

International Overview Training: Post 2017 Tax Reform

Topic I U.S. Tax Regime and International Matrix: Pre Tax Cuts & Jobs Act (TCJA)



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IRS Front Matter Items

- The IRS Mission Statement
- 14 General Principles of Ethical Conduct for Federal Employees
- Your Rights as a Taxpayer

Learning Objectives

At the end of this lesson you will be able to:

- A. Describe the basics of U.S international tax (pre-TCJA)
- B. Describe the differences between inbound and outbound transactions
- C. Explain the organization and content of the International Matrix (pre-TCJA)



A. Basics of U.S. International Tax (Pre-TCJA)



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Tax Systems Overview

- In a **worldwide system of taxation**, a jurisdiction imposes tax on its residents on all income earned both at home or abroad. Double taxation is mitigated by foreign tax credits (**FTCs**). Taxpayers may pay residual tax on foreign income if the foreign tax rate is less than the domestic tax rate.
- In a **territorial system of taxation**, a jurisdiction imposes tax only on income earned at home. The hallmark of territoriality is a participation exemption, or dividends received deduction (**DRD**), for foreign dividends. No domestic tax on foreign income.

Tax Systems Overview (Cont'd)

- Most jurisdictions have a **hybrid system** with components of both worldwide and territorial systems.
- In a **hybrid system**, some foreign income may be currently taxed, some foreign income may be tax-deferred, and some may be tax-exempt.
- The U.S. Pre-TCJA system is a **hybrid system**.
- The U.S. taxation of international transactions is divided into “outbound” and “inbound.”

Global Tax Organizational Chart

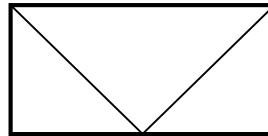
- The Global tax organizational chart (GTOC):
 - Is a visual/graphical representation of the taxpayer's global entities and reflects the entities' relationships
 - Consists of a series of shapes connected by lines which depict the ownership structure of the related entities

Entity Symbols

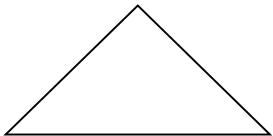
Below are commonly used symbols that you may encounter outside of IRS:



Corporation



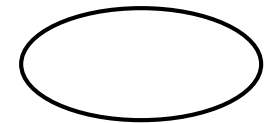
Reverse Hybrid Corporation
(US corporation, foreign pass-through)



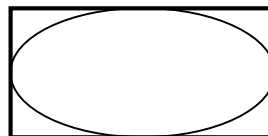
Partnership



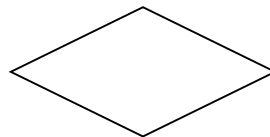
Hybrid Partnership
(US pass-through, foreign corporation)



Branch, DE or
Individual



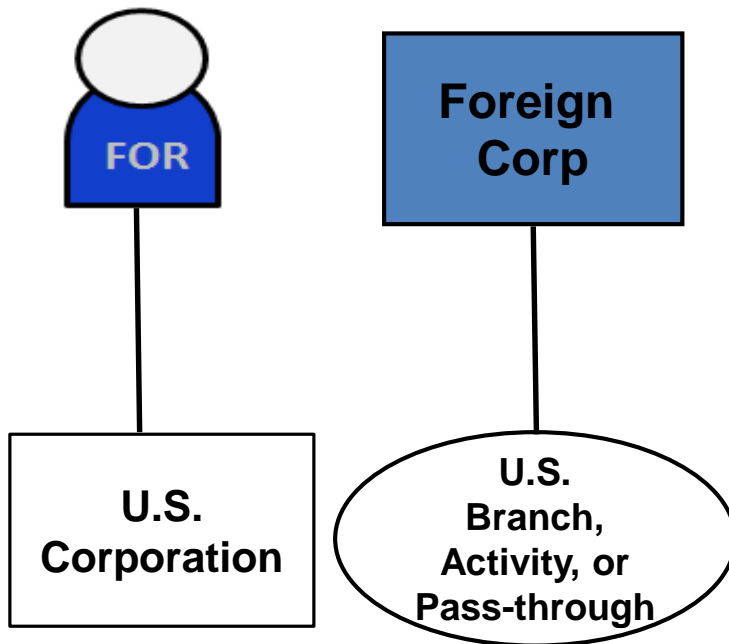
Hybrid Branch or Disregarded Entity
"DE"
(US branch or DE, foreign
corporation)



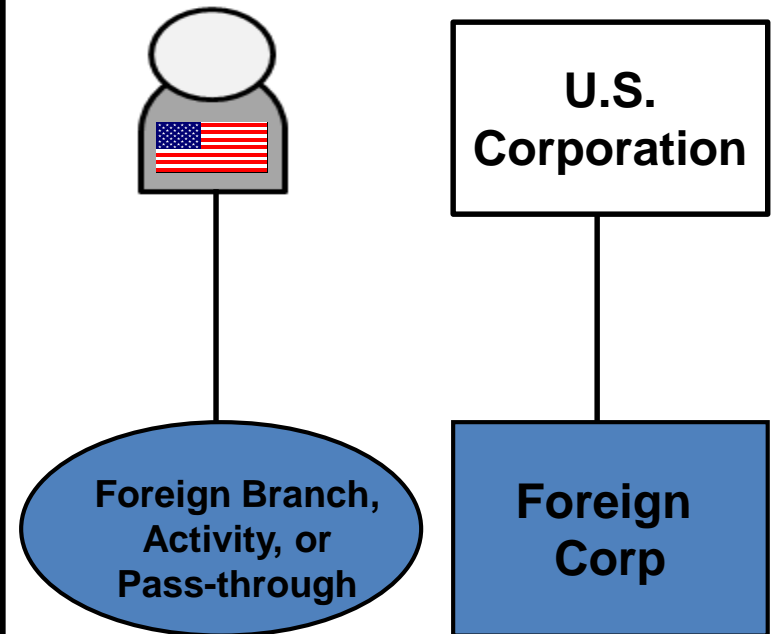
Trust

“Inbound” and “Outbound” Entities

Inbound: Foreign Persons Investing in the U.S.



Outbound: U.S. Persons Investing Overseas





B-1. Business Outbound Taxation

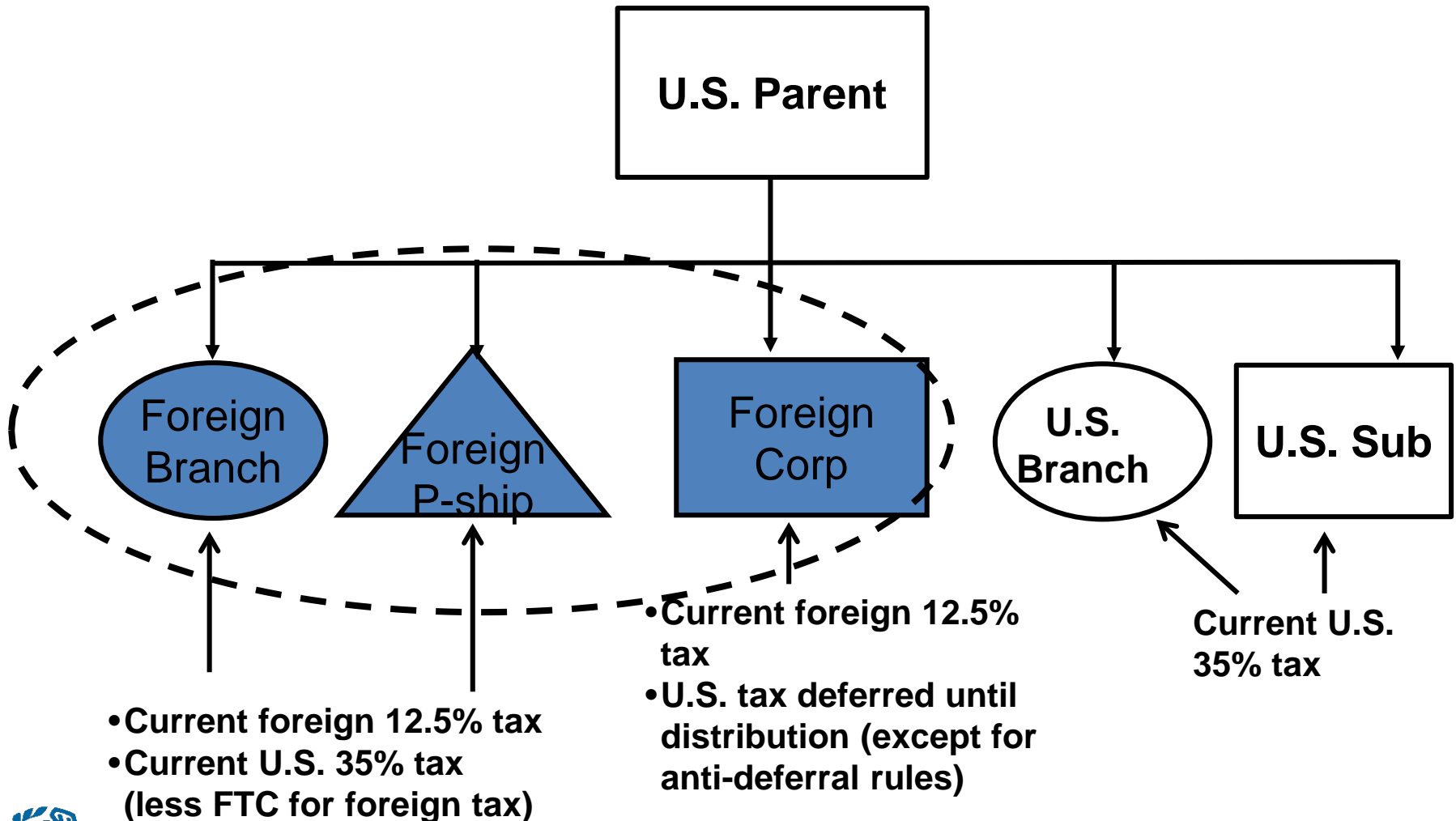


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Outbound Overview

- Outbound focuses on U.S. persons with foreign activities or investments.
- U.S. persons are subject to tax on all income earned at home or abroad.
 - Except: Deferral of income earned by foreign subsidiary, subject to anti-deferral rules (e.g., Subpart F).
 - Double taxation is mitigated by foreign tax credits (FTCs).
- Other outbound areas of concern.
 - Shifting of income and/or income producing property.
 - Repatriation with minimal U.S. tax.

Business Outbound Illustration



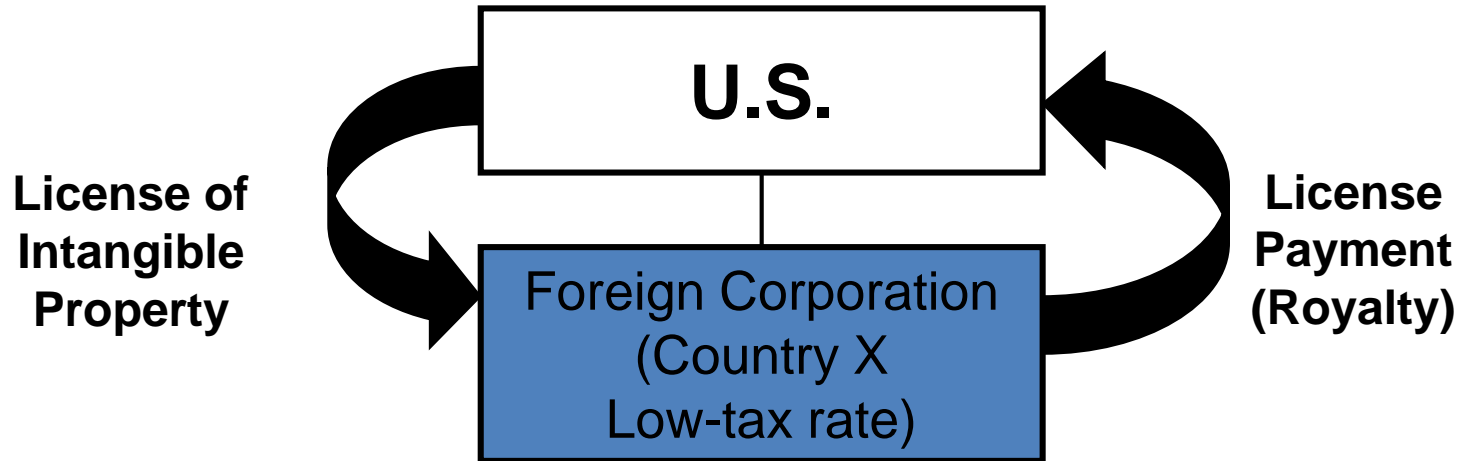
Income Shifting Outbound

- U.S. multinational enterprises (MNEs) may own one or more foreign entities (“related parties”).
- When two related parties transact business with each other, the possibility exists that the price paid may be affected by the related party status, and differences from the prices that would be negotiated at arm’s length between unrelated parties could be motivated by differences in domestic and foreign tax rates.

Income Shifting Outbound (Cont'd)

- For example, a U.S. taxpayer may shift valuable Intangible Property (IP) to its controlled foreign subsidiary.
- The U.S. taxpayer should be compensated for the use or transfer of the IP by the controlled foreign subsidiary.
- The U.S. taxpayer may inappropriately underprice the royalty, which decreases U.S. earnings and increases foreign earnings.
- Such pricing disparity could result in a U.S. taxpayer underreporting its future U.S. taxable income, and consequently, its federal income taxes.

Income Shifting Outbound: Illustration



Income Shifting Outbound: Arm's Length Standard

- Income shifting is not unlawful in and of itself, if the related parties reach an arm's length price, then the resulting income shifting is permissible.
- The transfer pricing IRC and regulations provide that the pricing for transactions between controlled parties must meet the arm's length standard, which is met if the results are consistent with those that would have been realized between uncontrolled parties under the same or similar circumstances.

Outbound - Deferral Planning

- After shifting income to one or more CFCs in low-tax jurisdictions to achieve a low ETR, under a worldwide tax with deferral system, U.S. MNEs may have incentives to defer current U.S. taxation of the CFCs' earnings for as long as possible.
- Recall, income earned indirectly through a CFC is not taxed until profits are repatriated (unless caught by one of the anti-deferral rules).
- Thus, U.S. MNEs are incentivized to structure and plan to avoid triggering anti-deferral rules.

Outbound Anti-Deferral Rules

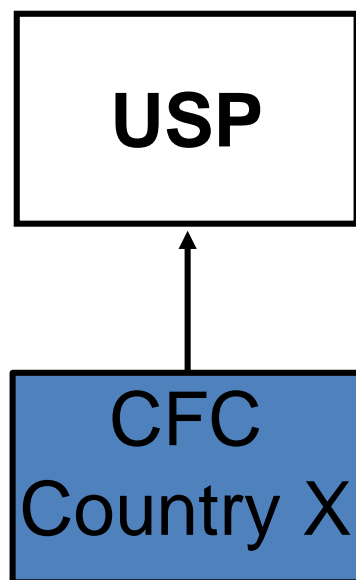
- Main Anti-Deferral Regimes:
 - Subpart F income:
 - Passive income (dividends, interest, rent, royalties and annuities)
 - Related party sales and services income
 - Many exceptions and opportunities for deferral planning
 - Investments in U.S. Property
 - Targeted at acts that bring earnings back to U.S. without a “dividend”. E.g., loans to U.S. related party.
 - Passive Foreign Investment Company (“PFIC”)
 - $\geq 75\%$ of gross income passive or $\geq 50\%$ assets produce passive or no income
- Consequence: Current U.S. tax, potentially reduced by FTCs.

Outbound Anti-Deferral Rules (Cont'd)

- The Subpart F and investment in U.S. property anti-deferral rules apply to a “**U.S. shareholder**” who owns stock in a “Controlled Foreign Corporation” (**CFC**).
- CFC: >50% (vote or value) owned by U.S. Shareholders
- U.S. Shareholder: U.S. person who owns 10% or more of voting power
- U.S. Shareholder required to file Form 5471

Example 1:

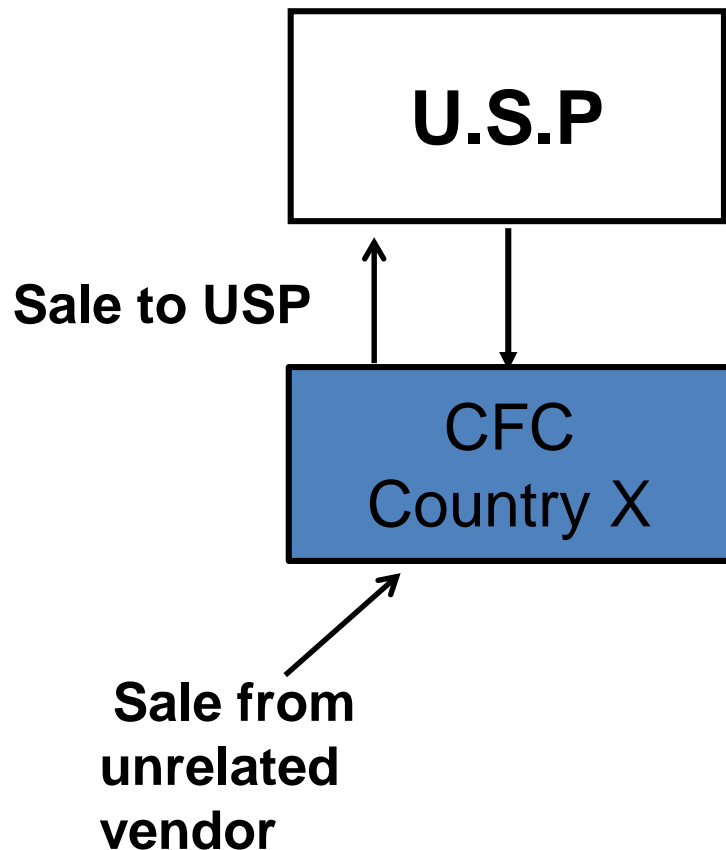
Deferral Planning Outbound - Subpart F



Subpart F Example 1:

U.S. Parent (USP) is subject to current tax on its pro rata share of CFC's subpart F income.

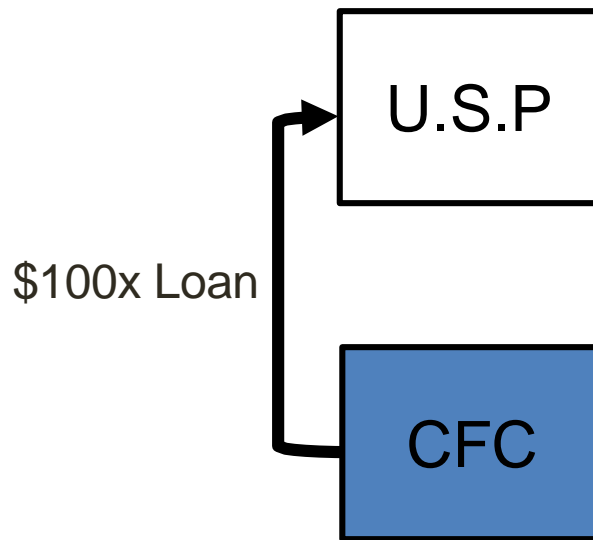
Example 2: Deferral Planning Outbound - Subpart F



Subpart F Example 2:
CFC's income from the sale of widgets is Foreign Base Company Sales Income.

Example 3:

Deferral Planning Outbound - Inv in US Prop



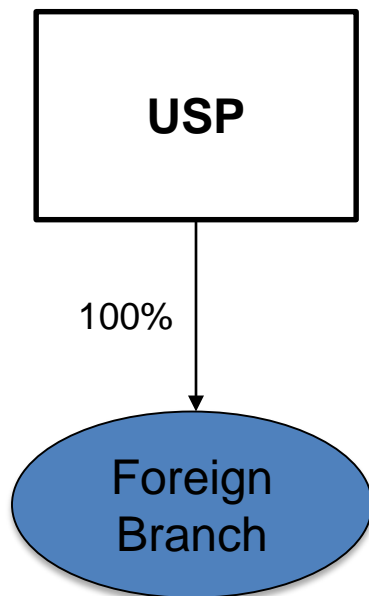
Investment of earnings in U.S. property Example 3

CFC's loan to U.S.P is included in U.S.P's income currently.

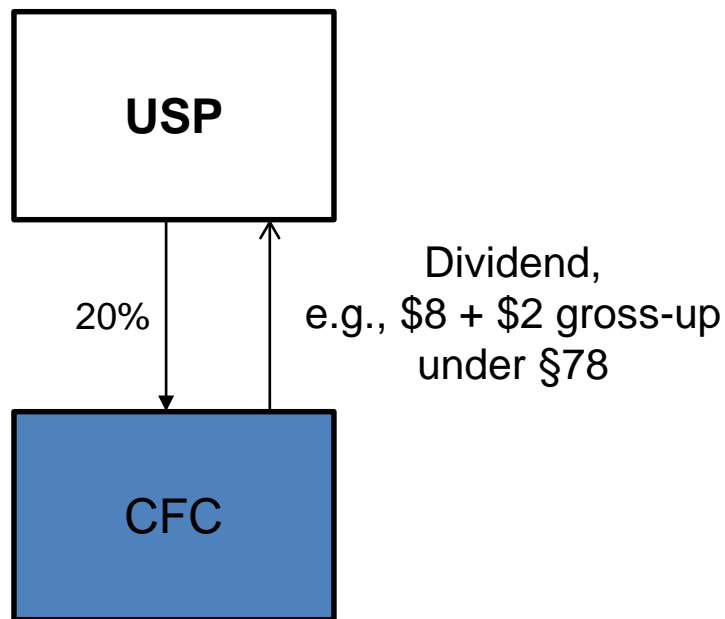
Foreign Tax Credit (FTC) Basics

- U.S. taxpayers (by citizenship or place of incorporation) pay U.S. tax on worldwide income, but may also pay foreign tax where the income is earned (source country) or where the taxpayer is doing business or has a subsidiary (residence country)
- FTC alleviates double taxation on foreign source income to neutralize the effect of tax considerations on investment location
- Foreign tax paid must be an income tax, and must be compulsory.

Intro to Outbound: Foreign Tax Credit



- \$100 active business income
- \$20 Foreign tax



- \$100 active business income
- \$20 Foreign tax
- \$80 Earnings and Profits

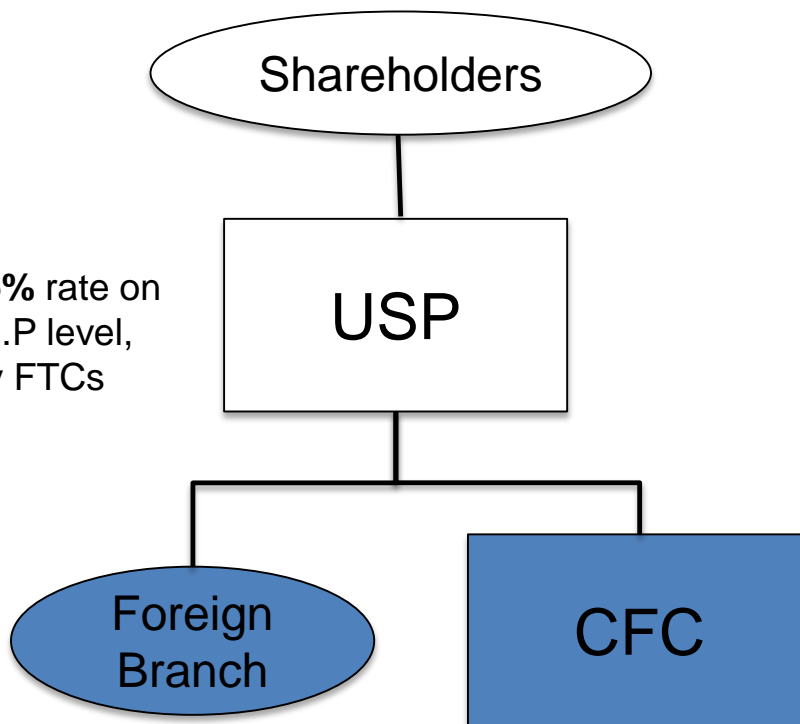
Intro to Outbound: FTC

USP:

Current U.S. tax at **35%** rate on income earned at U.S.P level, potentially reduced by FTCs (limited by baskets)

USP/Branch:

Current U.S. tax at **35%** rate on income earned at foreign branch level, potentially reduced by FTCs (limited by baskets)



CFC:

- Current U.S. tax at 35% rate on “subpart F income,” potentially reduced by FTCs (limited by baskets)
- Income increased by gross-up for foreign taxes deemed paid
- U.S. tax at 35% on dividend with respect to residual foreign earnings



Foreign Tax Credit (FTC)

Section 904 limits effectuate FTC goals:

- Section 904 limits FTCs to U.S. tax on foreign-source income. No credit for foreign tax paid on U.S. source income.
 - Goal: U.S. has primary right to tax U.S. source income.
- Section 904(d) further limits FTCs by certain categories (“baskets”) of income.
 - Goal: Prevent crediting excess foreign taxes paid on high-tax income of one type (e.g. high-taxed manufacturing income) against U.S. tax on lower-taxed income of another type (e.g., low-taxed interest income).

FTC Basket Limitation Equation

- §904(d) *limits* the FTC to the pre-credit U.S. tax on a *specific type of foreign-source taxable income* (“FSTI”):

$$\frac{\text{FSTI in 904(d) Basket}}{\text{World-wide taxable income}} \times \text{Pre-credit U.S. Tax}$$

- Or: *FSTI in each basket* x U.S. tax rate
- Because FSTI is on a net basis, expense allocation (domestic vs. foreign and basket-by-basket) is key

FTC Basics – Expense Allocation

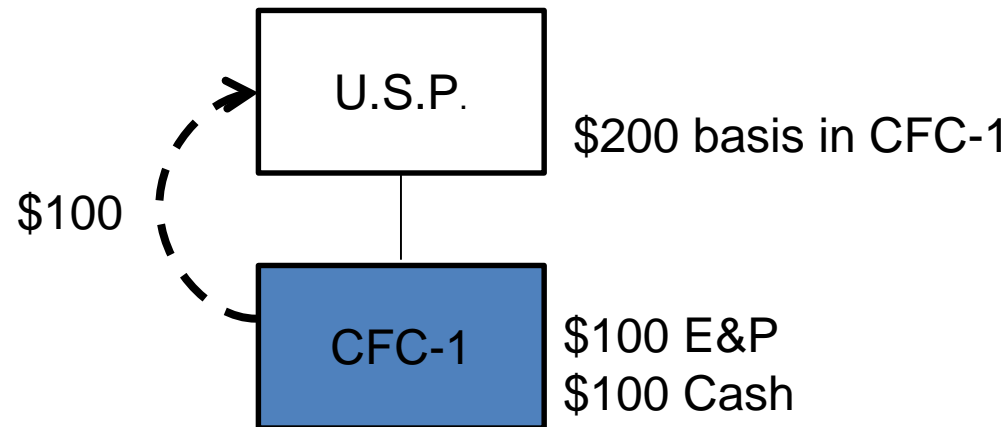
- U.S.-based MNEs may seek to maximize foreign tax credits and reduce their ETR through expense allocation to income.
- Interest expense is considered to relate to all income, and must be apportioned to each category based on the relative value (or tax basis) of the assets that produce income in that category.

Outbound - Repatriation

- Once a U.S. MNE has lowered its ETR by shifting income to a lower-tax CFCs, the taxpayer may want to repatriate the cash accumulated back to the U.S. without incurring a residual U.S. tax (35% less available credits) on the repatriated earnings.
- Repatriation
 - Actual distributions – cash may be subject to current U.S. tax
 - “Investment in U.S. property” such as CFC loans to U.S. affiliates, CFC purchases of tangible property located in the U.S. or stock issued by a related domestic corporation are subject to current U.S. tax like taxable distributions.

Basic Distribution Rules

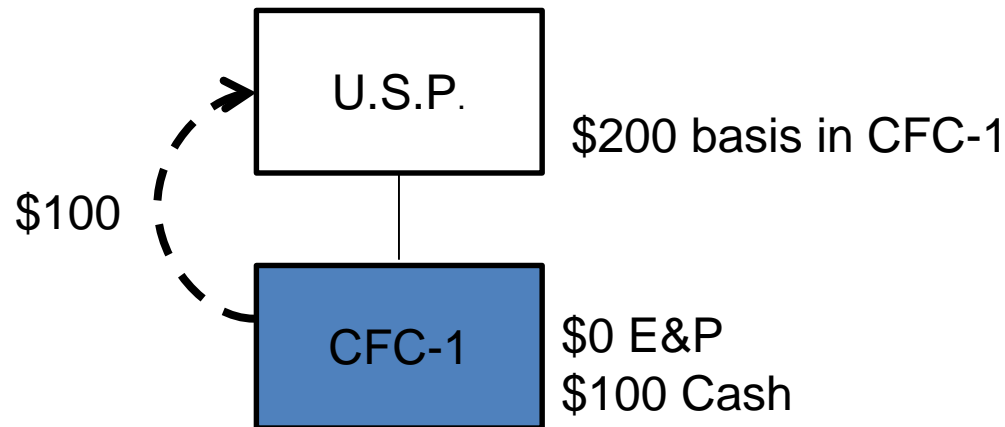
Example: Taxable Dividend Distribution



- **Basic Rules for corporate distributions:**
 - 1st - § 301(c)(1) – Dividend to the extent of Earnings & Profits (E&P) (taxable);
 - 2nd - § 301(c)(2) – Return of basis to the extent thereof (non-taxable); and
 - 3rd - § 301(c)(3) – Gain from the sale or exchange of property (taxable).
- **Note –** because CFC-1 has \$100 E&P, the \$100 distribution is a taxable dividend distribution under section 301(c)(1).

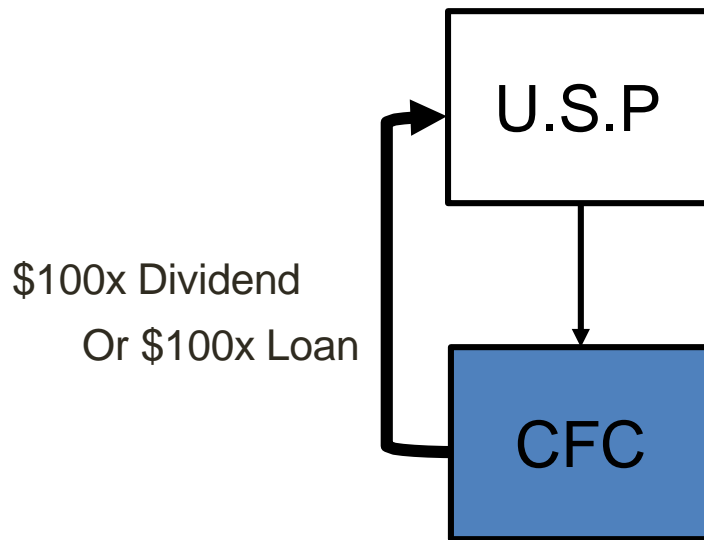
Basic Distribution Rules

Example: Tax Free Return of Basis



- Basic Rules for corporate distributions:
 - 1st - § 301(c)(1) – Dividend to the extent of E&P (taxable);
 - 2nd - § 301(c)(2) – Return of basis to the extent thereof (non-taxable); and
 - 3rd - § 301(c)(3) – Gain from the sale or exchange of property (taxable).
- Note that because CFC-1 has no E&P, the \$100 distribution is a non-taxable return of basis under section 301(c)(2)

Repatriation: Investment in U.S. property



Investment in U.S. Property Example

- U.S. Parent (U.S.P) corporation wholly owns CFC. CFC makes a loan distribution of \$100x.
- Loan as a disguised repatriation
- Included in U.S.P's current income and subject to U.S. tax



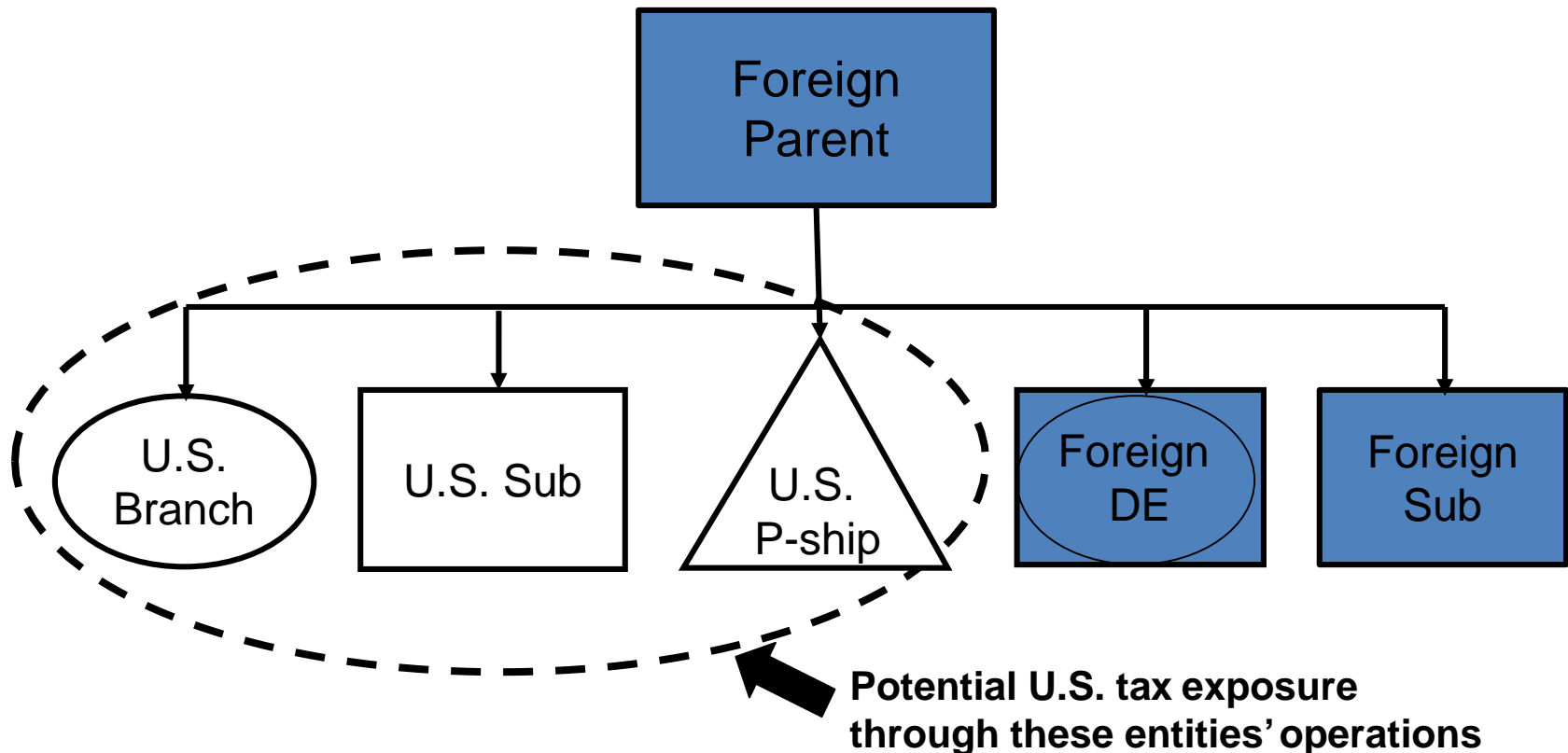
B-2. Business Inbound Taxation



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Business Inbound Taxation (pre-TCJA)

- Business Inbound focuses on foreign-based MNE with U.S. activities or U.S. investments.



Inbound Overview

- Foreign Persons are subject to U.S. tax on:
 - Gross U.S.-source fixed, determinable, annual, or periodic income (“FDAP”) via 30% withholding tax.
 - U.S.-source dividends, interest, rents, royalties, etc.
 - The amount of income that is effectively connected with a U.S. trade or business, net of allocable deductions, (“effectively connected income” or “ECI” of a “USTB”) is taxable at graduated rates.
 - Non-FDAP & non-ECI, even if U.S.-source, is NOT taxed.
- Treaty may reduce withholding rates on FDAP and limit taxable ECI to income that is attributable to a permanent establishment (PE) in the U.S.

Inbound - Jurisdiction to Tax

- Foreign MNEs are generally subject to tax only on U.S.-source FDAP or the net amount of income that is effectively connected with a USTB.
- Therefore, sourcing of income (as U.S. vs. foreign) is crucial for Inbound taxpayers.
- Tax treaties among jurisdictions also assign taxing rights amongst countries. Therefore, treaties play an enhanced role in the inbound regime.

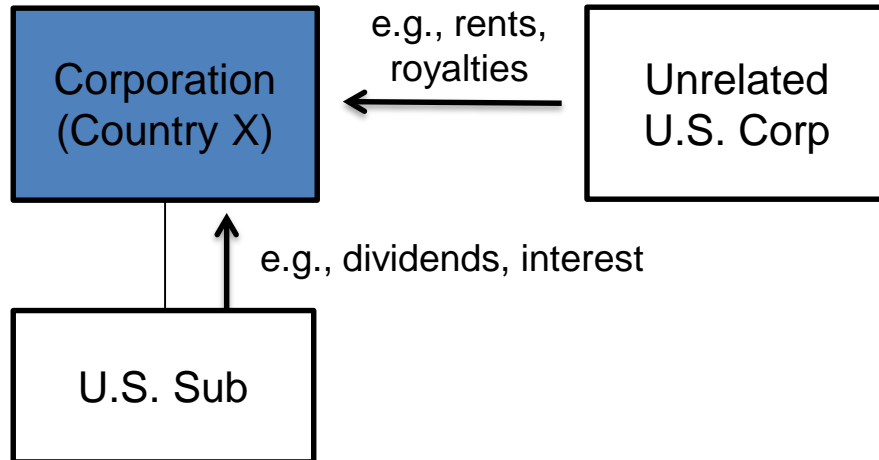
Source in a Nutshell

- Where are the types of income being recognized and taxed:
 - Interest, Dividends: generally, residence of payor
 - Personal services: place of performance
 - Rents and royalties:
 - Tangible Property: location of property
 - Intangible Property: location of protection
 - Gain on sales of real property: location of real property
 - Gain on sales of personal property:
 - Default: location of seller
 - Purchased Inventory: passage of title
 - Manufactured Inventory: generally split
 - Depreciable personal property: U.S.-source up to depreciation taken
 - Contingent comp for intangible personal property: follow royalty rule
 - Space/ocean income: place of residence of performer
 - Insurance income: location of insured
 - Special rules for sales through offices / fixed places

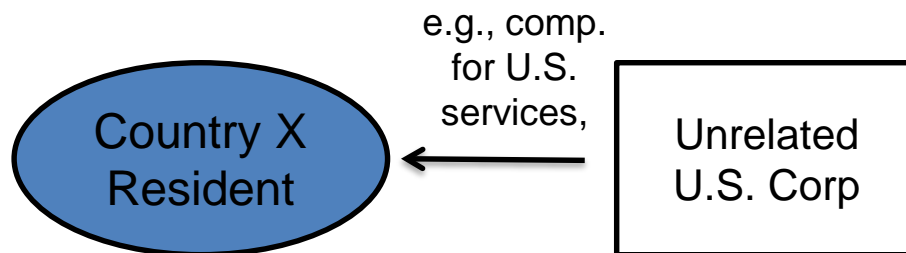


Illustration: U.S. Source FDAP

Example 1: FDAP



Example 2: ECI



- U.S.-Source FDAP subject to 30% withholding tax on gross amount.
- FDAP includes U.S.-source:
 - Dividends
 - Interest, OID
 - Rents, royalties
 - Comp. for personal services
 - Commissions
 - Pensions, annuities
 - Alimony
 - Scholarships, grants, prizes
 - And more...
- FDAP does not include **ECI**.
 - Usually good for taxpayers, because FDAP is 30% gross withholding, ECI is taxed on net.
 - Taxpayer must claim ECI exemption, else withheld at 30%.

Inbound - Jurisdiction to Tax (Cont'd)

- If foreign MNE has a U.S.-based Foreign Controlled Corporation (FCC*) as a subsidiary, the FCC is taxed like a U.S. Corporation and files a Form 1120 return
- If foreign MNE engages in activities in the U.S. through a branch or partnership, the foreign MNE must file Form 1120-F if:
 - Engaged in a U.S. trade or business and had income effectively connected with a U.S. trade or business, or
 - Had any other U.S. FDAP (interest, dividends, royalties, etc.) that is not effectively connected with a U.S. trade or business and for which tax was not properly withheld
- As the nature of activities by the FCC increases, the foreign MNE may become subject to U.S. taxation.
 - U.S. trade or business threshold (IRC based)
 - Permanent Establishment threshold(Treaty based)



Inbound - Jurisdiction to Tax: U.S. Trade or Bus/Perm Establishment

■ USTB

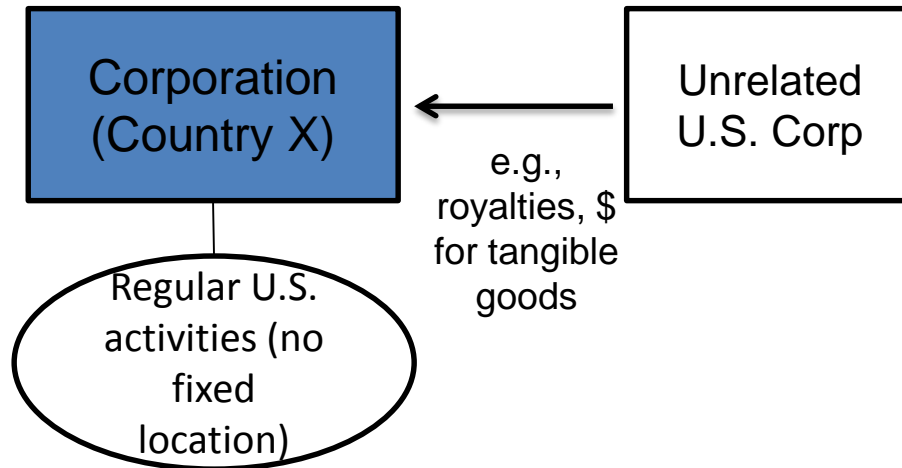
- Under the IRC, an FC engaged in a “U.S. trade or business” (through a branch or partnership) is taxed on its *ECI*.
- It may also be subjected to the “branch profits tax.”
- If it is a partnership, U.S. withholding tax may be required.

■ PE

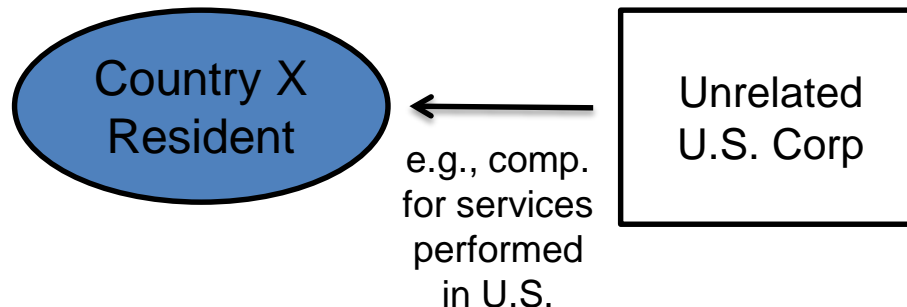
- If a tax treaty applies between the countries, these rules are a little different.
- Tax treaties serve to establish who has primary jurisdiction to tax the income.
- Tax treaties also specify how certain income types will be taxed and at what rates.

Illustration: Income Effectively Connected to U.S. Trade or Business

Example 1: USTB with ECI



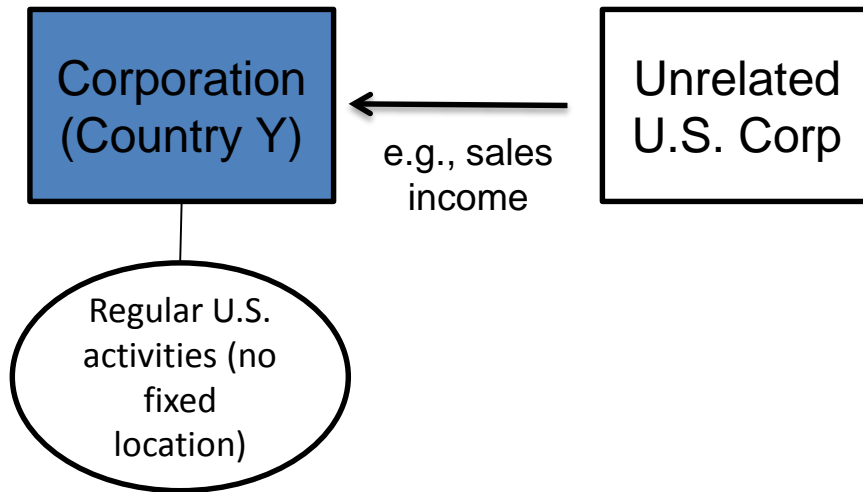
Example 2: USTB with ECI



- ECI: Net income tax, normal rates
- Step 1: USTB?
 - Is the U.S. activity considerable, continuous, and regular so as to rise to the level of a USTB?
 - No fixed location required.
- Step 2: Determine source
- Step 3: Effectively connected?
 - If there's a USTB, most U.S.-source income is ECI. No factual connection required.
 - Certain foreign-source income may be ECI
 - Comp. for personal services performed in U.S. is generally ECI.
 - Investment income (e.g. dividends, interest, gains) requires a factual connection to assets or activities of USTB.

Illustration: Income Attributable to PE

Example 1: Treaty exempts payments that are otherwise ECI from U.S. tax

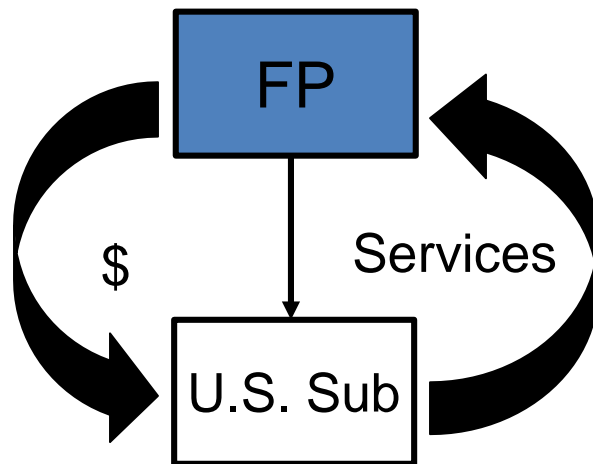


- **Permanent Establishment:**
 - Fixed place through which business is carried on
 - Places of management
 - Factories
 - Offices
 - Long-term construction sites
 - Income attributable to activities of dependent agents
 - Need not be owned or leased if regularly available to taxpayer
- **Attributable to:**
 - Net income economically generated by the activities of the PE.
- Treaty may also reduce withholding on non-business income.

Inbound - Income Shifting

- Income shifting inbound, similar to the Outbound Face, occurs when a foreign MNE and its FCC, U.S. Branch or U.S. Partnership shift income and/or expenses amongst themselves.
- Inbound income shifting is subjected to the arm's length standard and requires consideration of the same factors as the Outbound Face.

Income Shifting Inbound



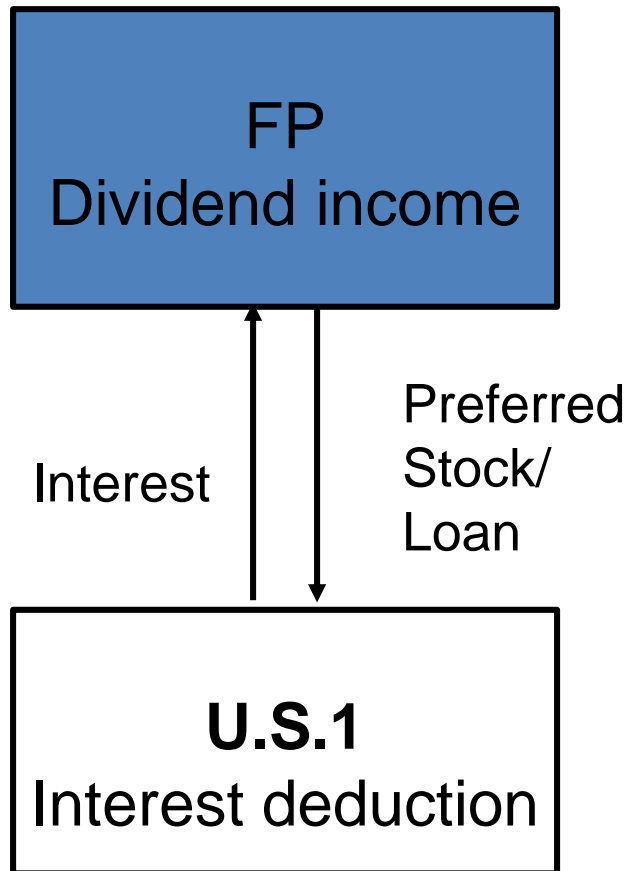
Inbound Transfer Pricing Services Example

- FP wholly owns U.S. Sub
- FP is in a low tax jurisdiction.
- U.S. Sub is providing Research & Development services to FP.
- U.S. Sub includes FP payments in income.
- Incentive to understate the services value.

Inbound Financing

- Inbound financing is a decision by a foreign MNE to invest in the U.S. through a variety of financing arrangements designed to minimize U.S. taxable income
- One of the most common goals from these arrangements is to generate U.S. deductions (usually interest deductions) that result in low tax or no tax to the foreign related party receiving the payment.
- Foreign MNEs had flexibility in how they set up these financing structures:
 - Debt
 - Equity
 - Hybrid Structures (Instruments/Entities)

Inbound Financing



Example:

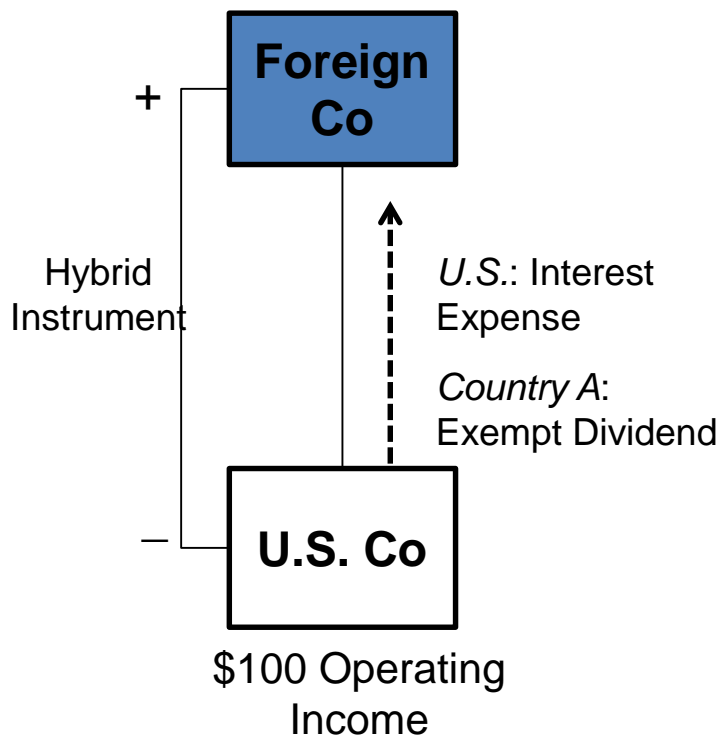
- Debt/equity standards are based on facts and circumstances developed through case law.
- FP could decrease U.S. tax liabilities through:
 - Deduction of interest.
 - Deduction of guarantee fees.
 - Elimination or minimization of U.S. withholding tax
- Treaties may provide lower or 0% withholding rates on interest.

Hybrid Mismatches – In General

- Generally, a country's international tax rules only take into account the application of that country's rules to a cross-border transaction, without regard to how the transaction is treated under another country's tax laws (or the combined treatment of the transaction under both countries' tax laws).
 - Often gave rise to "stateless income."
- Globally, foreign countries were concerned with the stateless income result. The Organization for Economic Cooperation and Development (OECD), an intergovernmental organization published a report intended to neutralize hybrid mismatches and, as a result, prevent stateless income arising from hybridity.
 - Represented a major shift in how hybridity was viewed globally.

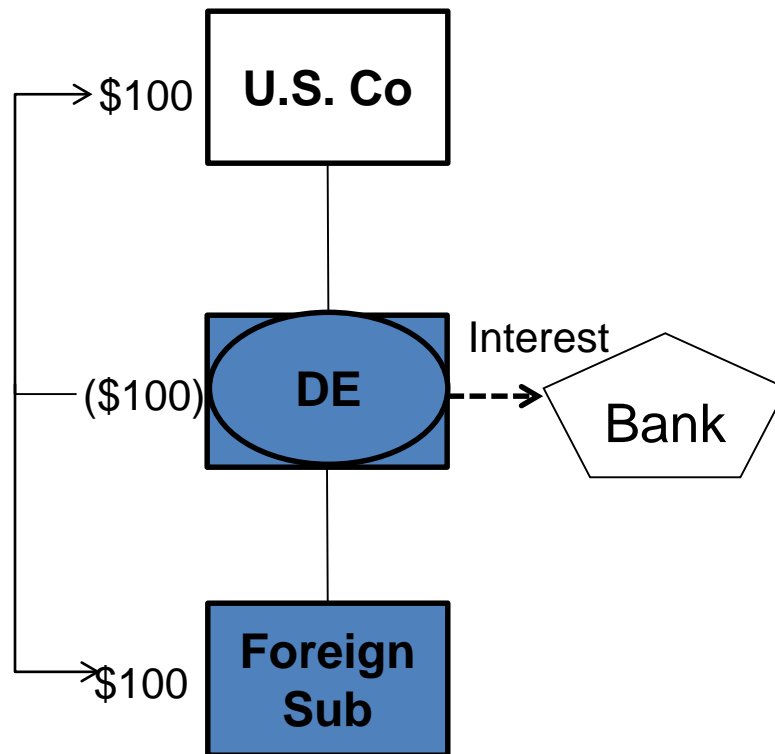
Hybrid Mismatch Policies

Deduction/No Inclusion (“D/NI”)



Group Economic Income: \$100
Group Taxable Income: \$0

Double Deduction (“DD”)



Group Economic Income: \$100
Group Taxable Income: \$0



Inbound - Repatriation/Withholding

- Once profits are earned in an FCC, the foreign MNE will strategically plan to bring the money “home” (out of the U.S.)
- To prevent income earned in the U.S. permanently escaping U.S. taxation:
 - Payments of U.S.-source FDAP income including dividends by FCC to foreign person may be subject to withholding tax (as may be modified by treaty).
 - U.S. branch E&P shifted out of, or amounts of interest deducted by, U.S. branch of foreign corporation may be subject to branch profits tax or branch level interest tax.



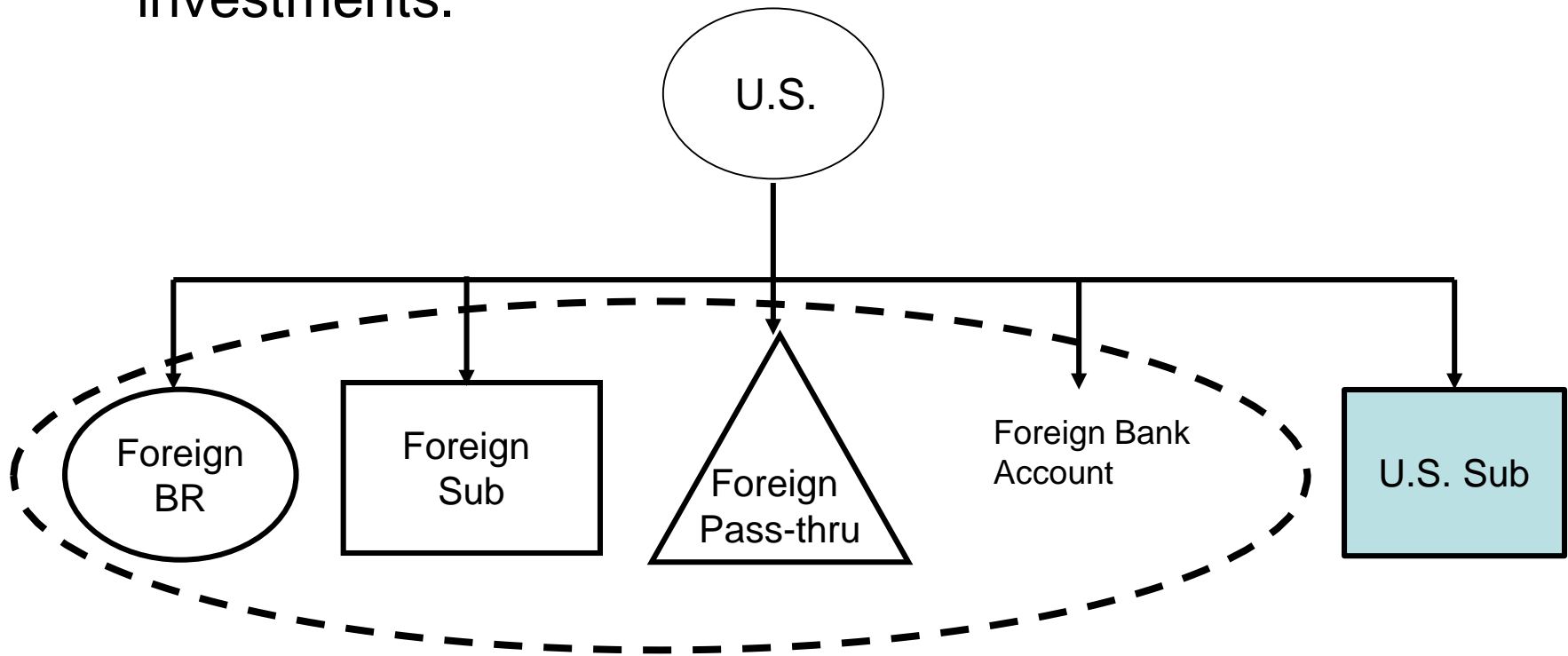
B-3. Individual Outbound Taxation



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Individual Outbound

- Individual Outbound focuses on U.S. citizens or resident aliens with foreign activities or foreign investments.



Individual – Jurisdiction to Tax

- Residency status is key to whether U.S. has jurisdiction to tax an individual
- To determine whether the U.S. has jurisdiction to tax the person in question, consider the following issues:
 - Determine whether the individual is a U.S. citizen, resident alien, NRA or whether the individual is a bona fide resident of a U.S. possession
 - Resident Alien: lawful permanent U.S. resident (“green card” holder); satisfies substantial presence test; or elects, under certain limited circumstances, to be treated as a resident alien.

U.S. Residency Status (pre-TCJA)

- U.S. citizens and resident aliens, whether residing abroad or in the U.S., must file a U.S. federal income tax return reporting their WW income from both U.S. and foreign sources.
- Residents of a U.S. possession generally file a single tax return with the territory of which the individual is a resident and not with the U.S. Facts and circumstances of each case are important to determine whether individual is considered a bona fide resident of a territory.

Special Rules in Taxation of U.S. Residents

- An individual may consider special applicable rules in the cross-border context:
 - Treatment of social security and self-employment taxes for U.S. individuals working abroad;
 - Treatment of cross-border pension plans;
 - Compliance with expatriation tax rules; and
 - Eligibility for any claimed credits, exclusions or special treatment.

U.S. Social Security and Self-Employment Taxes

- When are taxpayers working abroad subject to employment taxes?
 - Answer: Look to status of employer (U.S., foreign, or foreign affiliate of a U.S. MNE)

- When are taxpayers subject to self-employment taxes?
 - All U.S. citizens and resident aliens regardless of where they live or work

Cross-Border Pension Plans

- Participants in qualified domestic plans benefit from favorable tax treatment. In general:
 - Contributions to a domestic qualified plan by the taxpayer or employer are not includible in taxpayer's current income.
 - Earnings of a domestic qualified plan are tax-deferred.
 - Distributions from domestic qualified plan are taxed when received.
- Certain income tax treaties address the tax treatment of contributions to a foreign plan, plan earnings, and plan distributions.

Cross-Border Pension Plans (Cont'd)

- In the absence of an applicable treaty provision, contributions and earnings of a foreign pension plan for the benefit of a U.S. citizen or resident employee are generally taxed much like the contributions and earnings of a domestic non-qualified plan.
 - Employee plan contributions are non-deductible for U.S. income tax purposes;
 - The employee may be taxed currently on employer plan contributions; and
 - Plan participants are taxable currently on plan earnings.

Expatriation

- An “expatriation tax” is imposed on certain individuals who relinquish their U.S. citizenship or end their U.S. lawful long-term permanent resident (green card holder) status:
 - Generally applies only to certain high-income or high-net worth individuals, but can apply to anyone who fails to properly certify under penalties of perjury U.S. federal tax compliance for preceding 5 years.
 - Exceptions for certain dual citizens, but must still certify compliance.
 - Is a one-time tax on the unrealized gain of all property of the expatriate (regardless of location), calculated as if the property had been sold at its FMV on the day before the expatriation date.

Individual Credits/Exclusions/Special Treatments

- Eligibility for various credits, exclusions and special treatment depend on satisfying various requirements to claim these items.
 - Credits
 - Credits include the child tax credit/additional child tax credit, recovery rebate credit, premium tax credit, making work pay credit and earned income credit.
 - Exclusions
 - Certain qualified individuals may elect to exclude “foreign earned income” and foreign housing costs from gross income, subject to certain limitations.
 - Foreign earned income is limited to a base exclusion amount that is indexed for inflation.
 - Special Treatment
 - A U.S. citizen or resident alien employed by foreign government, or living and working in a designated combat zone, may be entitled to special treatment.



Individual Foreign Tax Credit

- A U.S. individual earning income from outside the U.S. may pay tax on that income to a foreign country. Double taxation often results because the same income is also taxable by the U.S.
- To mitigate this double taxation, a FTC is generally allowed against the U.S. income tax liability for foreign income taxes paid or accrued. This is the same FTC we discussed earlier.
- The calculation of the FTC involves complex rules, limitations and documentation requirements.

Individual Creditability of FTC

- Foreign Tax Creditability Requirements
 1. Taxpayer must have paid or accrued the tax
 2. The tax must be imposed on the taxpayer by a foreign country or possession of the U.S.
 3. The tax must be the legal and actual foreign tax liability
 4. The tax must be an income tax or a tax imposed in lieu of an income tax

Individual Calculation of FTC

■ FTC General Limitation

- The FTC is generally limited to the amount of tax the U.S. would have imposed on the taxpayer's foreign source income
- This is illustrated by the following formula:

$$\text{FTC Limitation} = \frac{\text{Foreign Source Income}}{\text{Worldwide Income}} \times \text{Total U.S. Tax}$$

Individuals Investing in Foreign Entities

- A U.S. individual may invest or conduct foreign activities through a foreign corporation or a foreign pass-through entity.
- The individual may seek to minimize U.S. tax by choosing a particular investment vehicle for his/her foreign activities.
- Therefore, it is important to understand the differing tax results of each entity type.

Individual Foreign Corporation

- Income earned by a U.S. individual investing through a foreign corporation is not subject to U.S. tax until distributed, unless it triggers one of the anti-deferral rules listed below:
 - Controlled Foreign Corporation – Similar to a domestic corporation, a U.S. individual that is a U.S. shareholder in a CFC will be subject to current U.S. taxation on the pro rata share of a CFC's subpart F income.
 - However, the subpart F income is taxed at the individual rate (not the corporate rate) AND an individual is not entitled to foreign tax credits on any foreign taxes paid or accrued by the CFC.
 - An individual MAY make a section 962 election to be subject to tax on its subpart F income as if it were a domestic corporation (but must still pay shareholder-level tax).
 - Passive Foreign Investment Corporation – A U.S. individual's investment in a PFIC may also be subject to current U.S. tax.

Individual Foreign Pass-Through Entities

- A U.S. individual who conducts activities or investments through a foreign pass-through entity will be generally subject to U.S. tax on all income earned through the entity on a current basis.
- An individual may make that investment through a foreign pass-through entity such as:
 - A foreign partnership
 - A foreign disregarded entity or foreign branch
 - A foreign trust
- Each pass-through entity will differ in how U.S. tax is imposed.



B-4. Individual Inbound Taxation



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U.S. Business Activities

- Nonresident aliens (NRAs) who engage in business activities that create a U.S. trade or business or permanent establishment (PE) may be subject to U.S. tax.
- This is dependent on if an NRA has certain types of income, including income effectively connected with a U.S. trade or business or profits attributable to a PE. Special filing requirements and failure to file penalties apply to NRAs.

U.S. Business Activities (Cont'd)

Example:

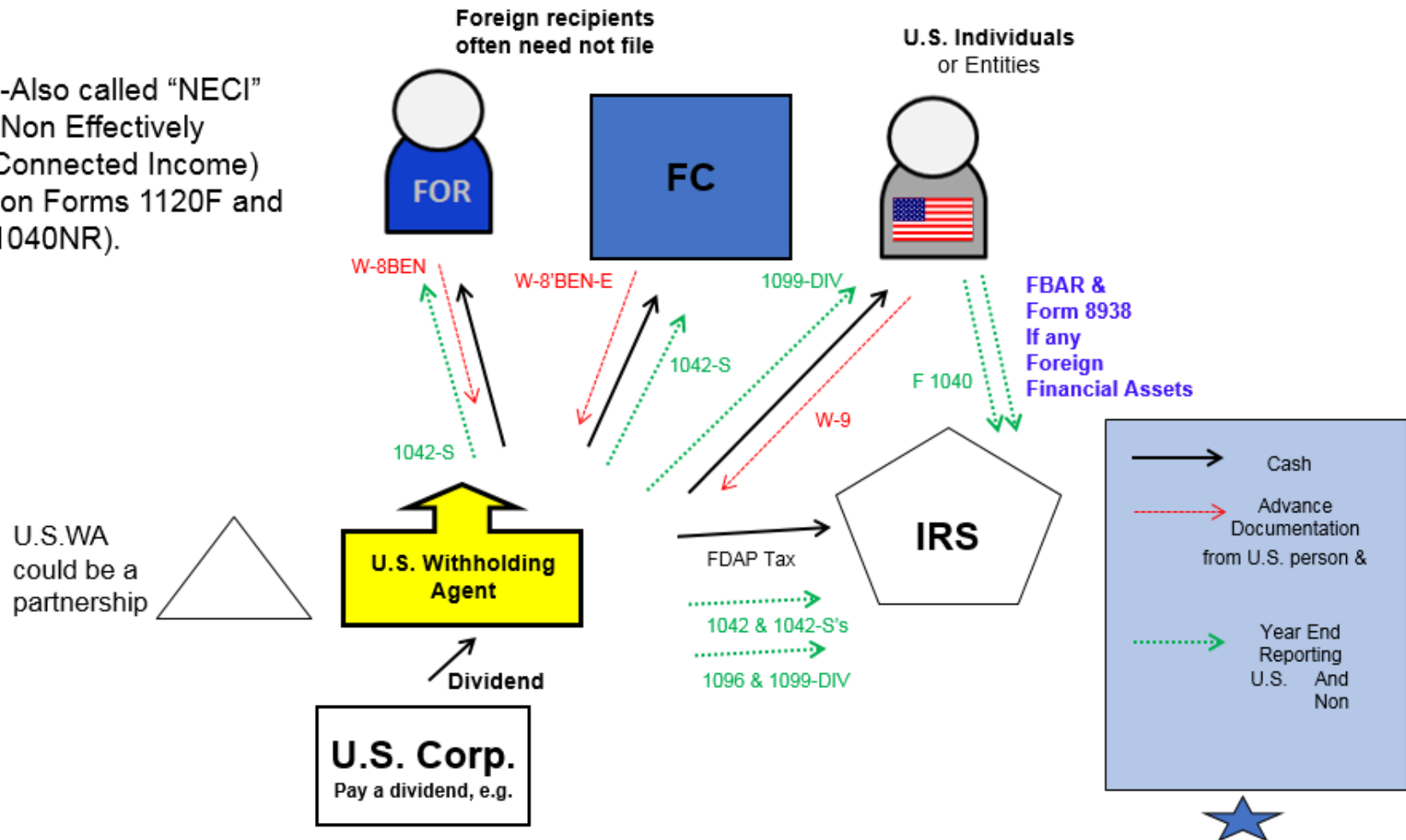
- During the tax year, an NRA F-1 student from China received \$10,000 in scholarship grants, \$15,000 for working as a teaching assistant and \$8,000 for a summer job.
- The taxability of these amounts will depend on the type of income and whether he is eligible for treaty benefits:
 - The scholarship grant of \$10,000 is exempt from U.S. tax under Article 20(b) of the U.S.-China income tax treaty.
 - The \$15,000 from teaching and \$8,000 from the summer job are income from personal services, of which \$5,000 is exempt from U.S. tax under Article 20(c) of the treaty.
- All the *taxable* amounts are considered ECI and the taxpayer should file Form 1040NR to report all the income and claim tax benefits.

Withholding

- A nonresident alien (NRA) may engage in U.S. investment activities and U.S. withholding taxes may be imposed on income from those investments.
- U.S. withholding tax rules apply to payments of U.S. source income to NRAs with respect to various types of portfolio investments such as “FDAP” and “FIRPTA” income.
- NRA is taxed on a sale of U.S. real property, and in certain situations the sale of shares of domestic corporations the business assets of which consist mostly of U.S. real property.

FDAP Withholding at Source

--Also called "NECI"
(Non Effectively
Connected Income)
(on Forms 1120F and
1040NR).



Chapter 3 Requirements

- The WA must determine the correct amount of withholding based on:
 - Income type (e.g., interest, dividend)
 - Source of income (U.S. vs. foreign)
 - Payee status (U.S. vs non-U.S.; beneficial owner vs intermediary or flow-through)
 - Payee type (e.g., corporation vs. individual)
 - Availability of treaty benefits or statutory exemptions
- Documentation is key.
- Presumption rules apply in the absence of documentation.

Reporting Requirements

- Form 1042 must be filed by any withholding agent or intermediary who receives, controls, has custody of, disposes of, or pays a withholdable payment (including U.S. source FDAP income).
- Generally, a single Form 1042 is filed consolidating the information from all of the Forms 1042-S filed by the withholding agent (whether the Form 1042-S reports an amount with respect to Chapter 3 or Chapter 4).
- Form 1042 is an annual return filed with respect to the previous calendar year.
- Form is required to be filed by March 15 (excluding extensions).

Reporting Requirements (Cont'd)

- In addition to a set of Forms 1042-S filed with the IRS copies of Forms 1042-S are sent to the to each beneficial owner.
- Documentation must be provided to the withholding agent before a payment is made. (W-8BEN,W-8BEN-E, etc.)
- In the absence of valid documentation (withholding certificate or documentary evidence, if permitted), or if the WA knows or have reason to know that the documentation is unreliable or incorrect, WAs must apply the presumption rules. Presumptions generally result in 30% withholding tax.



C. International Matrix (Pre- TCJA)

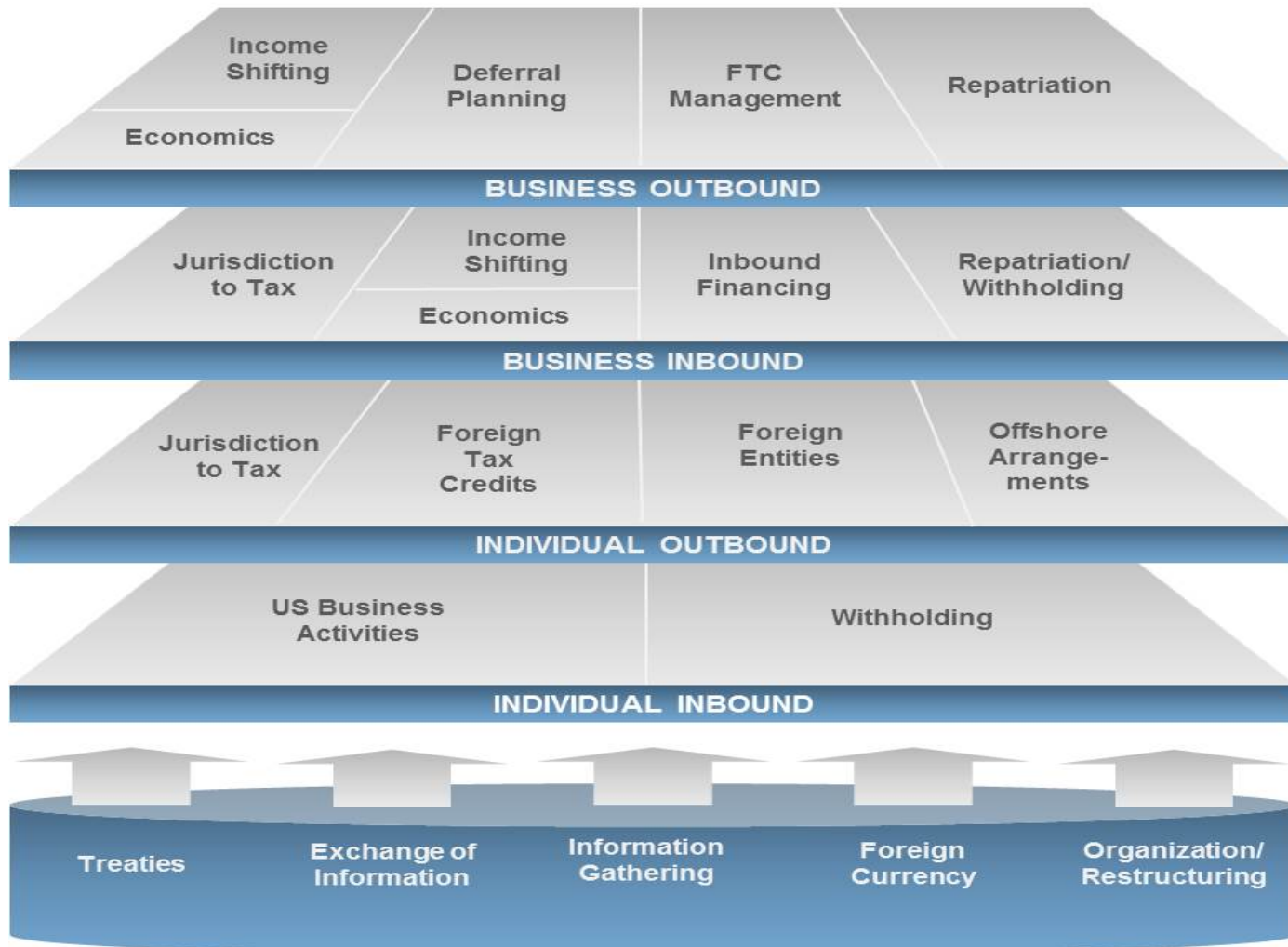


**Large Business
& International**

Introduction: LB&I International Program

- In 2010, LB&I implemented a new framework for approaching the international tax area which has been referred to as the International Matrix (but in the future may be known as the International Knowledge Base)
- The goals were to:
 - teach technical rules
 - focus on key strategic priorities
 - share knowledge through practice networks and a virtual library of practice units

The International Matrix



The International Matrix (Cont'd)

- The International Matrix consists of five faces—Business Outbound, Business Inbound, Individual Outbound, Individual Inbound and Crossovers.
 - It presents all areas (applicable to both businesses and individual taxpayers) of international tax in a relatively simple framework.
- The International Matrix organizes international tax based on the tax planning concepts from the Taxpayer's perspective, focusing on the most advantageous areas.
- The International Matrix is not tethered to the structure of the Internal Revenue Code (IRC) or Income Tax Regulations, but rather it presents a roadmap to allow an examiner to quickly identify areas where audit time is most warranted.

Internal Resources

The International Knowledge Management Base

- Tax resources to aid in the examination of Inbound and Outbound International issues involving Businesses and Individuals.
- <https://portal.ds.irsnet.gov/sites/VL008/Pages/default.aspx>

What Did We Learn?

You should now be able to:

- A. Describe the basics of U.S international tax (pre-TCJA)
- B. Describe the differences between inbound and outbound transactions
- C. Explain the organization and content of the International Matrix (pre-TCJA)

Appendix



**Large Business
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Glossary of Terms

Acronym/Terms	Definition
BR	Branch
CFC	Controlled Foreign Corporation
DD	Double Deduction
DE	Disregarded Entity
D/NI	Deduction/No Inclusion
DRD	Dividends Received Deduction
E&P	Earnings and Profits
ECI	Effectively Connected Income
ETR	Effective Tax Rate
FC	Foreign Corporation
FCC	Foreign Controlled Corporation
FDAP	Fixed, Determinable, Annual, or Periodic Income



Glossary of Terms

Acronym/Terms	Definition
FIRPTA	Foreign Investment Real Property Tax Act
FP	Foreign Parent
FSTI	Foreign-Source Taxable Income
FTC	Foreign Tax Credit
GTOC	Global Tax Organizational Chart
IP	Intellectual Property
IRC	Internal Revenue Code
MNE	Multinational Enterprise
NECI	Non-Effectively Connected Income
NRA	Nonresident Alien
OECD	Organisation for Economic Co-operation and Development



Glossary of Terms

Acronym/Terms	Definition
PE	Permanent Establishment
PFIC	Passive Foreign Investment Company
TCJA	Tax Cuts and Jobs Act
USTB	U.S. Trade or Business
WA	Withholding Agent

