Chapter 4  Federal International Taxation

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4.1 Introduction

a. Nature and Limitations of the US Taxing Jurisdiction
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d. US Indirect Taxing Jurisdiction

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. (R&TC §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
The following table summarizes the US taxing jurisdiction over income from sources inside and outside of the US.

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**b. US Taxing Jurisdiction of US Corporations**

Congress asserts the right to tax the income of entities incorporated in the US. A US corporation is taxed on all its income, regardless of source. (IRC §§11 and 61.)

**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. 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 the income of a foreign corporation that is effectively connected with the
conduct of a trade or business within the US as provided under IRC §882. (IRC §11(b).) ECI is discussed in more detail in WEM 5.

- 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 WEM 4.2 and WEM 5.)

- 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 payor 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. 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 provisions of Subpart F of Part III of Subchapter N of the Internal Revenue Code.
4.2 Tax Treaties

a. Nature of Tax Treaties
b. US Tax Treaties and California Law
c. Permanent Establishment (PE) and ECI
d. Tax Rate Reductions

**a. Nature of Tax Treaties**

The US government has entered into tax treaties or “tax conventions” with numerous foreign countries. You can view the list of the tax treaties at [www.irs.gov](http://www.irs.gov). 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.

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.

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.” However, there are numerous exceptions to the 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.
- Set the requirements for nexus for taxation through the permanent establishment (PE) rules.
- May provide for the reduction in tax rates applicable to investment income.
- Promote mutual cooperation between governments in furtherance of effective tax administration.
- Facilitate the resolution of disputes through the respective governments’ “competent authorities.”
- Expedite exchanges of information between governments and the carrying out of joint audit projects.

An important issue involving tax treaties has to do with the permanent establishment (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 WEM 5. 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. (CCR §25110(d)(2)(F)2(a).)

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(d)(2)(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.

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 2013, Corporation A is engaged in certain business operations in the state of California, and is “doing business” in California within the meaning of R&TC §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.

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 WEM 5.

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.
4.3 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. It is generally taken into consideration for determinations of the source of income and deductions, intercompany pricing arrangements, Subpart F considerations, and so on.

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. Refer to IRC §901 and the regulations thereunder.

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). 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, 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.

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.
Only by means of the special FTC rules can the parent corporation obtain a US tax benefit from the foreign taxes incurred by its subsidiary.

The direct FTC is fairly straightforward in application. The payor 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. See Treas. Reg. §§1.901 and 1.902 for complete rules and examples illustrating the provisions of these two IRC sections.

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 was reduced from eight categories to two categories. (IRC §904(d)(1).)

The two categories or baskets are:

1. General limitation income
2. Passive income
4.4 Source of Income and Deductions

a. In General  
b. Source Rules for Income

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 §§861 and 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
Therefore, whether income is US sourced or foreign sourced income is a key factor in determining whether a CFC has Subpart F income.

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 R&TC §24344(c) is based in large part on the federal rules governing the determination of the source of interest deductions. (CCR §24344(c) and Treas. Reg. §1.861-9.)

2. The intercompany allocation rules for services in both the water’s-edge and non-water’s-edge context. Treas. Reg. §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, Treas. Reg. §1.482-9, 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 national 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 WEM 5.

b. Source Rules for Income

The term "source" is a geographic concept that assigns income to a particular situs. The federal sourcing rules first look to the type of
income involved, and then applies a specific set of rules to that type of income. Sourcing of income is discussed in WEM 5.

Do not confuse the federal sourcing rules with the California market based sourcing rules.
4.5 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. California conforms to IRC §482. (R&TC §25725.) See WEM 15, Intercompany Transfer Pricing.
4.6 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. Discussions of tax havens can be found in many international tax areas. For example, tax haven issues were addressed in *E.I. Du Pont de Nemours and Co. v. US* (1979) 608 F.2d 445. In 1959, Du Pont 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.

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 that meet the definition of Subpart F income, without regard to whether the subsidiary pays a current dividend.

Subpart F is discussed in WEM 2.
4.7 US Possessions Corporations

Subpart D of Subchapter N of Chapter 1 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.

For taxable years beginning on or after January 1, 2006, a US possessions corporation are treated like any other US incorporated entity.
4.8 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.

Subchapter C of Chapter 1 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.

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). The potential of escaping taxation from a transfer of property from the US to a foreign corporation is mitigated by the provisions of 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. 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. For example, 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 R&TC §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 WEM 16.
4.9 Export Sales Incentives

For many years, the US provided US corporations tax incentives to promote export of goods from the US. For most of the last three decades, these benefits were provided under three regimes that provided export-related benefits. The three tax regimes are:

1. Domestic International Sales Corporations (DISC) – DISC provisions were enacted in the Revenue Act of 1971 as IRC §§991 to 994. To qualify as a DISC, at least 95 percent of its gross receipts must be "qualified export receipts" as defined in IRC §993(a). For federal purposes, DISCs rules continue to have limited application. DISCs are subject to favorable transfer pricing rules and partial deferral of income on foreign sales.

2. Foreign Sales Corporations (FSC) – FSC provisions were enacted in 1984 as IRC §§921 to 927, and §291(a)(4). The FSC rules largely replaced the DISC rules. Generally, FSCs are foreign subsidiaries of US companies that export goods. The FSC sells products supplied by its US parent. If a corporation qualifies for and elects FSC status, a portion of the FSC income is attributable to the US parent, and the other portion is exempt from US taxation.

3. Extraterritorial Income (ETI) – The ETI was enacted by the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. The ETI did not provide for a new entity like a DISC or a FSC. Instead, it excluded all foreign trade income from a US exporter's gross income. (IRC §114.)

California does not conform to any of the above three tax regimes related to export trade. For California purposes, DISCs and FSCs are treated as regular corporations and are fully included in the combined report whether the group files under worldwide or water's-edge. (For additional information see MATM section 5220.) Regarding ETI, taxpayers are required to add back as a state adjustment any federal income exclusion related to ETI.
4.10 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 and deemed subsidiaries are discussed in WEM 5.
4.11 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 WEM 8.