

# Cross-Border Taxation

By: Barry Leibowicz, J.D., LL.M.



**F**ifty years ago, Marshall McLuhan coined the phrase “global village”<sup>1</sup> to describe the contraction of the world caused by rapid advances in communication technology.<sup>2</sup> Ongoing technological advancement has brought with it a corresponding increase in cross-border business transactions. Once the exclusive province of large accounting and law firms, now even the smallest firms must master cross-border tax issues.

The tax laws governing cross-border transactions are both arcane and complex, and they present a host of traps, demanding familiarity with the basic tax rules that apply to both U.S. and foreign persons. The following discussion of inbound and outbound cross-border transactions is intended to provide that basic knowledge.

## The Basic Framework of Cross-Border Taxation

U.S. citizens are taxable on their worldwide income, with a credit or deduction for taxes paid on foreign income. The United States makes no distinction between earnings from business or investment activities within the United States and those outside its borders. Transactions by U.S. taxpayers in other countries are generally referred to as “outbound transactions,” while those of foreign taxpayers within the United States are “inbound transactions.” Rules for outbound transactions capture foreign income for U.S. tax purposes and are intended to prevent tax avoidance through the use of foreign entities. The tax rules governing inbound activities impose tax on income

from sources within the United States and income that is effectively connected with the conduct of a trade or business within the United States. Some inbound income of a nonresident alien (e.g., capital gain income)<sup>3</sup> is not taxed unless the individual is in the United States for more than 183 days during the tax year.

The Internal Revenue Code provides default rules for taxing cross-border transactions. However, a tax treaty between the United States and the home country of a foreign taxpayer, or a country in which a U.S. taxpayer does business or produces income, takes priority over the default rules. Thus, assessing the tax impact of cross-border activity requires familiarity with any applicable tax treaty as well as with the default rules set forth in the Code.

1 “The new electronic interdependence recreates the world in the image of a global village.” McLuhan, *The Gutenberg Galaxy*, p. 31 (University of Toronto Press 1962).

2 “Today, after more than a century of electric technology, we have extended our central nervous

system itself in a global embrace, abolishing both space and time as far as our planet is concerned.” McLuhan, *Understanding Media: The Extensions of Man*, Part I, p. 3 (McGraw-Hill 1964).

3 Sec. 871(a)(2).



## Outbound Transactions

In the simplest form of outbound transaction, individual U.S. taxpayers invest in or do business in foreign jurisdictions directly, reporting all income and losses on an annual basis just as they would for U.S.-based business or investment, subject only to their obligations to the relevant foreign jurisdiction. Income tax paid to the foreign jurisdiction is taken as either a credit or deduction against the U.S. taxes generated by the foreign income. The credit is limited each year by a taxpayer's total U.S. tax liability multiplied by a ratio of the taxpayer's total foreign source income over the taxpayer's total worldwide income. This limit effectively results in foreign income being taxed at the higher of the U.S. or average tax rate paid on worldwide foreign income. Income earned in low-tax jurisdictions thus permits the U.S. taxpayer to take advantage of excess tax paid in high-tax jurisdictions that would otherwise be lost.

## U.S. Taxpayers Investing Through Foreign Entities

U.S. taxpayers often choose to engage in foreign business and investment activity through corporations, partnerships, or limited liability companies for a variety of reasons. For example, the separate-entity status of corporations may permit shareholders to defer taxation on their corporate earnings until they receive a corporate distribution, either in the form of a dividend or redemption.<sup>4</sup> Historically, a corporation was often the investment vehicle of choice for foreign business and investment activity, since corporations with no U.S.-source income offered multiple tax-avoidance opportunities. In response, Congress enacted various provisions restricting the manipulation of income and expense that might otherwise accrue by using the corporate form for international investment.

## Controlled Foreign Corporation

Subpart F of the Code provides the primary mechanism used to prevent avoidance or deferral of U.S. tax through the use of a controlled foreign corporation (CFC). The subpart F rules trigger the immediate inclusion in shareholders' gross income of their pro rata share of certain earnings of a CFC even if not yet distributed, and, as such, are an antideferral regime. The types of undistributed income that a CFC shareholder must include are (1) the CFC's subpart F income for the year; (2) the CFC's previously excluded subpart F income that is withdrawn during the year from certain investments; and (3) the CFC's increase in earnings invested in U.S. property.<sup>5</sup> The income is not taxed again when distributed.<sup>6</sup>

A CFC is any foreign corporation in which U.S. shareholders own more than 50% of the value or voting power on any day during the tax year.<sup>7</sup> Subpart F defines a U.S. shareholder as a U.S. person<sup>8</sup> (citizen, resident alien, or U.S. partnership, trust, estate, or corporation) that owns 10% or more of the total combined voting power of the foreign corporation.<sup>9</sup> For purposes of determining U.S. shareholder and CFC status, stock ownership may be direct, indirect, or constructive, taking into account attribution of ownership from related persons or entities.<sup>10</sup> However, U.S. shareholders are subject to taxation under subpart F only to the extent of their direct and indirect ownership.<sup>11</sup> In addition, if shareholders do not own CFC stock at the end of the tax year, they have no subpart F inclusion, regardless of whether they were U.S. shareholders during the tax year.<sup>12</sup>

Taxable subpart F income is treated as a deemed dividend distribution up to the CFC's total earnings and profits for the tax year.<sup>13</sup> However, income included under subpart F is taxed at ordinary income tax rates rather than the U.S. rate on dividends.<sup>14</sup> A U.S. domestic corporate shareholder of a CFC is allowed a foreign tax

## EXECUTIVE SUMMARY

- In a world that is now a "global village," even small firms must master cross-border tax issues to serve their clients well.
- There are two basic types of cross-border transactions. Outbound transactions involve U.S. taxpayers doing business or investing in foreign countries. Inbound transactions involve foreign taxpayers doing business or investing in the United States.
- To prevent U.S. taxpayers from deferring income in outbound transactions, Congress enacted the subpart F and the passive foreign investment company (PFIC) rules.
- The tax treatment of a foreign taxpayer's U.S.-source income from inbound transactions depends on whether the income is effectively connected with a U.S. trade or business. If it is, it is taxed on a net basis (meaning that deductions are allowed) rather than on a gross basis (no deductions are permitted).

credit for any foreign taxes the CFC paid on income that is attributed or distributed to it as a U.S. shareholder, limited to the

4 Secs. 1(h)(11), 301, and 302.

5 Sec. 951(a).

6 Sec. 959.

7 Sec. 957(a).

8 Sec. 957(c), referring to the definition of a U.S. person as defined in Sec. 7701(a)(30).

9 Sec. 951(b); Regs. Sec. 1.951-1(g).

10 Secs. 958(a) and (b).

11 Sec. 951(a)(2).

12 Sec. 951(a)(1).

13 Secs. 951(a)(2)(B) and 952(c)(1)(A).

14 *Rodriguez*, 137 T.C. 174 (2011).



taxes that would have been deemed paid if the CFC had made an actual distribution to the domestic corporation.<sup>15</sup> A deemed-paid credit is also available to any individual U.S. shareholder who elects to be taxed at domestic corporate rates on amounts included in gross income.<sup>16</sup> Subpart F income is taxed directly to the U.S. shareholder, regardless of how many tiers of CFCs exist between the U.S. shareholder and the CFC whose income is deemed distributed.<sup>17</sup>

## Passive Foreign Investment Company

U.S. shareholders of foreign corporations are also subject to the passive foreign investment company (PFIC) rules,<sup>18</sup> which tax U.S. shareholders that escape CFC taxation because they own less than 10% of a foreign corporation.<sup>19</sup> Unlike the CFC rules, the threshold in determining PFIC ownership is based not on stock ownership or value, but rather on the nature of the income or assets of the particular foreign corporation.

A PFIC is a foreign corporation that meets either an income test (at least 75% of the foreign corporation's gross income is passive income) or an asset test (at least 50% of the foreign corporation's assets actually produce, or are held to produce, passive income).<sup>20</sup> PFIC passive income is any income treated as "foreign personal holding company income" as defined by Sec. 954(c). This generally includes dividends, interest, royalties, rents, annuities, net gains on property that gives rise to these items, certain net commodity transaction gains, certain net foreign currency gains, income equivalent to interest and dividends, net income from notional principal contracts, and certain personal service contracts that can be fulfilled by others.<sup>21</sup>

If a U.S. shareholder owns shares in a PFIC at any time during the tax year, the taxpayer is subject to the PFIC rules. The rules are designed to limit a U.S. shareholder's ability to defer PFIC income. Thus, if a U.S. shareholder receives an "excess distribution" on PFIC stock or disposes of PFIC stock, the income realized on the excess distribution is allocated ratably to each day of the taxpayer's holding period.<sup>22</sup> An excess distribution is any part of a distribution from a PFIC that is greater than 125% of the average distribution the shareholder received during the three preceding tax years or, if shorter, during the period the shareholder held the stock.<sup>23</sup> The gain allocated to the current tax year or to any prior tax year in which the corporation was not a PFIC is taxed as ordinary income.<sup>24</sup> The gain allocated to any other year is taxed at the highest rate applicable for that year, plus the interest that accrued since the due date for the taxpayer's return for that year.<sup>25</sup>

To avoid paying additional tax and interest on deferred PFIC income, a U.S. shareholder of a PFIC may elect to treat the corporation as a "qualified electing fund" (QEF). The QEF election allows U.S. shareholders to include their pro rata shares of the excess of the PFIC's earnings and profits over its net capital gain for the tax year as ordinary income and the PFIC's net capital gain as long-term capital gain for each year the PFIC stock is held.<sup>26</sup> To be eligible for the election, the QEF must agree to provide certain information to the IRS, and generally the U.S. shareholder must timely file Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, by the due date (including extensions) of the federal return for the

first year to which the election applies.<sup>27</sup> Once made, the QEF election is revocable only with the IRS's consent and is effective for the current tax year and all subsequent tax years.<sup>28</sup>

The taxpayer can also avoid the additional tax on the deferral of income by making a mark-to-market election, which requires the electing shareholder to report each year ordinary income equal to the excess of the fair market value of the PFIC stock over its adjusted basis as of the close of the tax year.<sup>29</sup> If the stock has declined in value, an ordinary loss deduction is allowed, limited to the net amount of gain previously included as gross income.<sup>30</sup>

## Inbound Transactions Taxpayers Subject to U.S. Taxation

Foreign business and investment activities in the United States are often collectively referred to as "inbound transactions." The gross income of a foreign person, whether an individual or business entity, is subject to U.S. income tax on only that part of the taxpayer's gross income that is U.S.-source income. The tax treatment of a foreign taxpayer's U.S.-source gross income depends on whether the income is effectively connected with a U.S. trade or business.<sup>31</sup> Effectively connected income (ECI) is defined as income from sources within the United States connected with a foreign person's conduct of a trade or business in the United States. ECI is taxed on a net basis after deductions for allocable expenses at regular U.S. income tax rates.<sup>32</sup>

U.S.-source income that is not ECI, such as "fixed or determinable annual or periodical" (FDAP) income,<sup>33</sup> is subject to withholding<sup>34</sup> and is taxed on a gross basis with no deductions for expenses at

15 Sec. 960.

16 Sec. 962.

17 Sec. 958; Regs. Sec. 1.958-1(b).

18 Secs. 1291-1298.

19 If a PFIC, however, is also a CFC, Sec. 1297(d)(1) generally treats the foreign corporation as not being a PFIC during the "qualified portion" of the shareholder's holding period with respect to stock in that corporation. The "qualified portion" means the portion of the shareholder's holding period that is after Dec. 31, 1997, and during which the shareholder is a "United States shareholder" (i.e., owns at least 10% of the foreign corporation) and the foreign corporation is a CFC.

20 Sec. 1297.

21 Sec. 1297(b).

22 Sec. 1291(a)(1)(A).

23 Sec. 1291(b).

24 Sec. 1291(a)(1)(B).

25 Sec. 1291(c).

26 Secs. 1293(a)(1)(A)-(B).

27 Secs. 1295(a) and 1295(b)(2).

28 Sec. 1295(b)(1).

29 Sec. 1296.

30 Sec. 1296(c)(1)(B).

31 Secs. 871(a) and 871(b).

32 Secs. 871(b), 882(a), and 864(c).

33 Sec. 871(a)(1)(A).

34 Secs. 1441 and 1442.



a flat 30% rate<sup>35</sup> (or a lower treaty rate, if it exists). However, a foreign investor who is not engaged in the conduct of a trade or business within the United States is not subject to U.S. tax on U.S.-source capital gain income unless the taxpayer is physically present in the United States for at least 183 days during the year of disposition.<sup>36</sup> An exception applies for U.S. real property gains, which are taxed even if the foreign person is never in the United States. Foreign-source income of a foreign person is taxed only if it is ECI, and foreign-source ECI is taxed only in rare circumstances.<sup>37</sup>

### Engaged in the Conduct of a Trade or Business Within the United States

With certain exceptions,<sup>38</sup> if a foreign person is not engaged in a U.S. trade or business at some time during the tax year, none of that person's U.S.- or foreign-source income will be considered ECI.<sup>39</sup> Thus, to characterize U.S.-source income as ECI, a foreign person must be engaged in a U.S. trade or business.

A "trade or business within the United States" is not defined in the Code or the regulations, although the Code provides limited guidance on the definition for personal services, the trading of securities and commodities, and banking activities.<sup>40</sup> Otherwise, the nature and existence of a "trade or business within the United States" is a question of fact determined on a case-by-case basis, using the same criteria applied to trade or business expense deductions under Sec. 162.<sup>41</sup> The determination requires an inquiry into the type of activity, its relationship to the income earned, and where the activity is performed.<sup>42</sup> In addition, some kind of considerable,

continuous, and regular business activity within the United States is necessary.<sup>43</sup> Nonresident aliens conducting import-export operations as sole proprietors or through partnerships are sometimes treated as "engaged in a trade or business in the United States"; however, for most nonresident aliens, questions whether income is ECI or whether they are engaged in a trade or business in the United States arise from receiving compensation for personal services rendered in the United States.

## Tax laws governing cross-border transactions are both arcane and complex, and they present a host of traps.

### Effectively Connected Income

ECI can be either U.S.-source or foreign-source income. Different rules apply depending on the source of the income.<sup>44</sup> Only ECI that exceeds allocable deductions is subject to tax, i.e., ECI is taxable on a net basis. Non-ECI income is subject to tax on a gross basis.<sup>45</sup> A foreign taxpayer who is engaged in a U.S. trade or business must therefore determine whether, and to what extent, any of his or her income is effectively connected with a U.S. trade or business.<sup>46</sup>

U.S.-source income falls into one of three categories: (1) FDAP or similar income<sup>47</sup> that is not ECI; (2) capital gains; and (3) ECI.<sup>48</sup> FDAP income is treated as ECI under two conditions: (1) if the income is derived from assets used in the active conduct of a trade or business

(asset-use test); or (2) if the business activities conducted in the United States were a material factor in the realization of the income (business-activities test).<sup>49</sup> Income that is FDAP and not ECI under the asset-use or business-activities test is subject to the 30% flat tax rate (or a lower treaty rate). U.S.-source income that is ECI, but neither capital gains nor FDAP income, is treated as effectively connected with a U.S. trade or business, whether or not the income, gain, or loss is derived from the trade or business

being carried on in the United States during the tax year.<sup>50</sup>

For example, a foreign manufacturer that solicits orders for foreign manufactured goods from U.S. customers through a U.S. branch office would be engaged in a U.S. trade or business, and the income from the branch office sales would be treated as ECI. In addition, if the manufacturer has income that is generated from direct sales to customers in the United States by the home office in the foreign country, the income from the direct sales is also ECI.<sup>51</sup>

### Net Election for Real Property Income

Income earned by a foreign taxpayer through the rental of U.S. real property may be characterized as either FDAP income

35 Sec. 871(a).

36 Sec. 871(a)(2).

37 Secs. 864 and 871.

38 Secs. 864(c)(6)-(7) and 871(d).

39 Sec. 864(c)(1)(B).

40 Sec. 864(b), Regs. Sec. 1.864-2.

41 Regs. Sec. 1.864-2(e).

42 *Balanovski*, 236 F.2d 298 (2d Cir. 1956), cert. denied, 352 U.S. 968; *Spermacet Whaling & Shipping Co.*, 30 T.C. 618 (1958), aff'd, 281 F.2d 646 (6th Cir. 1960).

43 *Lewenhaupt*, 20 T.C. 151 (1953), aff'd, 221 F.2d 227 (9th Cir. 1955); *Inver-World Inc.*, T.C. Memo. 1996-301.

44 The determination whether a foreign taxpayer's foreign source income is ECI is made under Sec. 864(c)(4). Certain types of foreign source income, such as rental and royalty income, may be deemed ECI if the foreign taxpayer has an office or other fixed place of business within the United States as determined by Sec. 864(c)(5).

45 Secs. 873(a) and 882(c).

46 Sec. 871(b).

47 Secs. 871(a) and 881(a).

48 Secs. 864(c)(2) and 864(c)(3); Regs. Sec. 1.864-4.

49 Sec. 864(c)(2); Regs. Sec. 1.864-4.

50 Sec. 864(c)(3), Regs. Sec. 1.864-4(b).

51 Regs. Sec. 1.864-4(b), Example (1).



subject to a 30% withholding tax on a gross basis (i.e., without the allowance of any deductions connected to the income) or ECI subject to tax on a net basis, depending on the presence of a U.S. trade or business.<sup>52</sup> Although most types of FDAP income subject to the 30% flat rate will be taxed at reduced rates under an income tax treaty, most treaties do not provide for a reduced tax rate on rents derived from U.S. real property interests. Thus, the manner in which the rent would be taxed is determined by whether the taxpayer's U.S. real estate activities constitute a U.S. trade or business.

The Code and some U.S. income tax treaties provide an election to treat U.S. real property income as ECI.<sup>53</sup> If a taxpayer makes a valid election, this "net election"<sup>54</sup> treats the foreign person as if he or she is engaged in a U.S. trade or business, with the result that all real estate income is taxed on a net basis after allowable deductions. The election is available if (1) the taxpayer derives gross income during the tax year from U.S. real property, and (2) in the case of a nonresident alien individual, the property is held for the production of income.<sup>55</sup>

After a valid net election is made, a foreign person is allowed to claim deductions only if that person files an accurate<sup>56</sup> and timely return.<sup>57</sup> The foreign person will be taxed on a gross basis and denied all deductions if he or she does

not timely file a true and accurate return reporting the ECI.<sup>58</sup>

The due date of a foreign person's return is later than the due date provided by the Code for U.S. residents. Further, the foreign due date depends on whether prior returns were filed.<sup>59</sup> If a return was filed for the prior tax year, or it is the first tax year for which a return is required to be filed, the foreign due date for a corporation is 18 months (16 months for an individual) after the regular due date of the return.<sup>60</sup> If no return was filed for the preceding tax year, the return for the current tax year (if not the first tax year for which a return is required) must be filed by the earlier of:

- The date that is 18 months (16 months in the case of a nonresident alien individual) after the due date of the return; or
- The date the IRS mails a notice to the taxpayer that no return has been filed and therefore no deductions or credits may be claimed.<sup>61</sup>

These deadlines may be waived if the taxpayer establishes to the IRS's satisfaction that the taxpayer acted reasonably and in good faith.<sup>62</sup>

## Real Property Dispositions

The U.S.-source capital gains of a foreign person not engaged in a U.S. trade or business<sup>63</sup> are generally taxable only if the individual is physically present in the

United States for at least 183 days during the year the property is disposed of.<sup>64</sup> However, the Foreign Investment in Real Property Tax Act (FIRPTA)<sup>65</sup> imposes tax on the capital gains foreign persons derive from disposing of a U.S. real property interest (USRPI).<sup>66</sup> Under FIRPTA, the foreign taxpayer is first deemed to be engaged in a U.S. trade or business within the tax year of the sale, with the gain or loss from the sale treated as ECI with that trade or business. As ECI, the gain is taxed on a net basis just as for a U.S. person.<sup>67</sup>

Unlike the treatment for a U.S. person, however, FIRPTA imposes a withholding requirement. Under Sec. 1445, the purchaser is required to withhold 10% of the gross purchase price of the property, which serves as a deposit and is credited to the foreign seller's U.S. tax obligation, if any, for the year of sale. This prepayment does not determine the seller's tax liability, which is determined when the seller files his or her return including any gain or loss on the property, and which can generate a refund from the withheld amount or a further liability. Note that the law allows a seller to apply for an exemption from withholding in certain circumstances.<sup>68</sup>

A USRPI includes a direct "interest in real property" located in the United States or the Virgin Islands<sup>69</sup> but not an interest solely as a creditor.<sup>70</sup> Real property includes

52 Since rental and royalty income derived from U.S. real estate will not qualify as effectively connected with a foreign taxpayer's non-real estate U.S. trade or business unless it meets either the asset-use test of Sec. 864(c)(2)(A) or the material-factor test of Sec. 864(c)(2)(B), it is imperative that the rental activities themselves qualify as a trade or business to avoid gross-basis taxation of the income.

53 Secs. 871(d) and 882(d); 2006 U.S. Model Income Tax Treaty, Art. 6(5).

54 It is referred to as a "net election" because it allows a taxpayer to pay tax on the U.S. real estate income on a net basis (i.e., with the allowance of deductions) at graduated rates of tax.

55 Sec. 871(d)(1); Regs. Sec. 1.871-10(a).

56 Secs. 874(a) and 882(c)(2).

57 Regs. Secs. 1.874-1(b)(1) and 1.882-4(a)(3)(i). The Tax Court held that the regulation's timeliness requirement is invalid because it is inconsistent with the plain meaning of the statute, which requires only that the return be filed in the "manner" required by statute, but this decision was overturned on appeal. *Swallows Holding, Ltd.*, 515 F.3d 162 (3d Cir. 2008), rev'g 126 T.C. 96 (2006).

58 Regs. Secs. 1.874-1(a) and 1.882-4(a).

59 Regs. Sec. 1.874-1(b).

60 Regs. Secs. 1.874-1(b)(1) and 1.882-4(a)(3)(i). See *Espinosa*, 107 T.C. 146 (1996) (deductions denied because taxpayer did not satisfy the timely filing requirement of Regs. Sec. 1.874-1(b)(1)).

61 *Id.*

62 Regs. Secs. 1.874-1(b)(2) and 1.882-4(a)(3)(ii). Before 2003, the waiver was

granted only in "rare and unusual circumstances" upon a showing of good cause by the taxpayer. In Notice 2003-38, 2003-2 C.B. 9, the IRS announced a compliance initiative in which certain nonresident alien individuals and foreign corporations that had not filed a U.S. federal income tax return for any prior tax year could act by Sept. 15, 2003, to obtain a waiver of the filing deadline, both for purposes of protecting deductions and credits under Regs. Secs. 1.874-1(b)(1) and 1.882-4(a)(3)(i) and for purposes of the fraudulent failure-to-file penalty under Sec. 6651(f), by (among other requirements) submitting all required U.S. federal income tax returns and payments for the tax year(s) at issue ending after 1995.

63 See Sec. 7701(b), which defines a nonresident alien as any alien who is not a "resident alien."

64 Sec. 871(a)(2).

65 Foreign Investment in Real Property Tax Act, enacted as part of the Omnibus Reconciliation Act of 1980, P.L. 96-499.

66 Secs. 897(a) and (c). Note, however, that Sec. 897 is not a taxing provision in itself (i.e., it does not impose a tax, *per se*); rather, it is a jurisdictional provision in that it brings within the U.S. taxing jurisdiction gains or income derived by foreign persons from the disposition of USRPIs. The tax itself is imposed by Secs. 871(b) and 882(a).

67 Secs. 881(a) and 882(a).

68 Sec. 1445(b)(4); Regs. Sec. 1.1445-3(a).

69 Sec. 897(c)(1)(A)(i).

70 Regs. Sec. 1.897-1(c).



land,<sup>71</sup> buildings, and improvements, such as to a building.<sup>72</sup> An interest includes a fee ownership, co-ownership, or a leasehold.<sup>73</sup> Even rights to share in appreciation in the value, or in the gross or net proceeds or profits generated by, the real property,<sup>74</sup> or an interest contingent on the appreciation in value of a shareholder, partner, or beneficiary interest, or which is contingent on the appreciation in value of assets of, or the general gross or net proceeds or profits derived by, that entity,<sup>75</sup> may be characterized as USRPIs depending on the circumstances. A FIRPTA "disposition" means any transfer that would constitute a disposition by the transferor for any purpose of the Code and regulations thereunder.<sup>76</sup> An outright sale of property is clearly a disposition.

Sec. 897, which treats gain or loss from the disposition of a USRPI as effectively connected gain or loss, does not change the capital asset character of the USRPI itself. Thus, a USRPI gain on a capital asset held for more than 12 months,<sup>77</sup> or characterized as such under Sec. 1231, is long-term capital gain<sup>78</sup> and is taxed at a preferential rate.<sup>79</sup>

The same characterization rules hold true for a net election made under Sec. 871(d). Any capital gain or loss realized from the disposition of U.S. real property for which an election under Sec. 871(d) has been made remains capital gain or loss. Note that gain or loss realized from the sale or exchange of stock in a corporation that owns U.S. real estate or of an interest in a partnership that owns U.S. real estate will also be subject to FIRPTA and is generally treated as capital gain or loss. If the foreign taxpayer holds an asset through a corporation, however, the corporation is taxed at

ordinary, rather than preferential, rates in the same manner as a U.S. corporation.

### Branch Profits Tax

A foreign corporation that operates a business in the United States will pay a branch profits tax and a branch-level interest tax in addition to the tax on income effectively connected with the conduct of a U.S. trade or business.<sup>80</sup> The branch profits tax applies to after-tax earnings and profits that are effectively connected with a foreign corporation's U.S. trade or business to the extent that such effectively connected earnings and profits (ECE&P) are not re-invested in a U.S. trade or business by the close of the tax year or disinvested in a later tax year.<sup>81</sup> Foreign corporations that are engaged in a U.S. trade or business or that receive ECI from the conduct of a U.S. trade or business are subject to branch profits tax.<sup>82</sup> Foreign corporations treated as receiving ECI include not only those that engage directly in branch business operations in the United States but also any foreign corporation that is in a partnership engaged in a U.S. trade or business,<sup>83</sup> that realizes gain from the sale of a U.S. real property interest,<sup>84</sup> or owns U.S. real property and makes a net-basis tax election under Sec. 882(d).<sup>85</sup>

The branch profits tax is imposed at a statutory rate of 30% and is in addition to the regular U.S. federal corporate income tax applicable to the ECI of foreign corporations engaged in a U.S. trade or business. The branch profits tax is imposed after the application of the regular U.S. federal corporate income tax, resulting in a combined maximum effective tax rate equal to the maximum corporate tax rate, plus 30% of the taxpayer's ECE&P.<sup>86</sup>

### Conclusion

Cross-border transactions are becoming more frequent and more complex. The taxation of these transactions, as well as the obligations they generate for withholding tax and filing returns and information reports, makes recognizing issues critically important for both planning and compliance. As discussed above, the type of entity that is involved, the timing of elections, and proper filing can all dramatically affect the taxation of cross-border income. The complexity caused by the default rules in the Code is compounded by the fact that they are merely default rules, and are therefore subordinate to any treaty provision that applies to a given transaction or investment. These transactions bring opportunity as well as risk, and the foregoing is intended to help practitioners recognize the issues arising from these activities. McLuhan's global village is a fact of our times, and tax practices must adapt to accommodate it.

TTA

### EditorNotes

Barry Leibowicz practices tax and business law in Great Neck, N.Y., and is an associate professor in the Department of Accounting and Information Systems at Queens College of the City University of New York. For more information about this article, contact Mr. Leibowicz at [barry@leibowiczlaw.com](mailto:barry@leibowiczlaw.com).

71 Regs. Sec. 1.897-1(b)(1).

72 Regs. Sec. 1.897-1(b)(3)(i).

73 Regs. Sec. 1.897-1(d)(2)(i).

74 Regs. Sec. 1.897-1(d)(3)(i)(D).

75 Regs. Sec. 1.897-1(d)(3)(ii)(B).

76 Regs. Sec. 1.897-1(g).

77 Sec. 1221.

78 Sec. 1222(4).

79 Secs. 1(h)(1) and 55.

80 Sec. 884.

81 Secs. 884(a) and (b); Regs. Sec. 1.884-0(a)(1).

82 Secs. 884(a) and (d)(1); Regs. Sec. 1.884-1(f)(1).

83 Sec. 875; see Regs. Secs. 1.884-0(a) and 1.884-1(f)(1); Rev. Rul. 85-60, 1985-1 C.B. 187; and S. Rep't No. 313, 99th Cong., 2d Sess. 403 (1986).

84 Sec. 897(a). ECE&P also includes gain from the sale of a U.S. real property interest by a foreign corporation that has elected to be treated as a domestic corporation under Sec. 897(i), but excludes gain from the sale of a U.S. real property interest that is stock in a U.S. real property holding corporation. See Regs. Secs. 1.884-1(f)(1) and (2)(iii).

85 Sec. 882(d); see Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 99th Cong., 2d Sess. 1040 (Comm. Print 1987).

86 Secs. 11(b), 882, and 884(a); Regs. Sec. 1.884-1(a). Branch profits tax is imposed on a tax base measured by reference to ECE&P, rather than taxable income. Therefore, the maximum combined rate may be different from corporation to corporation, to the extent that ECE&P adjustments differ from the computation of taxable income. Furthermore, if the branch interest tax applies, it might produce an even higher combined rate of federal taxation.