

MEMO

To: PUBLIC
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U.S. TAXATION OF WORLDWIDE INCOME

I. TAX ISSUES

1. What US tax implications affect a US company with operations in a foreign country?
2. What US tax implications affect a foreign company or foreign subsidiary?
3. What individuals must pay US tax on foreign income?
4. What US tax implications affect a US person with shares in a foreign company?
5. What tax implications are there from transferring assets of a US entity to a foreign entity?
6. What tax implications are there from transferring assets of a foreign entity to US taxpayer?

II. ANSWERS

1. **US company with foreign operations.** The analysis turns on whether the entity is a branch or subsidiary. *See* III(A)-(B) *infra*.
 - a. Branch. Income of the branch is included in the gross income of the US parent.
 - b. Subsidiary.¹ Income is imputed to the US parent if it is “*effectively connected with the active conduct of a US trade or business*” (“effectively connected”).
 - i. Non-effectively connected income is not taxed until or unless the proceeds are repatriated or the stock in the foreign company is sold.
2. **Foreign entity.** Taxation depends on whether the income is effectively connected.
 - a. Effectively connected gains. Essentially, 30% tax.
 - b. Non-effectively connected gains. No US tax.
 - c. Portfolio Interest. No US tax unless it is a controlled foreign corporation.
 - d. Dividends paid by foreign company. No tax on foreign entity, but recipient may be liable.
3. **Individuals.** The only persons **not** subject to US taxation are non-citizens (who never were citizens) who are also non-residents and who do not receive income from a US source.

¹ A US corporation may maintain a “subsidiary” in a foreign country, which is treated as a foreign corporation. The distinction between a “branch” and a “subsidiary” is basically determined by whether the entity is organized under the laws of the host country.

- a. Citizens. Subject to US taxation no matter where they live or what the source of income is. There are some mitigating factors (e.g. foreign tax credit, personal services exclusion).
 - b. Resident Aliens. Subject to US taxation on worldwide income.
 - c. Expatriate non-resident. Subject to taxation for up to 10 years after loss of US citizenship, essentially 30% tax.
4. **US shareholder**. Generally, US shareholder does not pay tax on non-effectively connected income of a controlled foreign company (“CFC”) until the earnings are repatriated or the stock in the CFC is sold. **Caveat:** Certain “anti-deferral” provisions may override this general rule in specific instances.
 5. **Transfer of US assets to foreign entity**. This maneuver used to work, but there is a new provision that now requires recognition of gain on Outbound Transactions.
 6. **Transfer of foreign assets to US entity**. Generally, there is no tax on the Inbound Transaction, but any realized gains will eventually have to be recognized by US taxpayer.

III. ANALYSIS²

A. US Corporation with a Foreign Branch

A US corporation is generally subject to US tax on the income of its foreign branch. There is a credit for foreign tax paid (i.e. no double taxation), so foreign branches pay the difference between the tax rate of the host country and the applicable US tax rate. §901.

The advantage of this arrangement is that the US parent may also claim the losses of the foreign branch. Be aware that there are rules governing the situation where a branch is converted to a subsidiary as soon as, but not until, it becomes profitable. §367.

B. Foreign Corporation/Subsidiary

1. Taxed Transactions

- a. US Source “fixed” or determinable” annual or periodic income §921, §881(a)(1).
- b. Effectively connected income. Income that is effectively connected with the active conduct of a US trade or business is subject to typical corporate taxation. §882(a)(1).
- c. Non-effectively connected income. Basically, no tax for our purposes. There is a 30% tax on *certain* non-effectively connected income, but nothing applicable to Formula Costa Rica. §881(a).

² This memorandum was originally prepared for a client, so this section was tailored to his particular situation. Accordingly, please note there are many details omitted which may pertain to the reader’s situation.

- d. Election option. A foreign corporation has the option to treat income gained from the sale of real property as income gained in connection with a US business. §882(d)(1).
- e. Transfer of assets from US corporation to foreign corporation (“Outbound Transaction”). Such a transaction under Subchapter C would normally defer taxation and, possibly, result in full forgiveness of tax since, in this case, the jurisdiction of the IRS in Costa Rica is very limited.³ However, §367 is intended to prevent this result by requiring recognition of gain/loss on Outbound Transactions. There are certain exceptions to this rule—*e.g.* there is no tax on transfer of company goodwill—but none that seem useful.
- f. Dividends paid by foreign company. The general rule is no tax until repatriated or stock in foreign company is sold. §881(a); §871(i)(2). As a result, many US companies would create subsidiaries in low-tax countries and keep their excess profits there until needed. When the funds were required, the money could be transferred and tax paid. Or, a loan could be made, which generated deductions for the parent company. In response, Subpart F was created.

Now, the US shareholders must pay tax on certain “Subpart F” income received by the subsidiary.

2. Tax-Free Transactions

- a. Income not effectively connected with the US is **not** subject to tax. §882(a)(1).
- b. Short-term capital gains dividends. No tax. §881(e)(2).
- c. Transfer of assets from foreign corporation to US corporation. A foreign corporation can generally transfer assets to a US corporation tax-free if it is in exchange for stock, provided the transferors are in control of the transferee corporation immediately after the transfer.⁴ §§351, 355.
- d. Inbound and foreign to foreign transactions. Generally, not subject to US taxation. §367(b); *see also* Treas. Reg.

C. US Shareholders of Foreign Corporations

1. Definitions §7701

- a. “US Shareholder”—citizen or resident of the US, domestic corporation, or trust over which a US court may exercise supervision.

³ Currently, the only tax treaty between the US and Costa Rica is an agreement to share information.

⁴ Recognition of the gain is simply deferred.

- b. “Controlled Foreign Corporation”—more than 50% of the stock is owned by US shareholder(s). §957.
- c. “Dividend”—any distribution of property made by a corporation to its shareholders out of its earnings and profits. §316(a).

2. Rules

- a. Generally, US shareholder does not pay tax on non-effectively connected income of CFC until the earnings are repatriated or the stock in the CFC is sold, although some “anti-deferral” provisions may override this general rule.
- b. Tax-Free Distributions. Distributions made to shareholders more than five years after the transaction in which gain/loss was recognized.
- c. Distributions other than money. Basis is the FMV of the property. §301(b)(1)(C).
- d. Dividends are included in gross income. §301(c)(1).

D. US Citizen

- 1. Worldwide Income
 - a. US citizen domiciled abroad must still pay US tax according to the same rules, and situs of property from which gain is derived does not matter either. *Cook v. Tait*.
- 2. Mitigating Factors
 - a. Credit for foreign taxes paid.
 - b. Exclusion allowed for payment of personal services rendered, up to 75K.

E. Non-Resident Alien §871

- 1. Effectively connected non-capital gains. There is a 30% tax on *certain* non-capital gains earned by non-resident alien. §871(a)(1). [**Note:** This may not apply to you, though. Original discount obligation?]
- 2. Capital gains of aliens present in the US 182+ days. Tax of 30% on net gains from sale of effectively connected capital assets. §871(a)(2).
- 3. Income from US business. Normal taxation on effectively connected income. §871(b).

4. Election to treat gains from real property as business income. A non-resident alien has the option to treat capital gains as business income. §871(d)(1).

F. Expatriate §877

1. Alternative Tax. The expatriate has to pay an “alternative tax” if that amount is greater than the tax imposed on non-resident aliens under §871.
2. Sale of US Property. For purposes of this section, gains on the sale or exchange of property (other than stock or debt obligations) located in the US are considered to be from a US source. §877(d)(1)(A).