.[8]

2) **Dividends**. The general rule is that dividends have their source in the country of incorporation of the payor corporation. For example, dividends received by a U.S. parent corporation from its U.K. subsidiary have their source in the U.K. Note the logic of such a rule in the context of the foreign tax credit limitation: the dividends are foreign source income and thus are put in the numerator of the applicable limitation formula, and the dividends are related in this way to the "indirect" foreign taxes on the payor corporation which are creditable on the U.S. tax return of the payee-stockholder.[9] There are exceptions to this general rule. The most important (and most complicated) exception has to do with payor-corporations which are incorporated in a foreign country but engage in business in the United States. In such instances a portion of the dividends may be attributed to sources in the U.S.[10]
3) **Compensation for labor or personal services**. Income from personal services performed by a corporation has its source at the location where the services are rendered.[11] Factors such as the residence of the payer, the location where the contract was entered into, or the time and place of payment are irrelevant.[12] There are no exceptions to this rule.[13] If compensation is received for services performed within and without the United States, then it may be necessary to make an "apportionment" between geographic sources. Generally, income from personal services is

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apportioned to the U.S. in the ratio that the time spent performing services in the U.S. bears to the total time spent performing the services, although another method of apportionment "that most correctly reflects the proper source of income under the facts and circumstances of the particular case" may be used instead.[14]

4) **Rentals and royalties.** Rental and royalty income has its source where the property subject to the rent or royalty is located. In the case of intangible personal property such as a patent, copyright, secret process or formula, good will, trade-mark, trade brand, or franchise, the royalty has its source at the location where the intangible can be exploited. For example, where a foreign corporation licenses another person to exploit a patent in the United States, then the royalty has its source in the U.S. Conversely, where a U.S. corporation licenses another person to exploit its patent in the U.K., then the licensor's royalty income has its source in the U.K., even though the research and development of the patent took place entirely in the U.S.[15]
5) **Gain from the sale or exchange of real property**. Gain from the sale of realty has its source where the property is located.[16]
6) **Gain from the sale or exchange of personal property**. Gain from the sale of personalty is attributed to a particular source under a complex set of rules. The general rule, to which there are three important exceptions, is that gain from the sale of personal property has its source at the place of residence of the seller.[17] Thus if a U.S. corporation sells the stock of a subsidiary foreign corporation, gain therefrom has its source in the U.S.
   a) The first exception to the general rule applies to inventory property. Where inventory property is purchased and then sold by the taxpayer, the gain therefrom has its source at the place where title to the goods passes to the buyer.[18] Where inventory property was produced by the seller, however, the income is considered to have been "derived from sources

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partly within and partly without the United States."[19] Complex special rules apply to determine what part of the income has its source within the U.S., and what part has its source without the U.S. The regulations provide three methods for doing this:

i) The taxpayer may use, or the Internal Revenue Service may require the use of, the "independent factory price" method (I.F.P.), under which a profit with respect to the manufacturing operation is set by reference to, for example, an uncontrolled price charged to independent distributors. This price-setting device is similar in many respects to the methods employed in pricing tangible personal property under IRC §482, which you will study in Chapter 17, Water's-Edge Manual. The income deemed to be derived from manufacturing is deemed to have its source at the location of the manufacturing operation, and the remainder is deemed to have its source at the location where title to the goods passes to the buyer.[20]

ii) If the I.F.P. method is not applicable, a formula apportionment method employing property and sales factors is to be used. The property factor is the relation that the property within the U.S. used to produce the income bears to the total property used to produce the income; the sales factor is the relation that the total U.S. sales of the inventory property bears to the total sales worldwide. The total of these factors is divided by two and the resulting percent is applied to the total income to determine the portion derived from sources within the U.S.[21]

iii) The Internal Revenue Service can grant permission to a taxpayer to employ the method of source attribution reflected on its books of account where the taxpayer, "in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than [the I.F.P. or two-factor apportionment methods] the taxable income derived from sources within the United States."[22] It is believed that this method is only rarely employed.

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b) The second important exception to the general rule for determining the source of gain derived from the sale of personal property has do with property subject to depreciation. To the extent depreciation deductions with their source in the U.S. have been allowable with respect to the property, they will be recaptured; that is, gain to the extent of the U.S.-source depreciation deductions will be U.S. source income.[23] The remainder of the gain attributable to depreciation deductions will be foreign source income. [24] Gain in excess of total depreciation deductions is subject to the rules for determining the source of income from the sale of inventory property (see above).[25]
c) The last important exception affects the determination of the source of gain derived from the sale of certain intangible property.[26] The recapture rules applicable to depreciation and discussed at (b), above, apply to intangible personal property as well as tangible personal property.[27] However, in the case of intangible property, gain in excess of total depreciation has its source at the residence of the seller (the "general rule" referred to above).[28]

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c. Source Rules For Deductions

The rules for determining the sources of deductions are among the most important and most controversial of all the provisions of the Internal Revenue Code. Whereas gross income lends itself to more or less ready classification based on its nature and the location of the income producing property or activity, costs and deductions applicable (or arguably applicable) to more than one class of gross income present obvious difficulties. The rules related to research and development expenditures (R&D) and interest expense have historically been among the most controversial in this respect. As you might suspect from our discussion of the foreign tax credit, U.S.-based multinationals have a very substantial incentive for establishing that R&D and interest expenses have their source in the U.S., and not in a foreign country, so as to leave the numerators of their foreign tax credit limitation fractions as large as possible. For a different reason, foreign banks and corporations operating through branches in the U.S. have a similar substantial incentive for establishing that their interest expense, as well as certain administrative expenses, has its source in the U.S.: in this case they directly reduce U.S. taxable income.

You will recall that the determination of taxable net income from a particular source is a two-step process -- first gross income from a particular source is determined and then the deductions related to that income are subtracted to determine net income. Implicit in such a process is the idea that deductions should be associated -- matched -- with the income to which they relate.

This matching process is accomplished by means of an "allocation and apportionment" system prescribed by the federal regulations.[29] Note that this has nothing to do with the concepts related to "allocation" and "apportionment" under the Uniform Division of Income for Tax Purposes Act (UDITPA).[30]

"Allocation" under the federal source of deductions regulations refers to the matching of deductions to a "class" of gross income to which the deductions are

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"definitely related."[31] This is a simple idea. For example, if a taxpayer has gross income from the sale of personal property, then the expenses of selling that property are definitely related to the gross income. A deduction is definitely related to a class of gross income if "incurred as a result of, or incident to, an activity or in connection with property from which" the gross income is derived.[32]

The term "apportionment" is used in two different ways under the federal source of deductions regulations, depending upon what step in the overall process is being discussed. Taking our preceding example of a sale of personal property, suppose that the property involved was inventory and that the independent factory price method was applicable so as to attribute part of the gross income from the sale to U.S. sources and part to foreign sources. Deductions for expenses related to the sale would first be "allocated" to the gross income from the sale. Then such deductions would be "apportioned" between the U.S. and foreign source gross income from the sale.[33]

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The term "apportionment" is also used to describe the means of assigning deductions related to all gross income, or the means of assigning deductions not definitely related to any gross income.[34] For example, if a taxpayer incurs expenses for preparing the consolidated financial statements, such expenses, having the nature of being related to a "support" function, may not be definitely related to a particular class of gross income, and they may be related to all gross income (or, at least, to more than one class of gross income). In such an instance the deductions are apportioned between classes of gross income, and they are apportioned between foreign and U.S. sources for a particular class of gross income.

How this apportionment among classes of gross income, and to foreign and U.S. sources, is to be accomplished is the main problem addressed by the federal regulations. The general principle which guides the process is that the "attribution (i.e., apportionment) must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income."[35] Among the bases for apportionment offered for consideration by the regulations are units sold, gross receipts, costs of sales, profits, expenses, salaries, space utilization, time spent[36], gross income[37], and asset values[38]. For some classes of expenses the regulations provide specifically for the means of apportionment, but as to others the regulations are silent and we are left to choose that method which best reflects the "relationship between the deduction and the grouping of gross income."

Special rules are prescribed for determining the source of interest expenses. Generally interest expense is to be assigned to sources by means of an asset value based apportionment, although attribution of debt, and therefore interest

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expense, to a specific property is required under certain circumstances. However, the new temporary regulations are sufficiently complex to render almost any generalization flippant at best.[39] Special rules are prescribed for determining the source of research and development expenditures as well. Generally, 50 percent of R&D expenditures are to be allocated to the physical location of the research facility, and the remaining 50 percent are subject to gross receipts or gross income based apportionment.[40]

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Footnotes

1. The source of income and deductions rules pervade the consideration of virtually every international tax issue. Therefore one reasonable pedagogical approach is to introduce the source rules before the issues to which they relate are covered. Indeed, this is the approach of the Internal Revenue Service in training their International Examiners. See Internal Revenue Service, International Issues Phase I Training 3135-201 (Rev. 11-93), TPDS 88288E, Module A, Lesson 1, "Sourcing of Income." For Franchise Tax Board auditors thoroughly grounded in the source of income concept applicable for California purposes, and for whom the federal source of income rules are of rather limited importance, this writer believes that a better approach is to introduce the source rules at a point where the trainee can relate them to the broad framework of the federal system.
2. For this two-step process as it applies to determining net taxable income from sources within the United States, see Internal Revenue Code §§861(a) and (b). For the process as it applies to determining foreign source net taxable income see §862(a) and (b).
3. See Treas. Reg. §1.861-8(f), for example, although the list of operative sections given there is to some extent obsolete.
4. There are two other areas of the water's-edge rules where the federal source rules have indirect application. As noted in Chapter 1(a), Water's-Edge Manual, the water's-edge regulations governing the "interest offset" under Rev. and Tax. Code §24344(c) were based in large part on the federal rules governing the determination of the source of interest deductions. Compare 18 CCR §24344(c) with former Treas. Reg. §1.864-8(e)(2) and temporary Treas. Reg. §1.861-9T(a). The California rules will be explored in depth in Chapter 13, Water's-Edge Manual. The second area where the federal source rules have indirect application to water's-edge (and non-water's-edge) California tax returns has to do with intercompany allocations for services, the subject of Chapter 18, Water's-Edge Manual. Treas. Reg. §1.861-8(e)(4) includes a discussion of so-called "stewardship expenses" and the means for determining their source in respect of certain dividends. The source determination regulation includes a cross-reference to the allocation regulation, §1.482-(b)(2), "Performance of services for another," and it explains more clearly the stewardship expenses concept which is introduced in the allocation regulation. This source regulation will be of

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limited importance to importance to water's-edge tax returns; however, you may wish to refer to the regulation as an aid to understanding the rules relating to allocations for services under IRC §482.

5. 18 CCR §25110(d)(2)(G).
6. IRC §§861(a), 861(b), 862(a), and 862(b); see note2, above.
7. IRC §§861(a)(1) and 862(a)(1).
8. IRC §861(a)(1)(B)(i).
9. IRC §§861(a)(2) and 862(a)(2).
10. IRC §861(a)(2)(B).
11. IRC §§861(a)(3) and 862(a)(3).
12. Treas. Reg. §1.861-4(a)(1).
13. IRC §861(a)(3)(A) through (C) provides an exception applicable to certain nonresident alien individuals.
14. Treas. Reg. §1.861-4(b)(1)(i).
15. IRC §§861(a)(4) and 862(a)(4).
16. IRC §§861(a)(5) and 862(a)(5).
17. IRC §865(a).
18. IRC §865(b) which refers to §861(a)(6) and 862(a)(6). See also Treas. Reg. §1.861-7(c).
19. IRC §863(b), which is also referenced by §865(b) (note 18).
20. Treas. Reg. §1.863-3(b)(2), Example (1).
21. Treas. Reg. §1.863-3T(b)(2), Example (2).
22. Treas. Reg. §1.863-3(b)(2), Example (3).
23. IRC §865(c)(1)(A).
24. IRC §865(c)(1)(B).
25. IRC §865(c)(2).
26. IRC §865(d)(2) defines "intangible" to include "any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property." Evidently such does not include stock or other securities of a corporation, or otherwise marketable securities.
27. IRC §865(d)(4)(A).
28. See IRC §865(d)(4)(B), with a resulting default to section 865(a).
29. Treas. Reg. §1.861-8(a)(2) 1.861-8T(b) and (c).
30. Rev. and Tax. Code §25120, et seq. See Chapter 1(c), Water's-Edge Manual.
31. Treas. Reg. §1.861-8(b)(1).
32. Treas. Reg. §1.861-8(b)(2).
33. This sense of the term "apportionment" is clear from a reading of Treas. Reg. §1.861-8(a)(2) and 1.861-8T(c)(1). The terms "statutory grouping"

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and "residual grouping" are employed there (and elsewhere in the regulation) to denote that the determination of the source of gross income and deductions is made for purposes of a particular operative section of the code (see the text accompanying note 3, above). For example, if a foreign tax credit limitation fraction is applicable to certain dividend income, then all deductions allocated and then apportioned to such foreign source dividend income for purposes of the limitation are matched to that "statutory grouping," and all deductions allocated to those dividends but not apportioned to foreign source income (dividends) are said to be assigned to the "residual grouping."

A further potential source of confusion is the fact that the terms "allocation" and "apportionment" are, to some extent, used interchangeably in the federal regulations. Compare the foregoing discussion of "apportionment" with Treas. Reg. §1.861-8(b)(1) where the term "allocation" is used to describe the process described above, and elsewhere in the regulations, as "apportionment."

34. Treas. Reg. §§1.861-8(b)(5) and (c)(3), for example.
35. Treas. Reg. §1.861-8T(c)(1).
36. Treas. Reg. §1.861-8T(c)(1).
37. Ibid. and Treas. Reg. §1.861-8(c)(3), relating to deductions not definitely related to any gross income.
38. Treas. Reg. §1.861-8T(c)(2), but also mentioned in (c)(1)(v).
39. See Treas. Reg. §1.861-9T generally and, in regard to direct allocation to specific properties, §1.861-10T. The truly curious may consider §§ -11T and -12T, as well. Section -13T provides transition rules for certain periods covered by the Tax Reform Act of 1986 (generally, 1987 and later).
40. IRC §864(f). The history of the research and development allocation rules are long and torturous. Suffice it to say that Treas. Reg. §1.861-8(e)(3) has never actually been implemented. For a sense of the complexity regarding the effective dates of the various allocation rules, see IRC §864(f)(6) and Rev. Proc. 92-56, 1992-2 CB 409.

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Section 6.5 Section 482

Contents:

Section 482 General Overview

References:

IRC §482
Treasury Regulation §§1.482-1 through 1.482-8

Training Objectives:

In the preceding three sections of text we have discussed in general three very important areas of the federal international tax system: tax treaties, the foreign tax credit, and sources of income and deductions. Although these have limited direct affects on water's-edge tax returns, it is important for you to have a solid understanding of the role they play in the federal system. Therefore, although we have only briefly summarized the applicable federal rules, we have discussed the general concepts relating to these areas at some length.

In this and in the remaining six sections of this chapter we will very briefly discuss areas of the federal system which will have important direct application to your audits of water's-edge tax returns. We are doing so at this time in order to provide you with a basis for understanding the overall scheme of the federal system, and with a point of reference for the detailed discussion of issues related to these general areas which you will find in later chapters of your text.

At the end of this section the auditor will be able to explain in general terms the nature of intercompany allocation principles under IRC §482 and their relationship to water's-edge returns.

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a. Section 482 - General Overview

Section 482 of the Internal Revenue Code grants to the Internal Revenue Service the authority to allocate income and deductions among related organizations. The IRS may do this whenever an allocation is "necessary in order to prevent evasion of taxes or clearly to reflect...income." This is a simple idea: that net income should be associated with the activity or property by which it was generated; that the substance of economic and business relationships, and not the form in which they may be shrouded, should be the governing factor when it comes to income taxation. For example, if a U.S. corporation causes income which it has earned by means of its property or activity to be received by its foreign subsidiary, and thus shields such income from U.S. taxation, §482 empowers the IRS to reallocate such income to the U.S. company.

As you will learn in Chapter 17, Water's-Edge Manual, §482 is a relatively short and simple provision of the IRC which has, to some extent, come to be burdened by lengthy regulations which are difficult to apply in practice. The concept underlying the regulations is, however, easy to understand. The regulations require that two or more organizations subject to common control conduct business between themselves as if they were unrelated: that each member of a group deal with the other member or members of the group at arm's length. In determining the "true taxable income" of a taxpayer from transactions with related organizations "the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer."[1]

Example 1:

A U.S. corporation sells its product to its foreign subsidiary and to an independent third party, each of whom operate as distributors of the product in a particular market. The unit price charged the foreign subsidiary is $500, while the unit price charged the independent distributor is $750. Had the U.S. corporation dealt with its subsidiary at "arm's length," as if the subsidiary were "another uncontrolled taxpayer," then the unit price charged the subsidiary would have been $750, the same amount charged to the independent third party.

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In this instance the U.S. corporation has misallocated $250 of profit from itself to its subsidiary, which has acquired the product at a bargain price. The IRS may utilize §482 to allocate this $250 in profit to the U.S. corporation.

Under a worldwide combined report system such as that which generally applies to a California taxpayer engaged in a unitary business with a large multinational group of corporations, it of course makes no difference whether a particular member of the group under- or overcharges its affiliates for goods or services. In this instance only the net income of the group taken as a whole is subject to apportionment; the intermediary profits on intercompany transactions are not subject to apportionment. But in a California water's-edge combined report the allocation of income between affiliated corporations, some of whom are members of the combined reporting group and some of whom are not, is of tremendous importance. Consider for example a U.S. distributor of consumer products which is controlled by a parent corporation which manufactures those products in a foreign country. Price-setting for the goods sold to the U.S. distributor could obviously be arranged in such a way as to limit the amount of such company's U.S. taxable -- and therefore California water's-edge apportionable -- income.

Section 482 applies to the whole range of transactions and relationships which take place or appear in the context of the operations of a typical multinational business organization. The federal regulations specifically address loans or advances between related parties (interest income and expense), performance of services for another member of a controlled group, use of tangible property (rents, etc.), sales of tangible property, and transfer or use of intangible property (license or sale).[2] As you will see in Chapter 17, Water's-Edge Manual it is important to analyze all aspects of the relationships within the worldwide organization of the water's-edge taxpayer and its affiliates when you are considering a §482 issue. It is probably rare that a §482 adjustment is called for in only one of the general areas governed by the regulations. Most often one should find that the common control of two or more entities influences in one way or another a wide range of business relationships within a controlled group.

Another feature of §482 problems worth note at this point is the potential effect of audit adjustments other than the obvious increase to the net income of the taxpayer under examination. As with virtually every federal international issue, a

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§482 issue can affect any number of other areas, and auditors need to carefully evaluate such effects in order to predict the net results of their potential adjustments. From the preceding sections of text you have already seen the interaction of the tax treaty, foreign tax credit, and source of income and deduction rules. Section 482 adjustments have implications in all of these areas. For example, if an IRS examiner proposes an increase in a taxpayer's net income for foreign source income, he or she must increase the numerator of the appropriate foreign tax credit limitation factor. For a taxpayer with excess credits in a particular basket, the effect may well be to eliminate or significantly reduce the impact of the §482 audit adjustment. As another example, §482 adjustments involving the operations of affiliates of the taxpayer in a country which has entered into a tax treaty with the United States are subject to special procedures for resolution of federal tax issues under the "competent authority" provisions of the applicable treaty.[3] Finally, the §482 regulations themselves require the making of a "correlative adjustment."[4] This is an adjustment to the accounts of the entity on the opposite side of the transaction from the taxpayer whose return is being adjusted. For example, if an IRS or Franchise Tax Board auditor proposes to increase the net income of a U.S. corporation under §482 at the expense of its foreign subsidiary, then he or she must adjust that foreign subsidiary's earnings and profits.

A §482 audit issue can involve a very substantial audit effort. Chapter 17, Water's-Edge Manual discusses some of the problems and issues you will encounter in these audits, as well as techniques for dealing with them. Although §482 audit adjustments are not the only potentially significant adjustments to be made to water's-edge tax returns, they certainly have the most obvious potential. However, you should not underestimate the work involved in making these adjustments: even in a case where there has been an obvious and calculated

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misallocation of income by the taxpayer, a tremendous amount of work will be required to develop sustainable audit adjustments.

The Internal Revenue Service of course addresses §482 issues in its audits of taxpayers related to multinational organizations. IRS audit coverage in this area is not, however, very extensive. Further, the interests of the IRS do not in all cases coincide with those of the Franchise Tax Board in connection with our audits of water's-edge tax returns. Therefore you should have no difficulty discovering opportunities for raising §482 issues in your audits.

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Footnotes

1. Treas. Reg. §1.482-1(b)(1).
2. Treas. Reg. §§1.482-2(a), (b), (c), 1.482-3, and 1.482-4, respectively.
3. For Franchise Tax Board auditors consideration of an adjustment to the foreign tax credit limitation is obviously unnecessary because California law does not allow a foreign tax credit. Nor must the FTB auditor consider the competent authority provisions of treaties in proposing adjustments inasmuch as such provisions have no application to California tax returns. See the discussion in Section 6.1(b), Water's-Edge Manual, "U.S. Tax Treaties and California Law."
4. Treas. Reg. §1.482-1(g).

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Section 6.6 Tax Havens And Subpart F

Contents:

Subpart F General Overview

References:

IRC §§951 through 962

Training Objectives:

At the end of this section the auditor will be able to describe generally the federal treatment of U.S. shareholders of controlled foreign corporations under Subpart F of the Internal Revenue Code.

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a. General Overview - Subpart F Of The IRC

"Tax haven" conjures up thoughts of tropical islands with suitable supplies of lawyers, bankers, telex machines, and manilla folders. Although there is some truth in this, it is simplistic to think of tax havens in these terms. In the context of a global economy and the operations of multinational business organizations, it may be more accurate to consider as a tax haven any jurisdiction which taxes income at a lower effective rate than do competing jurisdictions. Thus where the location of a particular transaction, including the establishment of a legal entity, is free of other constraints the choice of the tax haven as the venue for that transaction will result in a lower overall tax liability.

The United States in fact is a "tax haven" in a number of respects. The current maximum marginal rate of corporate income taxation by the United States is only 35 percent, much lower than most industrialized nations. Less obvious but perhaps as important is the fact that the United States generally does not tax certain types of income derived from investments in the U.S. by foreign entities, including notably the earnings on U.S. Treasury obligations. Thus the U.S. offers a more attractive venue for certain business and investment transactions than do many other nations. Other industrialized nations are likewise tax havens for certain purposes, in some instances despite high generally applicable marginal rates of income taxation.

In the context of a discussion of issues relating to water's-edge tax returns, therefore, you should consider that a "tax haven" can be found in most any climate. We just completed a discussion of §482, and so it may be appropriate to introduce the subject of tax havens and Subpart F of the Internal Revenue Code by means of an example from the Du Pont case. (Summarized below, with some embellishment, from E.I. Du Pont de Nemours and Co. v. United States, 608 F.2d 445 (1979)).

Du Pont de Nemours and Company was based in the United States and made and sold chemical products. In 1959 it created a wholly-owned subsidiary, known as "DISA" in Switzerland. DISA's function was as a marketing and sales arm of Du Pont. DISA purchased large volumes of chemical products manufactured by Du Pont in the U.S. which were intended for resale as raw materials to manufacturers and finished, or semi-finished, goods. DISA indeed resold the

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products to manufacturers throughout Europe, as well as in such faraway places as Australia and South Africa.

Although title to these large volumes of bulk chemicals transferred from Du Pont to DISA and only thence to the ultimate customers, it is doubtful that they were shipped across the Atlantic Ocean, trucked up the Alps to DISA, and then down again in preparation for ultimate shipment to customers in Australia, for example.

Switzerland was selected as the venue for Du Pont's sales subsidiary by a corporate task force principally because of Swiss tax incentives; that is, because DISA would be subject to little or no income tax on its earnings from sales to customers outside Switzerland. An important feature of the arrangement between Du Pont and DISA was the setting of "a selling price sufficiently low as to result in the transfer of a substantial part of the profits on export sales to the 'PST company'," according to a Du Pont internal memorandum. "PST" was Du Pont shorthand for "profit sanctuary trading company."

The IRS adjusted Du Pont's tax returns under IRC §482 for the undercharging of DISA. The U.S. Court of Claims sustained the IRS adjustments.

Du Pont's use of DISA in Switzerland can be viewed as a classic illustration of the use of a tax haven. Switzerland was used as the base of operations of the sales company in order to put profits into that company in order to reduce the company's overall tax burden. In 1959 and 1960, the years at issue in Du Pont, the only tool available to the IRS for combating such a scheme was §482, which of course only applies to constrain the affiliated corporations to deal with one another at arm's length. Had Du Pont dealt with DISA at arm's length the placing in Switzerland of profits from the sale in other countries of goods manufactured in the U.S. would have not run afoul of U.S. tax laws.[1]

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The idea that profits could be thus placed in a tax haven was and is generally considered to be objectionable from a tax policy standpoint. Section 482 addresses only one aspect of such problems, and is a rather cumbersome tool to use, as is revealed in part II of the Du Pont court's decision, "Section 482 and the 'Resale Price Method` of Allocating Profits," for example.

In 1962 Congress enacted the so-called "Subpart F" rules of the IRC to deal with this tax haven problem.[2] The Subpart F provisions apply to foreign business and investment operations controlled by U.S. taxpayers. The underlying principle is that income should be taxed where it is earned, and that if income accrues in the hands of an entity operating in a tax haven then such income should be taxed to the person controlling events. This is accomplished by means of what is often referred to as a "deemed dividend." Under section 951 a controlling U.S. shareholder is currently taxed on tax haven earnings of its foreign subsidiary,

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without regard to whether the subsidiary pays a current dividend. In the case of Du Pont and DISA, for example, had such an arrangement been in place subsequent to 1962, DISA's earnings on sales of Du Pont's U.S. manufactured products to customers in Australia (and elsewhere, excepting only sales to Swiss customers) would have been taxable to Du Pont, even if DISA retained the earnings and did not pay a dividend.[3]

Subpart F applies to a wide range of tax haven earnings, including earnings from passive investments.[4]

While California has not strictly speaking adopted the federal Subpart F provisions as part of the Bank and Corporation Tax Law, Subpart F issues are nevertheless an important consideration in water's-edge audits. Under Rev. and Tax. Code section 25110(a)(7), water's-edge combined reports are to include a portion of the income and apportionment factors of foreign subsidiaries with Subpart F income. This "partial combination," as well as the Subpart F rules themselves, is the subject of Chapter 9, Water's-Edge Manual. For now we will merely observe that Subpart F-related issues in your audits should prove interesting, challenging, and material. The adaptation of the Subpart F rules for the purposes of requiring a partial water's-edge combination has led to some curious gaps and some interesting differences in the ways that the federal and the California Subpart F rules apply. As with §482 issues, you should not underestimate the work required to sustain your adjustments in this area. Indeed, you will find that, as with Du Pont and DISA, §482 and Subpart F issues often arise in the same case, and you may find yourself making an argument that a Subpart F issue is a backstop or alternative in the event your principal §482 issue can not be sustained (or vice versa![5]).

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The interrelationship with §482 is not the only link between the Subpart F provisions and other aspects of the federal international tax system. As with other international issues, Subpart F implications are to be found in a wide variety of areas. For example, a Subpart F "deemed dividend" is treated in many respects as an actual distribution, providing the controlling shareholder with an opportunity to claim an indirect foreign tax credit for foreign income taxes imposed on the Subpart F earnings. Obviously, for the IRS examiner this means that a Subpart F adjustment may not be worth pursuing because the foreign tax credit could completely negate its effect. But inasmuch as FTB auditors need not be concerned with the foreign tax credit they may pursue Subpart F issues which are of little or no interest to the IRS examiner.

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Footnotes

1. DISA did in fact perform certain substantive marketing functions; it was not a "sham." Had DISA not performed any substantive functions Du Pont's arrangement may have been subject to attack under §482 or other code provisions, perhaps despite any appearance of an effort to set transfer prices "at arm's length." See Chapter 9, Water's-Edge Manual.

   Indeed, Du Pont's sin may have been the creation of documents which so explicitly detailed its tax motivations and an altogether cynical appreciation of the potential outcomes of the anticipated IRS audit. See footnote 4 of the decision. Judge Davis dismissed this possibility, after he had "itemized the special status of DISA," by stating that such was "not ... direct proof, in itself, supporting the Commissioner's reallocation of profits under Section 482, but instead [it suggests] the basic reason why [Du Pont's] sales to DISA were unique and without direct comparable in the real world," and went on to say there was not "anything 'illegal' or immoral in Du Pont's plan; it is simply that plan made it very difficult, perhaps impossible, to satisfy the controlling Treasury regulations under Section 482." But this comment may be belied even by the accompanying footnote 10 which cites Treas. Reg. Section 1.482-1(c) for the proposition that section 482 applies "to any case in which ... by ... design the taxable income ... of a controlled taxpayer, is other than it would have been had the taxpayer [dealt] at arm's length ..." Despite the opinion's disavowal it is obvious that Du Pont "convicted" itself of doing just that by means of the referenced documentation. On the other hand, the quoted language should illustrate a point from the preceding section of text -- that §482 adjustments are difficult to sustain. That is, even if the auditor can show the taxpayer's error, as well as bad faith, the job is not done: one must demonstrate the correctness of the audit adjustment, not merely the fact that there exists an error in need of correction.
2. Public Law 87-834, section 12(a). "Subpart F" refers to the placement of these provisions within Part III of Subchapter N of Chapter 1 of the IRC; IRC sections 951, et seq. "Subpart F" is also used in the code as the designation for certain income subject to these provisions. See IRC section 952(a), for example.
3. Du Pont and DISA present a basic example of "foreign base company sales income." See IRC section 954(d).
4. IRC section 954(c) defines "foreign personal holding company income."

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5. For the IRS examiner dealing with certain tax haven problems, higher deficiency assessments generally follow from the application of §482, if appropriate. This should be true as well for the FTB auditor of a water's-edge return; however, owing to the nature and the mechanics of the partial combination rule it may be more likely, though still uncommon, for the opposite to be true in the case of a water's-edge return.

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Section 6.7 U.S. Possessions Corporations

Contents:

General Overview - Possessions Corporations

References:

IRC §936

Training Objectives:

At the end of this section the auditor will be able to describe generally the special federal rules applicable to possessions corporations.

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a. General Overview - Possessions Corporations

The approach of the United States to dealing with tax haven problems has come to be admired by tax and fiscal authorities of other nations, and in recent years Australia, Canada, and some European nations have either adopted or considered adopting provisions similar to those of Subpart F of the IRC. Obviously the concept of a tax haven is anathema to the primary interests of industrialized nations with relatively high marginal rates of income taxation. Nevertheless, in the pursuit of its own non-tax policy goals, the United States has led the way in the creation of what may be the ultimate tax haven: U.S. possessions, including particularly the Commonwealth of Puerto Rico.

The IRC has for about 30 years included special tax incentives for U.S. companies to base operations in Puerto Rico with the aim of promoting the development of the Puerto Rican economy. In addition, the government of Puerto Rico has pursued policies resulting in the granting of liberal and extended tax holidays for such operations. The result has been the creation of opportunities for placing in Puerto Rico substantial profits which are effectively exempt from federal or local level income taxes. As was the case with the Swiss tax haven in Du Pont discussed in the preceding section of text, the IRS has sought to attack what it saw as abuses related to business arrangements in Puerto Rico through the use of §482.

Perhaps the most egregious documented "public" example of the advantages accruing by reason of tax planning in connection with operations in Puerto Rico is provided by the case of G.D. Searle and Co., a U.S.-based pharmaceutical firm, although Searle's case merely reveals the basic pattern of pharmaceutical operations in Puerto Rico, albeit carried to their logical and inevitable extreme.[1] Searle developed through its research and development facilities in the U.S. extremely valuable patents for pharmaceutical products. It transferred ownership of those patents in a tax free exchange under IRC section 351 to a U.S. subsidiary doing business in Puerto Rico. Searle also transferred to its subsidiary ownership of marketing intangibles such as applicable trademarks in connection with the patented products. Thereafter the Puerto Rico subsidiary utilized the patents to manufacture consumer pharmaceutical products, and it

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contracted to have Searle market those products in the U.S., utilizing the marketing intangibles now owned by the Puerto Rico subsidiary.

The result was that the Puerto Rico subsidiary realized enormous profits on the manufacture and marketing of the valuable patent- and trademark -protected products, while Searle operated only marginally, or even at a loss, in the U.S. Consequentially, Searle paid little or no U.S. taxes, and its Puerto Rico subsidiary paid little or no U.S. or Puerto Rican taxes because of the tax incentives and tax holidays provided. The IRS utilized §482 in an attempt to allocate to Searle earnings attributable to the valuable intangible properties which it had developed in the U.S. and then transferred to Puerto Rico. The IRS was even partially successful in doing so, although the Tax Court's decision is not exactly a model of exposition in terms of pointing out exactly where it was that Searle ran afoul of section 482. [2]

In any event, what is clear from the Searle decision and that of its companion case (Eli Lilly; see note[2]) is that section 482 was a not entirely satisfactory means by which the limits of the tax advantages available to Puerto Rico operations could be contained. A more definitive solution to the problems which the IRS sought to address was developed, and the possessions corporation tax incentives in the IRC were substantially amended in 1982.[3]

Under the present system a U.S. corporation with substantial and continuing business operations in Puerto Rico may claim a special tax credit on its U.S. tax return with respect to income tax (which would otherwise be due) on its non-U.S. source income.[4] Pursuant to the 1982 amendments, such a U.S. corporation operating in Puerto Rico (generally, a subsidiary) and its U.S. parent corporation are strongly encouraged to elect to treat as taxable income on the return of the

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parent corporation a portion of the earnings attributable to the exploitation of intangibles which were developed in the U.S.[5] In other words, under the Searle fact pattern discussed above, Searle-U.S.A. would be taxable under IRC section 936(h) for a portion of Searle-Puerto Rico's earnings from the intangibles. Two alternative methods for determining what is that taxable amount are provided under section 936(h), the "profit split" and "cost sharing" methods, and these will be discussed in detail in Chapter 7, Water's-Edge Manual. It suffices at this point to say that the profit split method is almost universally preferred to cost sharing at this time, and that it results in a roughly 50-50 split of the profits between the U.S. and the Puerto Rico based companies.

Possessions corporations also occupy a unique niche in California's water's-edge law. They are the only entities explicitly excluded from the water's-edge combination.[6]

The exclusion from the water's-edge combination in conjunction with the fact that California has not adopted the profit split or cost sharing rules of IRC section 936(h) give rise to certain problems in connection with your audits of the tax returns of water's-edge electing taxpayers with possessions corporation affiliates. Very interesting is the fact that IRC sections 367, 482, and 936 were significantly amended in 1986 to provide that in the case of a transfer or license of an intangible the income with respect to such transfer or license shall be "commensurate with the income attributable to the intangible."[7] In other words, under the Searle fact pattern, the profits derived from the intangibles would evidently be attributed to Searle-U.S.A., the developer of the properties (under the amendment to section 482). For federal purposes, in the case of a possessions operation, this "commensurate with income" rule is overridden by the profit split rule of section 936(h). However, since California has not adopted the provisions of IRC section 936(h), the "commensurate with income" standard applies under the California counterparts to section 482 to possessions

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corporations and their water's-edge affiliates.[8] Thus California water's-edge combined reports involving possessions corporation affiliates may involve very substantial section 482 issues for your consideration. Moreover, such issues may prove far less difficult to audit than section 482 issues involving, for example, U.S.-based distributors of foreign manufacturing concerns. See Chapter 17, Water's-Edge Manual and Chapter 7, Water's-Edge Manual.[9]

Another major water's-edge audit issue may be whether the possessions corporation can indeed be included in the combination pursuant to Rev. and Tax. Code section 25110(a)(3) by virtue of extensive sales and nexus for taxation in the U.S.[10] See the discussion in Chapter 2, Water's-Edge Manual and Chapter 7, Water's-Edge Manual.

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Footnotes

1. G.D. Searle and Co. v. Commissioner, 88 T.C. 252 (1987).
2. The oft cited companion decision in Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985) includes a similar fact pattern, a similar result, and a similarly oblique rationale. Lilly has now been reversed in part and remanded; Nos. 86-2911 and 86-3116, 7th Circuit, August 31, 1988.
3. Public Law 97-248, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), section 213(a)(2), amending IRC section 936.
4. IRC section 936(a).
5. IRC section 936(h).
6. Rev. and Tax. Code section 25110(a)(1) and (4). See footnote /6/ to Chapter 1, Water's-Edge Manual, and Chapter 2, Water's-Edge Manual.
7. Public Law 99-514, section 1231.
8. Rev. and Tax. Code sections 24725 and, especially, 25114(b)(1), with its explicit references to IRC section 936(h) and the commensurate with income standard.
9. This rather sanguine view of matters is based to some extent on the IRS views on the application of the "commensurate with income" standard as revealed in its so-called "White Paper" on section 482 ("A Study of Intercompany Pricing," Treasury Department and IRS, October 18, 1988). Revised Treasury Regulations under section 482 are believed to be forthcoming, someday, and may reveal a further evolution of the IRS position from that contained in the "White Paper.
10. Note that intercompany sales by the Puerto Rico subsidiary to the water's-edge affiliates are eliminated pursuant to 18 CCR section 25110(d)(2)(C)(ii)(IV). See Chapter 2, Water's-Edge Manual.

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Section 6.8 Section 367 Transfers

Contents:

General Overview of Section 367 Transfers

References:

IRC §367

Training Objectives:

At the end of this section the auditor will be able to describe generally the federal treatment of transfers of property to and from foreign entities as governed by IRC §367.

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a. General Overview Of §367 Transfers

We have seen thus far that the federal government taxes U.S.-incorporated entities on all of their income and foreign-incorporated ones on their U.S. income. Governance of transactions and investments across national lines is manifested in the application of the arm's length principle embodied in IRC §482, and implicit in the Subpart F system.[1] All in all, the United States seeks only to tax entities and incomes which come within the boundaries of this system. Of course, there are a host of exceptions and special rules such as the possessions corporation rules, which we have discussed, and the export trade incentives, which we will discuss, which in a sense violate to at least some degree these boundaries. Nevertheless, it is clear that the U.S. has carved-out a perceptible territory. And as will become clearer as you proceed with your training, the California water's-edge rules carve-out a combined reporting territory which roughly, if not exactly, coincides with that of the U.S. system.

Subchapter C of the Internal Revenue Code allows for the tax-free (or tax-deferred) exchange of appreciated property in a number of contexts. IRC §§332, 351, 354, 355, and 361 provide for rules which are well known to you in this area. Generally, the Code provides opportunities for deferring the taxation of the appreciation of property which has been and will continue to be held in corporate solution.

This general theme of the Subchapter C rules of course makes a good deal of sense in the context of a closed system, where the U.S. is assured of the ability ultimately to tax the increases in the value of property held in the corporate form.

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However, it is impossible to justify such deferral where it would result in a permanent loss to the Treasury.

Example 1:

Corporation A, incorporated in the U.S., owns a very valuable property in which it has little or no basis for tax purposes. Corporation A transfers title in the property to its subsidiary, Corporation B, which was recently formed under the laws of Switzerland, in exchange for stock and securities of Corporation B. The transaction qualifies in all respects for the "no gain or loss" treatment under IRC §351(a). Thereafter Corporation B sells the asset and realizes the substantial gain on its appreciated value.

Assuming that Corporation B does not distribute its earnings to Corporation A, and that Subpart F does not apply (you will learn more about this in Chapter 9, Water's-Edge Manual), the taxation of the gain which has been in effect deferred by means of §351 will permanently escape taxation by the United States. You may wish to note that §351 is not restricted in any sense to application only to U.S. corporations. Compare §351(a) and the definition of "corporation" at IRC §7701(a)(3).

Pretty obviously there is potential here for a rather enormous hole in what we had thought was a closed system. The hole is covered however by IRC §367.

The general rule of IRC §367(a) is that gain is recognized on a transfer of property to a foreign corporation, notwithstanding the deferral provisions of Subchapter C.[2] The most important exception to this rule is for property which will be used in the active conduct by the foreign corporation of a trade or business in a foreign country.[3] Exceptions to this exception, requiring gain recognition on transfer, apply to certain types of property which are likely to be resold promptly or are highly fungible, such as inventory, receivables, foreign

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currency or foreign currency denominated investments, and interests in leased property.[4]

Gain is also required to be recognized on certain transfers of intangible personal property, such as patents or know-how, even though used in an active trade or business, apparently on the theory that the same or a similar business purpose could be achieved by means of a license, where the property remains in the hands of the U.S. developer of the intangible. A further theory could be that it is inappropriate to allow the tax-free exploitation of intangibles developed by means of costs and expenses incurred in the development process in the United States.[5] This rule is augmented by the provisions of §367(d), which require, in the cases of §351 or §361 transfers, that a transfer of an intangible be deemed to be a licensing arrangement, giving rise to a periodic royalty from the controlled foreign subsidiary to the U.S. developer of the intangible. You may recall at this point our brief introductory comments on the "commensurate with income" standard in the discussion of possessions corporation issues in the previous section of text. The term "commensurate with income" can be found in §367(d)(2)(A)(ii) and §482, and it is cross-referenced in §936(h)(5)(C)(i)(I). All roads lead to Rome.

IRC §367(b) similarly provides for exceptions to the Subchapter C provisions where property is transferred from one foreign corporation to another. The IRC §367 provisions apply to California water's-edge tax returns. Indeed, they apply to all California franchise tax returns. See Rev. and Tax. Code §24451. Thus a transfer of property from a water's-edge taxpayer or its affiliate in a water's-edge combination to a foreign affiliate can give rise to apportionable gain in the water's-edge combined report.

Obviously the complexity of business transactions covered by §367, as well as the complexity of the §367 provisions themselves, increase the likelihood that the tax returns may contain errors, or that gains which are taxable under §367 may not be reported. In order to provide assistance to you in understanding the complexities of §367, Chapter 19, Water's-Edge Manual covers the §367 regulations in quite a bit of detail.

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Footnotes

1. Perhaps some explanation is owed on this point. The arm's length principle requires that two or more related organizations must deal with one another as if they were unrelated. In other words, transactions in the controlled world of a multinational business organization must be comparable to those in the real world. Put this way, Subpart F can be seen to be an adjunct to the explicit arm's length rule of IRC §482. That is, Subpart F operates to constrain the multinationals to establish investment and transactional patterns which mirror at least in certain essential respects those which would arise in response to market forces in an uncontrolled environment, or which are at least not unduly influenced by tax considerations.
2. This is accomplished by providing that a "foreign corporation" "shall not ... be considered to be a corporation" for purposes of the application of the Subchapter C provisions. Note, for example, that §351(a) provides for no gain or loss if property is "transferred to a corporation."
3. IRC §367(a)(3).
4. IRC §367(a)(3)(B), generally.
5. IRC §367(a)(3)(B)(iv).

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Section 6.9 Export Sales Incentives

Contents:

Overview of Federal Export Sales Incentives

References:

IRC §§921 through 927
IRC §§970 through 971
IRC §§991 through 994

Training Objectives:

At the end of this section the auditor will be able to explain the nature and purpose of the special export incentive provisions of the Internal Revenue Code.

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a. Overview - Federal Export Sales Incentives

You will recall our statement in the introduction section of this chapter that the United States taxes all of the income of U.S. corporations. Then we told you about exceptions in the form of foreign tax credits and possessions corporations. And now we're going to tell you about another enormous exception to the taxation of all U.S. income by the U.S.

The U.S. has for many years provided U.S. companies incentives to promote export of goods from the U.S. Since 1985 the principal means of providing such incentives have been the foreign sales corporation (FSC) rules of IRC §§921 through 927. The immediate predecessor to the FSC regime was that of the domestic international sales corporation (DISC), which continues to have some effect in a substantially withered form. Refer to IRC §§991 through 994. The Code currently provides for a further incentive by means of an exception from the Subpart F rules for "export trade corporations" under sections 970 et seq.; however, to qualify currently for the exception such a corporation must have been qualified for a taxable year beginning before October 31, 1971.[1] Thus export trade corporations are quite rare.

Under the California water's-edge rules FSC's, DISC's, and export trade corporations are all required to be included in the water's-edge combined report.[2]

A FSC, like the DISC in both its pre-1985 and post-1984 incarnations, is essentially a shell or paper company. Although the FSC rules require certain connections with another jurisdiction outside the United States, the rules cannot be regarded as being much more than a nuisance.[3] The critical feature of the FSC system is the provision for administrative pricing rules, by means of which substantial income derived from the sale of export products is exempted from U.S. income tax.[4] The administrative pricing rules have no rational basis other

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than the desire of Congress to effect through the FSC rules about the same level of incentive as was available under the old DISC rules.

The FSC is included in the water's-edge combination just as it is in worldwide combinations with which you are already familiar. Thus the FSC in the water's-edge combination presents no particular challenge in your audits, at least under the usual circumstances. What may prove interesting, however, are problems related to the effects on the water's-edge combined reporting group of a determination that a reputed FSC in fact is not qualified for the benefits of the FSC provisions. The water's-edge regulations provide that such an entity is to be excluded from the water's-edge combination.[5] In such a case the administrative pricing rules would have no effect, and the arm's length standard of IRC §482 would apply to transactions between the purported FSC and its affiliates. Further consequences may follow from application of the Subpart F provisions to such an entity, or from any distributions by the entity to a shareholder in the water's-edge group.

The FSC rules in general and these special water's-edge problems are dealt with in Chapter 2, Water's-Edge Manual, which also covers DISC-related issues. Export trade corporations are also briefly mentioned in Chapter 2, Water's-Edge Manual.

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Footnotes

1. IRC section 971(a)(3).
2. Rev. and Tax. Code section 25110(a)(2) and (6).
3. IRC section 922(a)(1)(A), (D), and (E). Also see Treas. Reg. section 1.922-1.
4. IRC section 925.
5. 18 CCR section 25110(d)(2)(B)(ii).

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Section 6.10 U.S. Branches Of Foreign Corporations

Contents:

Overview - Federal Taxation of Foreign Corporations

References:

IRC §881
IRC §882
IRC §884

Training Objectives:

At the end of this section the auditor will be able to explain generally the federal system for taxation of income of foreign corporations from U.S. business operations and U.S. investments.

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a. Overview - Federal Taxation Of Foreign Corporations

A corporation, a single legal entity, may of course conduct its business activities in more than one country. When a corporation is based in one country but establishes a place of business in another, such other place of business is often referred to a "branch," or "branch operation."[1]

Such branch operations have legal significance under the U.S. tax laws.

A theme of U.S. international tax policy has been to equalize the tax treatment of operations conducted through subsidiaries and through branches. For example, if a foreign-based multinational seeks to establish a business presence in the U.S. it should make no difference in terms of its income tax burden if it does so through the formation of a U.S. subsidiary corporation or through the establishment of a branch operation. This theme is expressed through numerous provisions of the IRC dealing with the taxation of foreign investors and foreign businesses in the U.S., some of which we touched on briefly in the introduction and Section 6.1, Water's-Edge Manual. For example, the tax burden of an entity operating through a permanent establishment in the U.S. under most tax treaties will approximate the tax burden of a separately incorporated U.S. subsidiary operating in the same way.

The general theme of attempting to equalize the taxation of branch and subsidiary operations has been referenced much less consistently in the "outbound" context -- where a U.S.-based corporation operates through a branch or subsidiary in a foreign country. However, traces of such a policy objective can be found in the Code provision dealing with sources of income in respect of the foreign tax credit, in Subpart F, in the treatment of contiguous country subsidiaries under IRC §105(d), and elsewhere.

It is important for you to recognize the separate status of branch operations for the purposes of your water's-edge audits. Under the California water's-edge system it is indeed significant whether operations are conducted through branches, in either the inbound or the outbound context. Moreover, under water's-edge there are important differences between the treatment of branches

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of foreign banks and those of foreign corporations which are not banks.[2] The water's-edge treatment of branch operations of foreign banks and corporations will be explored in detail in Chapter 8, Water's-Edge Manual.

For a U.S.-based multinational with foreign subsidiaries and foreign branches, the water's-edge rule is simple and clear-cut. The subsidiaries are excluded from the water's-edge combination and the branches are included.[3] The fact that there is a clear-cut rule does not of course preclude a given taxpayer from excluding a foreign branch from its water's-edge report. See Chapter 2, Water's-Edge Manual.

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Footnotes

1. In fact, the IRC used the term "branch"; see §884.
2. Compare Rev. and Tax. Code §25110(a)(3) and (5).
3. See Rev. and Tax. Code §25110(a)(4) for the general inclusion rule applicable to a U.S. corporation. Generally a foreign corporation will not meet any of the conditions of §25110(a)(1) through (7) and (8)(B), and thus will be excluded from the water's-edge combination.

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Section 6.11 Dollars And Other Currencies

Contents:

DOLLARS AND OTHER CURRENCIES

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a. Dollars And Other Currencies

As a final note in introducing you to the federal international tax system we would just like to remind you of the simple fact that the U.S. dollar is not the world's only currency. Every aspect of the federal international tax rules that we have discussed -- from tax treaties to ECI to sources of income and deduction to §367 to branches -- has to do with multinational business operations conducted across national boundaries. Although the U.S. dollar may be your currency of choice[1], not all payments for goods and services and investments are made in that form.

Not surprisingly then the Internal Revenue Code includes special provisions governing the handling of transactions denominated in foreign currencies.

IRC §§985 to 989 include the key foreign currency provisions applicable to multinational business operations. Among issues addressed by these provisions which will be of concern to you in water's-edge audits are:

(1) The determination of net taxable income in dollars of a foreign branch operation of a U.S. corporation which uses a foreign currency designation in keeping its books and records.
(2) The determination of net taxable income in dollars of a U.S. branch of a foreign corporation which uses a foreign currency designation in keeping its books and records.
(3) Computing the earnings and profits in dollars of a foreign subsidiary with Subpart F income, or which has made a distribution.

The IRC §985 to 988 rules and their application in the water's-edge context will be explored in detail in Chapter 11, Water's-Edge Manual.

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Footnotes

1. Even if not, there are no reported instances of the State Controller issuing payroll warrants denominated in pounds, francs, marks, lira, yen, or pesos.

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