Chapter 6 FEDERAL INTERNATIONAL TAXATION

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a. Nature And Limitations Of The US Taxing Jurisdiction

There is a significant difference between the nature of the taxing jurisdiction of the United States (US) and that of the state of California. For multi-jurisdictional corporate business enterprises, California may only tax that income derived from, or attributable to, California sources. (Revenue and Taxation Code (RTC) §25101.) This limitation is based on the Commerce and Due Process Clauses of the US Constitution. (*Mobil Oil Corporation v. Commissioner of Taxes of Vermont* (1980) 445 US 425. *ASARCO, Inc. v. Idaho State Tax Commission* (1982) 458 US 307.)

The US government, however, has no such constitutional limitation. In the international context, the only significant limitation on the US taxing jurisdiction is self-imposed by Congress in the furtherance of tax, foreign relations and international trade policy considerations. There are no provisions of international law or in the US Constitution that in any way limit the worldwide jurisdiction to tax the income of US citizens or residents, or income derived from property having some connection with the US. In addition, the US can assert 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 US trade or business. (Internal Revenue Code (IRC) §864(c)(4)(B).)

The following table summarizes the US taxing jurisdiction over income from sources inside and outside of the US.

US Tax Jurisdiction		
	Over Income From Sources	
Entities	In the US	Outside the US
US Incorporated	All	All; Subject to Foreign Tax Credit
Foreign Incorporated – ECI	All; Subject to treaty	All; Subject to treaty
Foreign Incorporated – Non-ECI	Some; Subject to treaty	None
Foreign Incorporated – Subsidiary of US Corporation	ECI rules apply	Subpart F income taxed to shareholder

b. US Taxing Jurisdiction Of US Corporations

Congress asserted the right to tax the income of entities incorporated in the US. For US corporations, there is no exclusion from taxation for income derived from sources outside the US. (IRC §§11 and 61.)

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 or transacts no business with any other person in the US. All of Corporation A's income is subject to the US federal income tax.

As does the US, many foreign countries assert taxation on the basis of source.

Example 2:

> Corporation A, described in Example 1 above, conducts all of its business and derives all of its income from sources in the United Kingdom (UK). Therefore, the UK also asserts its taxing jurisdiction over all of A's income.
>
> When both the US, as the country of incorporation, and a foreign country, as the geographic source of income, assert the right to tax income, international double taxation occurs. Taking the preceding examples together, Corporation A's income is taxable in its entirety by both the US and the UK. When this occurs, the US in effect cedes all or part of its taxing jurisdiction of its corporate citizens to the country with the source-based jurisdiction. This is accomplished by means of the Foreign Tax Credit (FTC). In Example 2 above, a FTC would be available against A's US tax liability for the income taxes paid to the UK.

c. US Taxing Jurisdiction Of Foreign Corporations

Congress is more cautious with respect to entities incorporated in foreign countries. It asserts jurisdiction to tax only income with some connection with the US. The mechanism of applying the tax under this theory is more complicated than that that applies in the case of US incorporated entities. In asserting source-based jurisdiction to tax the income of foreign corporations, the US does not operate under a "minimum connection" or "nexus" limitation, such as that applicable to the states. Federal limitations are self-imposed, and they reflect a broad range of international policy considerations.

A number of federal provisions apply to limit the taxing jurisdiction of a foreign corporation's income. Many of these topics are the subject of separate chapters of this manual. Here is an outline of the treatment of items based on distinctions between countries of incorporation, types of income, and whether the income is related to US business operations.

- In general, the US asserts jurisdiction to tax only that income of a foreign corporation that is "effectively connected with the conduct of a trade or business within the US." (Referred to as "effectively connected income," or "ECI" under IRC §882(a)(1). ECI is discussed in more detail in Chapter 8, Water's-Edge Manual.)

- US jurisdiction to tax ECI is 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 discussed in Section 6.2, below, and in Chapter 8, Water's-Edge Manual.)

- Source-based jurisdiction is not limited to ECI. Certain types of income from US investments and activities, which do not rise to the level of being a trade or business within the US, are subject to tax under IRC §881. This is not the standard income tax rates, but rather a special 30 percent tax rate that is generally collected by means of withholding by the payer of the income. (IRC §1442.) 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 generally reduce the applicable tax rate to something less than the statutory 30 percent rate.

d. US Indirect Taxing Jurisdiction

The tax jurisdiction of the US extends to the earnings of foreign incorporated entities, which are controlled by US shareholders. Discussed in Section 6.6, below, the US imposes an income tax on US shareholders with respect to certain types of income of their Controlled Foreign Corporations (CFC). This is accomplished by means of a so-called "deemed dividend" pursuant to the Subpart F provisions. This can be viewed as simply a definition of a special type of income, or as merely an acceleration of tax on amounts that would be included in the shareholder's taxable income at some later date when actually distributed. Although, it seems equally valid to view it as an extension of the US tax jurisdiction into a foreign country, subjecting the foreign source earnings of a foreign corporation to US tax via an indirect means.

6.2 TAX TREATIES

a. Nature Of Tax Treaties

The US 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 US on foreign corporations engaged in business or investment activity in the US. As discussed in Section 6.1, treaties can be viewed as devices for ceding jurisdiction to tax to the country of incorporation. Treaties often operate to reduce tax rates applied to certain types of income.

Tax treaties are generally entered into for the purpose of avoiding international double taxation, which arises from competing claims of governments to tax the same income. The US asserts taxing jurisdiction on the worldwide income of US corporations, and also source-based jurisdiction with respect to income earned here by foreign corporations. Accordingly, international double taxation arises whenever a US corporation earns income in a foreign country, or when a foreign country asserts residence-based jurisdiction to tax US source income. It also arises when both countries assert source-based jurisdiction, using different definitions of "source" of income. Finally, double taxation also arises when a corporation is deemed to be a resident of two countries.

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

Establishing a treaty between two countries can be a complicated process. Treaty negotiations can go on for many years before ratification occurs. Based on constitutional procedures, US tax treaties are negotiated by US Treasury Department representatives, and then signed by the President. The treaty is then referred to the US Senate, who may advise and consent to the treaty terms. (US Constitution, Art. II, section 2, clause 2.) Ultimately, the treaty is ratified. Either treaty country can unilaterally terminate the treaty.

The relationship of tax treaties and IRC provisions is rather complicated. As a general rule, treaty provisions take precedence over the statutory provisions. Note, the supremacy clause of the US Constitution provides, "...all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land..." Also see IRC §894, which provides that the provisions of the IRC shall be applied with due regard to any treaty obligation that applies to the taxpayer. However, IRC §7852(d)(1) provides, "...neither the treaty nor the law shall have preferential status by reason of its being a treaty or law." In other words, the treaty overrides the IRC. 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 over the treaty.

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 US are compensated for by benefits extended to US residents or citizens by the foreign country. The most important benefits are the liberalization of requirements for nexus for taxation through the permanent establishment (PE) 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." In addition, treaty provisions may facilitate exchanges of information between governments and the carrying out of joint audit projects.

Tax treaties are a significant feature of the international tax landscape. Not only does the US enter into tax treaties with foreign governments, but also foreign governments have treaties amongst themselves. An important issue involving tax treaties has to do with the PE rules. It may be important that a foreign corporate resident of a treaty country confine its US activities in such a way that it avoids having those activities meet the threshold requirements for a US PE. If it does not have a PE, it pays no US tax. If it does have a PE, it pays US tax on its net business income.

b. US Tax Treaties And California Law

The application of tax treaties under the water's-edge statutes is discussed in Chapter 8, Water's-Edge Manual. Tax treaties have important effects on water's-edge combined reports. *For taxable years beginning before January 1, 1992*, under the water's-edge regulations, treaty provisions were applicable to foreign banks and corporations operating in the US, to the extent that they limited the definition of ECI for federal purposes. (California Code of Regulations (CCR) §25110(F)2(a).) Therefore, treaty provisions were important to determine if a foreign bank or corporation had a taxable presence in the US under relevant tax treaties, and thus had income and factors subject to inclusion in a water's-edge combined report.

For taxable 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 or taxation of ECI for federal purposes. (CCR §25110(F)1(a).) Therefore, situations will occur 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. In situations where a taxpayer has tax treaty immunity, a state adjustment to the water's-edge return would be necessary to properly include the ECI.

The worldwide network of treaty relationships presents important tax considerations. For example, if a corporate resident of a non-treaty country desires to do business in the US, it may choose to do so through a subsidiary formed in a third (foreign) country, which does have a treaty with the US. It may then take advantage of the PE rules, and it may eliminate any potential US tax. Similarly, a US-based multinational corporation desiring to do business in a non-treaty country may form a subsidiary in another country that does have a treaty to take advantage of the treaty provisions between the two foreign countries.

Tax treaties between the US 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 an exemption from US 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. In 2002, Corporation A is engaged in certain business operations in the state of California, and is "doing business" in California within the meaning of RTC §23101. Country X

has a tax treaty with the US. Corporation A's activity in California is such that, under the treaty, Corporation A is effectively exempt from US income taxes.

For purposes of the water's-edge combined report, Corporation A would not recognize the treaty provisions to determine its water's-edge includible income and factors. Corporation A is subject to the franchise tax, and must file a California tax return and include its net ECI.

US 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 the RTC. For example, RTC §24320, relates to income from the operation of aircraft or ships by a foreign county corporation. The exemption from US taxation under a treaty does not translate into immunity from California taxation, under water's-edge or worldwide filings.

c. Permanent Establishment (PE) And ECI

The most important effects of treaties for US taxation purposes, as well as for California water's-edge purposes, are derived from the concept of "permanent establishment" or "PE." For federal purposes, the first step in determining the US taxable income of a foreign corporation is to determine whether that corporation is engaged in a "trade or business" within the US. The second step is to determine the ECI related to that trade or business in accordance with IRC §882. Under a tax treaty, it does not matter whether the foreign corporation has a trade or business in the US; rather, the important question is whether the foreign corporation has a PE. These terms are discussed in Chapter 8, Water's-Edge Manual. More substantial connections with the US are generally required for a PE than for a trade or business. In other words, some activities in the US, which would be regarded as constituting a trade or business, might be insufficient to constitute a PE.

Example 1:

> For federal purposes, Corporation A was formed under the laws of Country X, which has a tax treaty with the US. Corporation B was formed under the laws of Country Y, which does not have a tax treaty with the US. Both A and B import goods to the US and both maintain US storage facilities for inventory. Other than these storage facilities, neither has a fixed place of business in the US.
>
> For federal purposes, both Corporation A and Corporation B would be regarded as engaged in a trade or business in the US. 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 PE in the US. Under the terms of the tax treaty with Country X, simply maintaining storage facilities in the US does not give rise to a PE. (Indeed, such treatment would be true of virtually all, if not all, tax treaties.) Thus, because Corporation A has no PE, it has no US tax liability. Since Corporation B is a resident of a non-treaty country, it is taxable by the US on the income from its US trade or business.

One difficulty with the PE concept is that it is not uniformly defined. What constitutes a PE under one US tax treaty may not do so under another. When dealing with a PE issue under a treaty in a water's-edge context, further review of the treaty may be required. In addition, treaties often include provisions that, in effect, redefine the source of income. That is, income that would be considered from US sources under the statutes and regulations may, under a treaty, be considered derived from sources in a foreign country for federal purposes. For

California purposes, this would affect the determination of net income derived from the PE. The tax treaty would be ignored, and the net ECI would be included in the water's-edge combined report. (See Chapter 8, Water's-Edge Manual.)

d. Tax Rate Reductions

Another effect of US tax treaties can be the reduction in the tax rate that applies to investment and certain other types of income not related to a US trade or business. The US asserts jurisdiction to tax some, but not all, US source income of foreign corporations even if they are not engaged in a trade or business in the US. The US also collects a "branch profits tax" with respect to the "dividend equivalent" of earnings of a foreign corporation that is engaged in a trade or business in the US. This is in addition to the standard US tax on ECI (or net income from a PE, if a treaty applies.) The tax rate generally applicable to both of these types of income is 30 percent. (IRC §884.) US tax treaties generally provide reduced tax rates on these types of income. For example, the 1981 US Model Income Tax Treaty provides for a general tax rate of 15 percent on dividends. (See Article 10 of the Model Treaty.)

6.3 FOREIGN TAX CREDIT

a. In General
b. Direct And Indirect FTCs
c. FTC Limitations

a. In General

For US multinationals, the FTC is of significant importance. Its influence on their worldwide tax planning is pervasive. There is no international tax issue, which can be considered without taking the FTC 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 FTC, or lack thereof, can have a significant effect; it is the difference between paying significant national-level income taxes to one country instead of two.

The principal goal of the FTC rules is the avoidance of international double taxation that would otherwise result from the US asserting residence-based jurisdiction, while a foreign government asserts source-based jurisdiction over the same income.

Example 1:

> Corporation A, a US-based multinational, earns $1,000,000 in pre-tax net income in West Germany. The US taxes this income at 34 percent, and the West German government taxes it at 56 percent. If Corporation A cannot credit its German taxes against its US taxes, its after-tax net income would be 10 percent of $1,000,000, only $100,000. It would pay $900,000 in tax; Corporation A's effective tax rate would be 90 percent (56% + 34%.) If Corporation A can credit the German tax against the US tax, then it would wipe out what would otherwise be a $340,000 US tax liability, and increase its after-tax earnings accordingly.

The US asserts tax jurisdiction because the earner of the income is a US corporation; West Germany asserts tax jurisdiction because the income was earned in West Germany. The credit allowed by the US is designed to eliminate double taxation by the US. It is not meant to eliminate double taxation by the foreign government. In other words, the US allows a credit for the foreign taxes paid, but only to the extent that US 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
US	340,000
Total	$ 900,000

In granting relief from double taxation, the US would permit a credit for the West German tax only to the extent that the US imposed a tax.

That is:

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

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

Example 3:

Same facts as Example 2, except that the West German tax rate is 20 percent:

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

Taking these examples together, it is apparent that the combined effective tax rate after the granting of the US FTC will always be the larger of the effective rate in the US or the foreign country.

A taxpayer can elect to deduct the foreign taxes, which it pays in computing US taxable income, rather than claiming a credit for these amounts. (IRC §901(a).) Foreign income taxes are generally deductible under IRC §164(a)(3), but not if the credit is claimed per IRC §275(a)(4)(A). Since eligible foreign taxes are creditable in full to reduce the US tax liability, the deduction route is preferable only in rare circumstances. For example, if the taxpayer has no US tax liability because it incurred current losses, and if the net operating loss (NOL) carryover is greater than a carryover of the FTC (see below), the deduction would be preferable.

A foreign country may assert jurisdiction over income that is sourced to the US under US rules, (i.e., there is a conflict of the source of income definitions used by the US and the foreign country.) The US would not allow a credit in this circumstance. Therefore, a taxpayer would usually prefer a deduction worth something to no credit.

Where creditable foreign taxes cannot be used in the current year, the taxpayer must carry them back to apply, if possible, to the first preceding year. If the excess credits are still not used, they can then be carried forward to the first subsequent year, then to the second, third, fourth, and fifth succeeding years, in that order. (IRC §904(c).) With the Tax Reform Act of 2003 and the American Jobs Creation Act of 2004, the FTC became even more important to US taxpayers. Per the American Jobs Creation Act of 2004, a federal NOL may be carried forward for up to twenty years under IRC §172(b)(1)(A)(ii), while a FTC may only be carried forward for ten years under IRC §904(c).

Significant business and investment decisions can turn on whether excess credit positions can be reduced. Despite the importance of the FTC for federal purposes, it is of little direct importance for California purposes. The FTC provisions are worthy of consideration, however, because an understanding will aid in analyzing international tax issues, reasons for some of the tax planning decisions reflected in a water's-edge tax return, or the effects of decisions made by an IRS International Examiner.

b. Direct And Indirect FTCs

Per IRC §§901(a) and (b)(1), the FTC is available with respect to taxes paid directly by a US corporation that incurs the tax liability to the foreign government. In this case, the taxpayer is said to claim a "direct credit." The FTC is also available with respect to taxes paid and incurred by foreign subsidiaries of US corporations. In this case, the taxpayer is said to claim a "deemed paid credit" or an "indirect" credit. (IRC §§901(a) and 902.) Only by means of the special FTC rules can the parent obtain a US tax benefit from the foreign taxes incurred by its subsidiary.

The direct FTC is fairly straightforward in application. The payer of the foreign tax liability claims a credit for the amount paid against its US tax liability, subject to the limitations discussed below. However, the indirect credit is far more complicated in application.

When a foreign subsidiary earns the income in a foreign country, such foreign subsidiary is obviously not subject to tax by the US. The only danger of double taxation arises when the foreign subsidiary's earnings are taxed in the US, and that can only occur when those earnings are distributed or are deemed to have been distributed under the Subpart F provisions.

Example 1:

> Corporation P, a US corporation, owns one hundred percent of the shares 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 be subject to international double taxation if FS makes a distribution out of current year earnings and profits (E&P) to Corporation P.

What happens when FS makes the distribution? This presents a somewhat complicated situation. The point of reference for measuring the potential double taxation is the total income subject to tax in both jurisdictions. Only after-tax income E&P is available for distribution. However, this natural point of reference is not readily available. That is, absent some special provision, the US in Example 1 above would tax only the dividend amount, not the entire earnings subject to the West German tax. To achieve rough equivalence of the effect of the direct and indirect credits, the distribution from the foreign subsidiary must be "grossed-up." (IRC §78.)

Example 2:

Assume the same facts as in Example 1. Further assume that FS distributed to P 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
US taxable income of P	$ 100
P's pre-credit US tax liability * 34%	$ 34
Less: Indirect credit for German taxes incurred by FS with respect to gross-up dividend amount, to extent of US tax thereon (total of $56, limited to $34)	34
P's post-credit US tax liability	$ 0

Note the result of the gross-up procedure approximates the result achieved in the case of the direct credit of Example 2 in Section 6.3(a), Water's-Edge Manual.

c. FTC Limitations

IRC §904 provides for "categories" or "baskets" of the source of any earned FTC. These baskets serve to limit the use of excess FTCs. Excess FTC of one FTC basket can only be applied against a tax liability of the same basket type. The number and types of baskets have fluctuated over the years. Commencing on January 1, 2007, the number of FTC categories will be reduced from eight categories to two categories. (IRC §904(d)(1).)

The two categories or baskets will be:

1. General limitation income
2. Passive income

With the 2007 amendments, most US taxpayers will have the opportunity to use excess FTCs more efficiently.

6.4 SOURCE OF INCOME AND DEDUCTIONS

a. In General

The federal source of income and deductions concept is different from the California concept. The federal international taxation rules, e.g., the FTC, tax treaties, etc., frequently reference the "source" of income. "Source" determinations are of great importance under the US international tax rules.

The rules determining the source of income for US tax purposes serve three major functions. **First**, the source of income determination is critical to the calculation of IRC §904 limitations. This is of great concern to a US corporation doing business abroad because it directly affects the corporation's ability to use FTCs to eliminate US income tax on its foreign source income.

Second, the source determination of income controls the imposition of US income tax on a foreign corporation. The US generally does not tax foreign corporations, except to the extent that the foreign corporation earns:

- US source fixed and determinable, annual or periodic (FDAP) income (IRC §§861and 881)

- Income effectively connected with the active conduct of a trade or business in the US (ECI) (IRC §§864(c) and 882)

A foreign corporation or person is subject to US withholding tax of 30 percent, subject to treaty reduction, on the gross amount of US source FDAP income. (IRC §1442.) ECI generally is US source income, but IRC §864 treats some types of foreign source income as ECI. A foreign corporation is taxed on a net basis at standard corporate rates on its ECI. (IRC §§882(a) and 882(c).)

Finally, the source of income determination is important to the computation of Subpart F income. Subpart F income does not include US source income, unless the income is exempt from taxation or is subject to a reduced tax rate. (IRC §§952 and 952(b).) Therefore, whether income is US sourced or foreign sourced income is a key factor in determining whether a CFC has Subpart F income.

The federal source rules are unrelated to the determination of the taxable income of US corporations. As previously noted, the US asserts jurisdiction to tax the worldwide income, income from sources within and without the US, of a US corporation. Determining the sources of such an entity's income will not affect its US taxable income. Rather, the source determination will affect its FTC. On the other hand, the source rules do affect the determination of US taxable income of foreign corporations.

For a California water's-edge tax return, the federal source of income and deduction rules is important in the determination of apportionable income of certain foreign-nation banks and corporations with branches in the US (US source income.) There are two other water's-edge areas where the federal sourcing rules have indirect application:

1. The water's-edge regulations governing the "interest offset" under RTC §24344(c) is based in large part on the federal rules governing the determination of the source of interest deductions. (Compare CCR §24344(c) with former Treasury Regulation (TR) §1.864-8(e)(2) and temporary TR §1.861-9T(a).)

2. The intercompany allocation rules for services in both the water's-edge and non-water's-edge context. TR §1.861-8(e)(4) includes a discussion of so-called "stewardship expenses," and the means for determining their source with respect to certain dividends. The source determination regulation includes a cross-reference to the allocation regulation, TR §1.482-(b)(2), "Performance of services for another." It explains more clearly the stewardship expenses concept, which is introduced in the allocation regulation. This source regulation is of limited 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.

Under the water's-edge regulations, the determination of the income and factors of foreign-nation banks and corporations with branches in the US, who are included in a water's-edge combined report, must be made according to the federal rules for determining the income attributable to US sources, either from a US trade or business (ECI) or from US investments. (CCR §25110 (d)(2)(F).)

Application of these rules is discussed in Chapter 8, Water's-Edge Manual.

b. Source Rules For Income

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 as referenced in IRC §§861(a), (b) and 862(a) and (b). Income from sources without the US (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 US sources as determined under IRC §861(a). IRC §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.

Some considerations relating to the nature of the federal rules for making geographic assignments include, but are not limited to, the following:

- There must be some sort of economic or business nexus between the income and the geographic source to which it is assigned.
- When there is some such nexus between two or more locations and the income, then the income is assigned to that location in which the nexus is more substantial. For income derived from tangible property, the source is the location of that property. Intangible property presents special problems here, which are resolved in different ways for different types of income. For income derived from transactions such as the sale of goods or the performance of services, the location of the transaction is the critical factor.

IRC §§861 and 862 provide the sourcing rules applicable to specific classes of gross income and should be considered when determining a corporation's income derived from or attributable to sources within the US as determined by federal income tax laws.

Sourcing of income is discussed in Chapter 8, Water's-Edge Manual.

c. Source Rules For Deductions

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, or matched, with the income to which they relate. This matching process is accomplished by means of an "allocation and apportionment" system described by the federal regulations. (See TR §1.861-8(a)(2).) This is not related to the concepts of "allocation" and "apportionment" under the Uniform Division of Income for Tax Purposes Act (UDITPA). (RTC §25120.)

Federal "allocation" refers to the matching of deductions to a "class" of gross income to which the deductions are definitely related. (TR §1.861-8(b)(1).) For example, if a taxpayer has gross income from the sale of personal property, then the expenses of selling that property are 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. (TR §1.861-8(b)(2).)

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. In the preceding example of a sale of personal property, if the property involved was inventory and the independent factory price method was applicable so as to attribute part of the gross income from the sale to US 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 US and foreign source gross income from the sale.

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. (TR §§1.861-8(b)(5) and (c)(3).) 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 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 US sources for a particular class of gross income.

Sourcing of deductions is discussed in Chapter 8, Water's-Edge Manual.

6.5 Transfer Pricing

IRC §482 grants the IRS 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." For example, if a US 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 US taxation, IRC §482 empowers the IRS to reallocate such income to the US corporation.

IRC §482 is a relatively short provision, although it contains the longest sentence in the IRC. Regardless, it is coupled with lengthy and complex regulations. In essence the regulations require that two or more organizations subject to common control conduct business between themselves as if they were unrelated. That is, that each member of a group deals 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." (TR §1.482(b)(1).)

Example 1:

> A US 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 US corporation dealt with its subsidiary at "arm's length," as if the subsidiary were "an uncontrolled party," then the unit price charged the subsidiary would have been $750, the same amount charged to the independent third party.
>
> Here, the US corporation has misallocated $250 of profit from itself to its subsidiary, which has acquired the product at a bargain price. The IRS may utilize IRC §482 to allocate this $250 in profit to the US corporation.

Under a worldwide combined report system, whether a particular member of the group under or overcharges its affiliates for goods or services is not an issue. The net income of the group, taken as a whole, is subject to apportionment. The intermediary profits of intercompany transactions are eliminated, and hence, not subject to apportionment. However, 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 a matter of concern. Consider for example, a US distributor of consumer products, which is controlled by a parent corporation that manufactures those products in a foreign country. Price-setting for the goods sold to the US distributor could obviously be arranged in such a way as to limit the amount of such company's US taxable income, and therefore, California water's-edge apportionable income.

IRC §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, leases, etc.,) sale of tangible property, and transfer or use of intangible property (licenses, patents, technology, etc.) (TR §§1.482-2(a), (b), (c), 1.482-3 and 1.482-4.)

This chapter discusses the interaction of the tax treaty, FTC, and source of income and deduction rules. IRC §482 adjustments have implications in all of these areas as well.

For example:

- If an IRS International Examiner proposes an increase in a taxpayer's net income for foreign source income, an adjustment must be made to the FTC. The effect may be to eliminate or significantly reduce the impact of the IRC §482 audit adjustment.

- Assume IRC §482 adjustments, involving the operations of affiliates of the taxpayer in a country that has entered into a tax treaty with the US, subject to special procedures for resolution of federal tax issues under the "competent authority" provisions of the applicable treaty.

- The §482 regulations themselves require the making of a "correlative adjustment." (TR §1.182-1(g).) This is an adjustment to the accounts of the entity on the opposite side of the transaction from the taxpayer being adjusted. For example, if an IRS or Franchise Tax Board auditor proposes to increase the net income of a US corporation under IRC §482 at the expense of its foreign subsidiary, then that foreign subsidiary's E&P must be similarly adjusted.

IRC §482 has been an area of significant controversy. To help resolve controversy, the Advance Pricing Agreement (APA) Program was created. Taxpayers have the ability to apply for an APA with the IRS National Office. The taxpayer can request, and complete, an APA for a specific line of products or a flow of product or sales to a specific country. The transfer pricing mechanism is determined within the APA process. Once completed, the taxpayer would apply the APA in determining their future tax return filings. As long as the tax return complies with the agreed APA as to how profit will be recognized between the US and the foreign location, the IRS would not challenge the filing. The APA remains in place as long as there are no significant changes to the corporation's operations.

Transfer pricing is discussed in Chapter 18, Water's-Edge Manual.

6.6 TAX HAVENS AND SUBPART F

A "tax haven" is considered to be any jurisdiction that taxes income at a lower effective rate than do competing jurisdictions. The US in fact is a tax haven in a number of respects. The current maximum marginal rate of corporate income taxation by the US is much lower than most industrialized nations. Less obvious, but perhaps as important, is the fact that the US generally does not tax certain types of income derived from investments in the US by foreign entities, including the earnings on US Treasury obligations. Thus, the US 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 marginal high tax rates.

Discussions of tax havens can be found in many international tax areas. For example, the subject of tax havens, more specifically the tax haven issues addressed in the *Du Pont* federal tax case, was the fuel for congress to enact Subpart F of the IRC. In *E.I. Du Pont de Nemours and Co. v. US* (1979) 608 F.2d 445, Du Pont was based in the US. It made and sold chemical products. In 1959, it created a wholly owned subsidiary, known as DISA in Switzerland. DISA's function was a marketing and sales arm of Du Pont. DISA purchased large volumes of chemical products manufactured by Du Pont in the US. These products were intended for resale as raw materials to manufacturers and as finished, or semi-finished, goods. DISA resold the products to manufacturers throughout Europe, as well as in Australia and South Africa.

Although title to these large volumes of bulk chemicals transferred from Du Pont to DISA and then to the ultimate customers, the goods flowed from DU Pont to the ultimate customers. Switzerland was selected as the venue for Du Pont's sales subsidiary 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 US 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 to put profits into that company 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 IRC §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 US would not have been questioned. It is further noted that DISA did in fact perform certain substantive marketing functions; and it was not a "sham." Had DISA not performed any substantive functions, Du Pont's arrangement may have been subject to attack under IRC §482 or other code provisions.

The idea that profits could be placed in a tax haven was objectionable from a tax policy standpoint. IRC §482 addresses only one aspect of such problems, and is a rather cumbersome tool to use. In 1962 Congress enacted the "Subpart F" rules of the IRC to deal with the tax haven problem. (Public Law 87-834, §12(a).) "Subpart F" refers to the placement of these provisions within Part III of Subchapter N of Chapter 1 of the IRC.

The Subpart F provisions apply to foreign business and investment operations controlled by US 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 the events. This is accomplished by means of what is often referred to as a "deemed dividend." Under IRC §951, a controlling US shareholder is currently taxed on tax haven earnings of its foreign subsidiary, without regard to whether the subsidiary pays a current dividend.

Subpart F is discussed in Chapter 2, Water's-Edge Manual.

6.7 US POSSESSIONS CORPORATIONS

Subpart D of the IRC contains specific rules under which electing US corporations operating in US possessions, e.g., Puerto Rico or the US Virgin Islands, in essence pay no federal income tax on qualifying income earned within the possession. An electing possessions corporation must file a separate federal Form 1120. It cannot file a consolidated federal tax return.

A "possessions" corporation is generally taxed on its worldwide income in a manner similar to any other US corporation. However, IRC §936 provided a special tax credit for US corporations operating in Puerto Rico, the US Virgin Islands or other US possessions, if the possessions corporation was an existing credit claimant. (An existing credit claimant is a corporation that had made an IRC §936 election, was actually conducting operations in a US possession on October 13, 1995, and was claiming the credit during that taxable year.)

In 1996, amendments were made to IRC §936 to phase-out the credit over a ten-year period. The IRC §936 credit ends with the last taxable year beginning before January 1, 2006.

Prior to the end of the IRC §936 credit, the exclusion of possession corporations from the water's-edge combination gave rise to certain issues with respect to transfer pricing. IRC §§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 must be "commensurate with the income attributable to the intangible." The term "commensurate with income" can be found in IRC §367(d)(2)(A)(ii) and IRC §482, and it is cross-referenced in IRC §936(h)(5)(C)(i)(I).

For federal purposes, in the case of a possessions operation, this "commensurate with income" rule is overridden by the profit split rule of IRC §936(h). However, since California never conformed to the provisions of IRC §936(h), the "commensurate with income" standard applies under the California counterparts to IRC §482 to possessions corporations and their water's-edge affiliates. With the repeal of the IRC §936 credit, the significance of this California water's-edge issue diminished. (Legal Ruling 2003-2, Application of Profit Split Method to Water's-Edge Taxpayers With Possessions Corporation Affiliates, dated May 6, 2003.)

Per RTC §25110(a)(2) for taxable years beginning elections prior to January 1, 2006, possession corporations may be includable in a California water's-edge combined report if the average of its property, payroll, and sales factors within the US is 20 percent or more. This is discussed in Chapter 2, Water's-Edge Manual.

For taxable years beginning on or after January 1, 2006, a US possessions corporation are treated like any other US incorporated entity.

6.8 OUT-BOUND TRANSFERS

The US government taxes US incorporated entities on all of their income and foreign incorporated entities on their US income. Governance of transactions and investments across international lines is manifested in the application of the arm's length principle embodied in IRC §482, and the Subpart F provisions. The arm's length principle requires that two or more related organizations 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 that mirror, at least in certain essential respects, those that would arise in response to market forces in an uncontrolled environment, or which are at least not unduly influenced by tax considerations.

The US seeks to tax entities and income that come within the boundaries of this system. Exceptions and special rules however, do apply, such as the possessions corporation rules, which were previously discussed, and the export trade incentives, which are discussed next. Nevertheless, it is clear that the US has carved-out a perceptible territory. The California water's-edge rules carve-out a combined reporting territory that roughly, if not exactly, coincides with that of the US system.

Subchapter C of the IRC allows for the tax-free (or tax-deferred) exchange of appreciated property in a number of contexts, e.g., IRC §§332, 351, 354, 355 and 361. However, in some instances the Subchapter C deferral rules may result in a permanent loss to the US Treasury.

Example 1:

> Corporation A, incorporated in the US, 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 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, the taxation of the gain, which has been in

effect deferred by means of IRC §351, will permanently escape taxation by the US.

Note that IRC §351 is not restricted in any sense to application only to US corporations. Compare IRC §351(a) and the definition of "corporation" at IRC §7701(a)(3). It is obvious that there is potential here for transactions to escape taxation, however IRC §367 would then apply. 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. 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 IRC §351(a) provides for no gain or loss if property is "transferred to a corporation." The most important exception to this rule is for property that will be used in the active conduct by the foreign corporation of a trade or business in a foreign country in accordance with IRC §367(a)(3). Exceptions to this exception, requiring gain recognition on transfer, apply to certain types of property that are likely to be resold promptly or are highly fungible, such as inventory, receivables, foreign currency or foreign currency denominated investments, and interests in leased property. (IRC §367(a)(3)(B).)

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, based 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 US 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 US. (IRC §367(a)(3)(b)(iv).) This rule is augmented by the provisions of IRC §367(d), which requires, in the cases of IRC §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 US developer of the intangible asset.

IRC §367(b) similarly provides for exceptions to the Subchapter C provisions where property is transferred from one foreign corporation to another. IRC §367 provisions apply to California water's-edge tax returns. Indeed, they apply to all California franchise tax returns. (See RTC §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.

For further discussion of out-bound transfers, IRC §367, see Chapter 19, Water's-Edge Manual.

6.9 EXPORT SALES INCENTIVES

For many years, the US provided US corporations tax incentives to promote export of goods from the US. Since 1985 the principal means of providing such incentives was the Foreign Sales Corporation (FSC) rules. (IRC §§921-927.) Before the FSC regime, the Domestic International Sales Corporation (DISC) rules provided such benefits. The DISC rules actually continue to have limited application. (IRC §§991-994.) The IRC currently provides for a further incentive by means of an exception from the Subpart F rules for "Export Trade Corporations" under IRC §§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. (IRC §971(a)(3).) Thus, Export Trade Corporations are quite rare.

The FSC Repeal and Extraterritorial Income Exclusion (ETI) Act of 2000 repealed the FSC rules, subject to transition rules, and adopted new rules creating the ETI exclusion. California did not conform to this Act. Because the federal ETI exclusion rules are not applicable for California purposes, taxpayers that claim an ETI exclusion on their federal tax return should make a California state adjustment to add back to income the federal ETI exclusion amount. This adjustment applies for taxpayers filing on either a worldwide or water's-edge basis. (Public Law 106-519, 114 Stat. 2423, dated November 15, 2000, added IRC §114.)

ETI is the taxpayer's gross income attributable to foreign trading gross receipts. The taxpayer reports all of its ETI on its federal tax return. Any taxpayer claiming the exclusion must attach federal Form 8873, Extraterritorial Income Exclusion, to its federal tax return. The federal Form 8873 is used to calculate the federal exclusion for the ETI that is qualifying foreign trade income. Although the amount on the Form 8873 is an exclusion from income and not a deduction, the ETI exclusion is reported within "other deductions" on line 26 of federal Form 1120.

The Act repealed the FSC provisions of Subpart C, IRC §§921 through 927, effective for transactions after September 30, 2000. Generally, new FSC elections cannot be made after September 30, 2000. However, for FSCs that were in existence on September 30, 2000, special transition rules apply whereby the FSC provisions remain applicable for a limited transition period.

Much controversy surrounded the ETI deduction. As a result, these rules have also already been repealed. (Public Law 108-357, 118 Stat.141, dated October 22, 2004, repealed effective for transactions after December 31, 2004.) Under the California water's-edge rules, FSCs, DISCs and Export Trade Corporations are included in the water's-edge combined report. (RTC §25110(a)(1) for taxable years prior to January 1, 2006. RTC §25110(a)(1)(A) for taxable years after January 1, 2006.)

For a further discussion of FSCs and DISCs, see Chapter 2, Water's-Edge Manual.

6.10 US BRANCHES 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, the other place of business is often referred to as a "branch" or "branch operation." (IRC §884.) Such branch operations have legal significance under the US tax laws.

US international tax policy has been concerned with equalizing 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 US, it should make no difference in terms of its income tax burden if it does so through the formation of a US subsidiary corporation or through the establishment of a branch operation. This concept is expressed through numerous provisions of the IRC dealing with the taxation of foreign investors and foreign businesses in the US. For example, the tax burden of an entity operating through a PE in the US under most tax treaties will approximate the tax burden of a separately incorporated US subsidiary operating in the same manner.

The general concept of attempting to equalize the taxation of branch and subsidiary operations has occurred much less consistently in the "outbound" context where a US-based corporation operates through a branch or subsidiary in a foreign country. However, traces of such a policy objective can be found in the IRC provision dealing with sources of income with respect to the FTC, in Subpart F, in the treatment of contiguous country subsidiaries under IRC §1505 (d), and elsewhere.

It is important to recognize the separate status of branch operations in the context of California water's-edge. 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 of foreign banks and those of foreign corporations, which are not banks.

Branches, deemed subsidiaries, are discussed in Chapter 8, Water's-Edge Manual.

6.11 US DOLLARS AND OTHER CURRENCIES

Though the US dollar is the currency of the US, obviously not all payments for goods and services and investments are made in that form. The IRC 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, these are of concern in the water's-edge combined report context:

1. Determination of net taxable income in dollars of a foreign branch operation of a US corporation, which uses a foreign currency designation for its books and records.

2. Determination of net taxable income in dollars of a US branch of a foreign corporation, which uses a foreign currency designation for its books and records.

3. Computation of E&P in dollars of a foreign subsidiary with Subpart F income, which has made a distribution.

The IRC §§985 to 989 rules and their application are discussed in Chapter 12, Water's-Edge Manual.