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# INTERNATIONAL COMMERCIAL AGREEMENTS

## Certain Tax Issues Relating to International Commercial Agreements

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# I. Introduction

## A. Scope of Outline

1. Special U.S. tax considerations arise in the international context because of the tension between the myriad of U.S. tax rules designed to avoid the erosion of the U.S. tax base and the rules of other countries designed to achieve a similar purpose for themselves and the legitimate tax planning of taxpayers attempting to live with-in the ever changing and often irreconcilable rules of the various jurisdictions in which they operate. Certain of the problems become apparent when considering agreements relating to transactions in which at least one party is a "U.S. person" (as hereinafter defined) and another party (or person deemed to be a party) is either a "non-U.S. person" (as hereinafter defined) or, in certain cases, a non-U.S. corporation in which U.S. persons are significant shareholders. Thus, e.g., an agreement or arrangement between two non-U.S. corporations may have U.S. tax significance if U.S. persons are significant shareholders of at least one of the non-U.S. corporations. Moreover, in certain limited circumstances, an agreement between two U.S. corporations may have special U.S. tax considerations apply of non-U.S. shareholders control one of the U.S. corporations. See, IRC § 367(a); Treas. Reg. § 1.367(a)-1T(c)(2).

   (a) A "U.S. person" includes a U.S. citizen, an alien individual who is regarded as a resident of the U.S. for U.S. federal income tax purposes, U.S. resident trust, and a U.S. corporation. All other persons are referred to as "non-U.S. persons." See, e.g., IRC §§ 7701(b) cf. IRC §§ 864, 881, 882, and 884.

   (b) A non-U.S. corporation in which U.S. persons are significant shareholders may be considered:

      (i) a controlled foreign corporation ("CFC"). See, IRC § 957(c); or

      (ii) a foreign personal holding company. IRC § 552.

(c) A U.S. person who is a shareholder in a non-U.S. corporation may also have to take into account the passive foreign investment company rules. See IRC §§ 1291 et seq.

(d) A U.S. person who is a shareholder in a CFC may have to take into account the pro rata share of accumulated earnings of the CFC invested in excess passive assets. IRC §§ 951(c), 956A, and 959 c.f. § 956

(i) This new change in law eliminates the deferral of tax to the extent CFC's accumulated earnings are invested in excess passive assets. The amounts are not includable, however, to the extent they represent previously taxed earnings and profits. See, Senate Committee Report discussion on Revenue Reconciliation Act of 1993, S. Fin. Comm. Rep. No 36, 103rd Cong., 1st Sess. (1993).

2. International commercial agreements may take a variety of different forms, including:

(a) Incorporation or unincorporated joint ventures for U.S. operations, or for non-U.S. operations, or both.

(b) Licenses for use of patents, technology, copyrights, etc. in the U.S. or outside U.S., or both.

(c) Loan transactions between U.S. lenders and non-U.S. borrowers, or non-U.S. lenders and U.S. borrowers.

(d) Swap agreements - notional principal and interest rate swaps.

(e) Participation agreements between or among lenders and swap counterparties.

(f) Agency and/or representation agreements.

(g) Other service agreements.

(h) Sales agreements.

(i) Distribution agreements.

(j) Agreements for the acquisition/disposition of a company or part thereof.

(k) International tax agreements, including income tax conventions, social security compacts, information sharing agreements.

(l) Advanced transfer pricing agreements.

(m) Withholding agreements and related gross-up and tax indemnity provisions.

3. Because different tax consequences may obtain depending on the "type of agreement," parties often plan to restructure their arrangements in a form that would achieve more favorable tax objectives.

(a) Opportunities may be available where different jurisdictions view the same arrangement in different ways.

(i) Consider, e.g., grantor trusts.

(b) Difficulties may arise where, because of differing tax rules of two or more jurisdictions, the optimum form dictated by the rules of one jurisdiction create problems for the counterparty residing in the other jurisdiction.

(i) Where the two jurisdictions view different parties as the technical taxpayer, tax credits may be more difficult to obtain.

4. This outline is limited to an overview of certain of the relevant U.S. tax issues that may arise in certain types of international commercial agreements. The outline is by no means intended as an exhaustive exposition of all of the U.S. tax issues which might arise in the various forms of international commercial agreements.

5. Before considering the tax considerations outlined below, it may be helpful to keep in mind what has become a recurrent theme in the U.S. taxation of international transactions, i.e., the U.S. legislative policy to expand upon the tax base, apparently, regardless of the effect such

expansion may have on international commerce. In furtherance of this policy, the U.S. has taken steps in recent years through changes in the Internal Revenue Code (the "Code") and regulations as well as through discussion of further proposed changes to preserve and expand the U.S. tax base by:

(a) enacting deduction deferral statutes or broadening those already on the books, such as IRC §§ 163(e)(3), § 163(j), 465, and 469 certain of which are directly aimed at non-U.S. persons; cf. IRC §§ 951, 956A and 959;

(b) narrowing or limiting the amount of allowable deductions through sections such as IRC §§ 274, 162, and 163(j) and raising the corporate rate of tax. IRC §§ 11, 882, and 1201.

(c) broadening transfer pricing provisions through amendments of sections 482 and 367; furthermore, by proposing legislation which would require arbitraty allocations. See, The Foreign Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, 102nd Cong. 2nd Sess. (1992) ("FITRSA") (which failed to pass through congress, however, it seems apparent that some form of FITRSA will be reintroduced to Congress in the future).

(d) extending required information reporting of international transactions. (See IRC § 6038A);

(e) tightening base erosion provisions through various amendments to section 367 and the regulations thereunder;

(f) extending U.S. tax jurisdiction to cover dispositions by non-U.S. persons of U.S. real property interests (IRC § 897; See also IRC §§ 864(c)(6)-(7), and proposing to tax other capital gains of non-U.S. persons;

(g) limiting deferral of foreign income through various amendments to the controlled foreign corporation, foreign personal holding company and passive foreign investment company rules and by making further proposals in this regard;

(h) limiting the availability of foreign tax credits by the adoption of numerous hurdles in the form of separate "baskets" (IRC § 904(d); and thereby increasing the incidence of double taxation;

(i) granting the IRS authority to recharacterize multiple-party financing transactions to permit taxing by the U.S. (See IRC § 7701(1) and any regulations which may be prescribed thereunder).

(j) enforcing the collection of taxes through new withholding rules, (see IRC §§ 1445 and 1446), and by putting teeth into the dividend withholding rules as they relate to foreign corporations doing business in the U.S. (See IRC § 884);

(k) overriding by statute treaty obligations and thereby not only making tax treaty negotiations more difficult but fostering a climate of concern for non-U.S. person investors; and

(l) seeking to limit treaty benefits to only certain treaty residents. See, infra I(B)(4)(f).

B. Basic Rules of U.S. Taxation

1. While the rules are many and are constantly changing, the basic principles are surprisingly simple.

2. It should come as no surprise that the rules of U.S. taxation differ depending on whether the taxpayer is a U.S. person or is not a U.S. person. As noted above, in the case of U.S. persons, income consequences to certain non-U.S. entities in which such person has an interest must also be considered and in the case of a non-U.S. person, income consequences with certain U.S. entities in which such person has an interest must too be considered.

3. Taxation of U.S. persons.

(a) In general, a U.S. person is subject to U.S. federal income tax on worldwide income. IRC §§ 1, 11, and 61; Cf. IRC §§ 871, 881, and 882.

(b) Income of a non-U.S. corporation may be attributed to its U.S. shareholders in certain limited circumstances. See IRC §§ 551, 951, 956, 956(A), and 1293.

(c) Where income attribution is not required, income earned by a non-U.S. corporation is not includable by its U.S. shareholders until repatriated, i.e., such income is deferred. In certain cases there is a penalty imposed for the deferral. IRC § 1291. cf. IRC § 668.

(d) In certain circumstances, income of a U.S. person may also be subject to a non-U.S. tax, e.g., where such income is earned through the conduct of a trade or business in another country through a permanent establishment. See, e.g., U.S. Treasury Model Income Tax Treaty of June 16, 1981, ("U.S. Model Treaty"), Article 7, 1 CCH Tax Treaties, ¶211. Note: the Internal Revenue Service has announced its intention to issue a revised U.S. Model Treaty.

(e) The U.S. system of taxation deals with issues of double taxation (i.e., the legal taxation by the U.S. and another jurisdiction of the "same income") through a foreign tax credit mechanism. IRC § 901 et seq. (Certain other countries resolve issues of double taxation through what is referred to as an "exemption system" under which income attributable to foreign activities of a resident conducted in a country that generally imposes a tax is exempt from taxation in the home country. See, e.g., U.S. -Switzerland, Article XV(1)(b), incorporating the exemption system into the tax treaty with the U.S.).

(i) Very generally, under the U.S. foreign tax credit provisions, a non-U.S. income tax (or tax imposed in lieu thereof) is creditable against U.S. income tax imposed on non-U.S. income of the same general type. See IRC §§ 901 and 904(d). However, the allowable foreign tax credit for a year cannot exceed the smaller of (x) the foreign tax paid with respect to a

specified category of income, (y) the U.S. tax paid with respect to the same category of income with the latter amount subject to a limiting fraction being non-U.S. taxable income from such category, divided by total taxable income for such category. Any foreign tax paid in excess of the allowable credit may be carried forward for five years and back two years. IRC § 904(c).

(ii) In order to determine non-U.S. income, income must be allocated between U.S. and non-U.S. sources (see e.g., IRC §§ 861 and 862) and expenses, losses and other deductions must be apportioned between U.S. and non-U.S. income. See also Reg. § 1.861-8.

(f) An affiliated group of U.S. companies with a common U.S. parent may file a consolidated federal income tax return thereby combining the results of all component members of the group of companies. See IRC § 1504. But see IRC § 1503(d).

(g) In general, a U.S. person is unable to transfer appreciated property to a non-U.S. person without recognition of income equal to the excess of the fair market value of the property over its basis even if the transaction might otherwise be described in a tax-free rollover provision. See IRC §§ 368, 367, and 1491.

(4) Taxation of non-U.S. persons.

(a) A non-U.S. person is subject to federal income tax only on its income which is or is considered to be "effectively connected" with the conduct of a U.S. trade or business and on certain types of U.S. source fixed, determinable or annual income. IRC §§ 864(c), 871, 881, 882, and 897.

(b) Certain types of non-business income, such as interest, dividends, rents and royalties derived from U.S. sources are subject to a 30% rate of tax usually collected by withholding at the source by the payor of such income. IRC §§ 871, 881, 1441, 1442, and 7701.

(i) Where withholding is applicable, the failure to withhold renders the person having the control receipt or custody of the payment liable for the tax it failed to withhold. IRC § 1461. However, such tax, but not interest or penalties for the failure to withhold, is abated if the tax of the recipient of the income is paid. IRC § 1463.

(c) Whether an item of income is deemed to be from U.S. sources is determined under certain specific rules. IRC §§ 861, 862, and 863.

(i) Interest and dividends paid by a U.S. corporation are considered U.S. source income. IRC §§ 861(a)(1)-(2), cf. IRC § 861(a)(1)(A).

(ii) Interest paid by a U.S. trade or business of a foreign corporation is also treated as U.S. source income. IRC §§ 884(f)(1)(A) and 861(a)(1).

(iii) Swap income is considered to be sourced in the country of the residence of the recipient unless effectively connected with a U.S. trade or business in which case the income is from U.S. sources. See Notice 87-4, 1987-1 C.B. 416.

(iv) Royalties and rents are considered sourced where the property is used which gives rise to the payment. IRC §§ 861(a)(4) and 862(a)(4).

(v) Compensation is considered sourced where the services for which payment is made have been rendered. IRC §§ 861(a)(3) and 862(a)(3). W.N. Dillin, 56 T.C. 228 (1971); Karrer v. United States, 152 F. Supp 66, 71 (Ct. CL. 1957).

(vi) For rules determining source in special cases, see IRC § 863(b) and the regulations thereunder. See also IRC §§ 861(c), 863(c), 863(d) and 863(e).

(d) Certain tax treaties to which the U.S. is a party modify certain of the above rules. Thus, e.g., tax treaties:

(i) May eliminate the tax (and therefore the requirements for withholding) on interest and royalties. See, e.g., Income Tax Convention between the U.S. and the Netherlands, Article VIII (interest), Article IX (royalties), U..S. -U.K. treaty, Article 11 (interest), Article 12 (royalties). Certain treaties may reduce, rather than eliminate, the otherwise applicable rate of tax. See, e.g., U.S. -Japan treaty, Article 13 (10% rate on royalties), Article 14 (10% rate on royalties), U.S. -Switzerland treaty, Article VII (5% rate on interest), U.S. -Canada treaty, Article XI (15% rate on interest).

(ii) Reduce the tax rate on dividends. See, e.g., U.S. -Canada treaty, Article X.

(iii) Insulate a treaty resident from tax on its business profits unless attributable to a U.S. permanent establishment. See, e.g., U.S. -Germany treaty Article 7.

(vi) Preclude the U.S. from providing worse treatment for treaty residents. See, e.g., U.S. -France Treaty, Article 24.

(e) In certain circumstances, the Code provisions specifically override the tax treaty provisions between the U.S. and other jurisdictions.

(f) Finally, newer tax treaties to which the U.S. is a party limit benefits to certain types of residents. See, e.g.,U.S. -Germany treaty, Article 28; U.S. -France

treaty, Article 24A; and proposed U.S. -Netherlands treaty, Article 26.

## II. JOINT VENTURES

### A. General Rules

1. In the commercial world the term "joint venture" is often used to describe either a corporation which is owned by two or more different interests (an "incorporated joint venture"), or an agreement or arrangement pursuant to which two or more parties agree to conduct a business or common investment for profit, albeit not through a corporate vehicle (an "unincorporated joint venture").

2. An incorporated joint venture is likely to be regarded as a corporation for tax purposes:

   (a) If formed pursuant to the corporation laws of any state, the District of Columbia, or the U.S.. Cf. Rev. Rul. 88-8, 1988-1 C.B. 403.

   (b) However, if formed pursuant to the laws of a foreign country, it will be treated as an unincorporated organization and therefore may or may not be regarded as a corporation, depending on whether its local law attributes more closely resemble a corporation than a partnership tested under the association regulations outlined below. See Rev. Rul. 88-8, supra; Rev. Rul. 73-254, 1973-1 C.B. 613.

      (i) An unlimited company incorporated under the Companies Act of England held not to be regarded as a corporation where memorandum of association provided for unlimited liability and precluded free transferability of shares. Rev. Rul. 88-8, supra.

      (ii) GMBH held to be an association taxable as a corporation. Rev. Rul. 77-214, 1977-1 C.B. 408. See also Larry D. Barnette, 1992 RIA T.C.M. ¶92, 371.

   (c) However, under certain treaties a juridical entity under foreign law will be regarded as a corporation of the foreign country for

treaty proposes. See, e.g., U.S. -Netherlands treaty, Article II(1)(d). See also, Aiken Industries Inc., 56 T.C. 925 (1971), acq., 1972-1 C.B. 1 (holding that for treaty purposes the definition of Honduran corporation contained in the treaty controls).

B. Association Regulations

1. Whether a joint undertaking to carry on a business for profit (other than one conducted through a U.S. corporation) will be regarded as a corporation for U.S. tax proposes is determined under what is referred to as the "association regulations." See Treas. Reg. § 301.7701-2. Under those regulations:

(a) Characteristics common to both partnerships and corporations, such as associates and an objective to carry on a business for profit are generally not taken into account for the purpose of determining whether the entity is to be regarded as a corporation or a partnership. Treas. Reg. § 301.7701-2(a)(2).

(b) In order for an entity to be regarded as a corporation, it must have more corporate characteristics than noncorporate characteristics. Treas. Reg. § 301.7701-2(a)(3).

(i) Continuity of life. An organization has continuity of life if the death, insanity, bankruptcy, retirement or expulsion of a member will not cause a formal dissolution of the entity under local law. A partnership formed pursuant to the Uniform Partnership Act and Uniform Limited Partnership Act will generally not have this corporate characteristic even if the partners agree to continue the business subsequent to the formal dissolution. Treas. Reg. § 301.7701-2(b).

(ii) Centralized Management. The corporate characteristics of centralized management exists if under the law governing the arrangement a person or group of persons not including all members have the exclusive authority to manage the business. Treas. Reg. § 301.7701-2(c).

A. This corporate characteristic will generally not exist in the case of a general partnership.

B. It will also generally not exist in the case of a limited partnership formed under U.S. law unless substantially all interests are owned by the limited partners.

(iii) Limited Liability. The corporate characteristic of limited liability exists if no member has personal liability. Treas. Reg. § 301.7701-2(d).

A. Under this "liberal" rule, virtually all general partnerships do not possess this corporate characteristic, even if the partners are all single purpose corporations.

B. Furthermore, limited partnerships will generally not possess this corporate characteristic unless no general partner has any significant assets apart from his investment in the partnership and all general partnerships are "dummies" (i.e., agents or nominees for the limited partners).

C. Limited liability companies formed pursuant to special legislation may qualify as partnerships. Rev. Rul. 88-76, 1988-2 C.B. 360.

(iv) Free transferability of interests. This corporate characteristic exists if members having a substantial ownership interest may sell their interest to a third party and substitute that party as a member without the consent of other members. Treas. Reg. § 301.7701-2(e).

A. The right to assign only a share in profits is not equivalent to the right to substitute.

B. General partnerships cannot have this corporate characteristic, since a substitution causes a formal dissolution.

C. Limited partnerships can have this corporate characteristic depending on what the agreement provides.

2. Under the above rules there is considerable flexibility for structuring arrangements to ensure partnership classification.

3. The IRS has issued guidelines for obtaining advanced rulings which provide somewhat more stringent rules than may be required under the above rules. See Rev. Proc. 89-12, 1989-1 C.B. 798. However, for all practical purposes, the IRS will generally not rule on the status of a foreign organization as a partnership. Rev. Proc. 90-6, 1990-1 C.B. 430.

C. The Characterization Issue

1. The above assumes that there is an entity for the joint conduct of business which either will or will not be regarded as a corporation or a partnership. Other commercial arrangements between independent parties may have to be analyzed to determine whether such arrangement might have to be evaluated under the above rules.

2. Examples of arrangements which may require such analysis include:

(a) Loans with interest calculated by reference to "profits."

(b) Licenses with royalties measured in whole or in part by profits.

(c) Participation agreements among lenders.

(d) Production/distribution agreements.

See Carnegie Productions, Inc., 59 T.C. 642 (1973); Rev. Rul. 70-435, 1970-2 C.B. 100; R.A. Meister, 1988 CCH T.C.M. ¶40, 355.66.

3. In each of the above cases the inquiry is whether there is an intention to have a joint undertaking to carry on a business for profit in which there is a sharing of profits (usually but not necessarily a sharing of losses) and a joint management of the business. See Commissioner v. Culbertson, 337 U.S. 733, 37 AFTR 1391, 1395 (1949); Commissioner v. Tower, 327 U.S. 280, 34 AFTR 799, 803 (1946); Hubert M. Luna, 42 T.C. 1067 (1964).

D. Tax Attributes

1. Profits derived from joint ventures which are considered to be corporations for U.S. tax purposes:

(a) Are subject to two layers of tax, first a U.S. corporate layer of tax (IRC § 11; cf. § 1363); and second, a tax on after-tax earnings either when distributed (IRC §§ 301, 312, and 316) or, when earned (IRC §§ 884, 951, 956, and 956A); cf. IRC §§ 531, 541, 551, 951, and 1248).

(b) Generally will not qualify for inclusion in a particpant's consolidated return because of the inability in most cases to meet the 80 percent vote and value requirements of IRC § 1504(a)(2), and as a result a participant's share of profits or losses may not be compensated for or set off by other profits or losses in such participant's group.

(c) Double taxation of U.S. corporate profits is minimized, but not avoided in the domestic context through the dividends received deduction available to a corporate recipient (in an amount equal to 70 percent of the dividend (IRC § 243(a)(1)) or 80 percent in the case of a 20 percent or more owned subsidiary; IRC § 243(c)). Thus, corporate profits become subject to a 10.5% additional federal tax in the case of a less than 20% owned subsidiary, and a 7.0% greater tax in the case of dividends from a 20% or greater owned subsidiary.

(i) In the international context, double taxation is minimized through an indirect foreign tax credit in the case of dividends paid by a foreign corporation to a U.S. corporation owning at least 10 percent of the voting power of the payor's stock. IRC § 902.

(d) Creates certain inflexibility:

(i) In connection with the termination of the venture. But cf. IRC § 336.

(ii) In the case of distributions of appreciated property. IRC § 355.

(e) Dividends paid by U.S. corporations to non-U.S. persons are subject to a withholding tax of 30%, or such lower rate as may be prescribed by an applicable tax treaty. IRC §§ 1441, 1442, and 894.

(f) While a dividend paid by a non-U.S. corporation is generally not subject to withholding (IRC § 884(d)(3) c.f. IRC § 1442), the entity may be subject to a "branch profits tax" and a "branch level interest tax." See generally, IRC § 884.

2. Joint ventures which are not considered to be corporations for U.S. tax purposes:

(a) In general, are not subject to an entity level tax. Rather, each participant is required to take into account its distributive share of the profits and losses of the venture. As a result one layer of corporate tax is completely eliminated.

(b) Each participant may include its distributive share of the results of the venture on its tax return (including its U.S. consolidated tax return, if any) enabling a participant to use losses generated by the venture against profits on its tax return and to offset profits generated by the venture with losses in its separate tax return subject, of course, to various limitations. IRC §§ 269,

382, 384, etc. Each participant may also be treated as having paid its distributive share of any foreign taxes imposed on or withheld from the venture.

(c) Subject to certain limitations (see IRC § 704 and the regulations thereunder), there is considerable flexibility for dealing with the different interests of the participants.

(d) Each participant in a venture which is engaged in a U.S. trade or business as defined in IRC section 875 would be required to file a U.S. tax return and would be subject to U.S. tax on the portion of its profits which were allocable to its venture income.

(e) Each non-U.S. participant of a venture that was engaged in a U.S. business would be subject to having its distributive share of the profits of the venture subject to payment of a withholding/estimated tax. See IRC § 1446.

## III. Loans

### A. Debt vs. Equity

1. Tax Significance of Distinction. The distinction between debt and equity can have considerable tax significance generally, and in particular in connection with "international financing." Indeed, financing by way of debt rather than equity will usually give rise to a more tax-efficient structure.

(a) Deductibility, in general. Interest paid or accrued on bona-fide debt incurred in connection with a trade or business is currently deductible by the borrower, generally regardless of whether the lender is subject to U.S. income tax with respect to such interest income (IRC § 163(a)) and as a result in many cases there can be a positive "tax arbitrage."

(i) Domestic exempt organizations. An organization described in IRC § 501(c) or (d) (an exempt organization) is generally exempt from tax on interest income. IRC

§§ 501(a) and 512(b)(1). However, that exemption does not apply to the receipt of interest from a "controlled organization" to the extent of such organization's non-exempt income. IRC § 512(b)(13).

(ii) Portfolio interest. A non-U.S. person is generally exempt from U.S. tax on U.S. source interest income if such interest qualifies as portfolio interest under IRC §§ 871(h) or 881(c).

A. In general, all interest currently received on debt issued after July 18, 1984 qualifies for the portfolio interest exemption, except:

(1) Registration requirement in certain cases. Interest on debt which is required to be in registered form (of a type issued to the public) but is not in registered form. IRC § 871(h)(2).

(2) Ten Percent Shareholder. Interest paid to a 10% shareholder. IRC § 871(h)(3). The term 10% shareholder means a person who directly or indirectly and through ownership attribution rules, owns, or is considered as owning:

- In the case of a corporate borrower, 10% or more of the total combined voting power of the

borrower. IRC § 871(h)(3)(B)(i).

- In the case of a partnership borrower, 10% or more of the capital or profits of such partnership. IRC § 871(h)(3)(B)(ii).

(3) Contingent Interest. The portfolio interest exemption available has been restricted to exclude certain contingent interest. IRC § 871(h)(4). The term contingent interest is determined by reference to receipts, sales, income or profits, dividends, distributions or property values.

(4) Banks. In the case of a corporate lender that is a bank, portfolio interest does not include interest received in an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business. IRC § 881(c)(3)(A).

(5) CFCs. Interest received by a controlled foreign corporation from a related person. IRC § 881(c)(3)(C).

B. Under the broad definition of portfolio interest, the following results may obtain:

(1) Interest paid by individuals appears to qualify as portfolio interest in all cases unless that interest is contingent.

(2) A lender which owns, either directly or indirectly and taking into account the applicable ownership attribution rules, less than 10% of the voting power of a U.S. corporate borrower may obtain the benefit of this rule even if the lender owns more than 10% of the equity of the corporation. However, a different and more stringent rule apparently applies in the case of partnership borrowers. See supra III A(1)(a)(ii)(2).

(iii) Treaty exemptions/reduced rates.

A. Various income tax conventions to which the U.S. is a party exempts from U.S. tax interest received by a resident of the other contracting state. See supra, I(B)(4)(d)(i).

B. Other tax treaties reduce the otherwise applicable statutory 30% rate to a

lower rate. See supra, I(B)(4)(d)(i) and (ii).

C. In order for an exemption from or a reduced rate of tax afforded by a tax convention to apply, the recipient of the interest must be the beneficial recipient of the income. See, Aiken Industries, Inc., supra; Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383; Rev. Rul. 87-89, 1987-2 C.B. 189.

D. Code section 884(f)(3) requires that the recipient of interest from a foreign corporation be a "qualified resident" of the treaty country in order for a treaty exemption or reduced rate to apply, i.e., a standard considerably more stringent than being merely a "resident" and beneficial recipient.

E. Several tax treaties to which the U.S. is a party limit treaty benefits to residents who have a substantial nexus to the treaty country. See, e.g., U.S.-German treaty, Article 28; U.S.-France treaty, Article 24A.

(b) Interest may not be currently deductible in a number of different circumstances.

(i) Original issue discount payable to a related foreign person is not deductible until paid. IRC § 163(e)(3).

(ii) Interest (and other deductible payments) payable to a related person is not deductible until the year in which such person is required to include the payment in income. IRC § 267(a).

(iii) Under section 163(j) (the so-called income stripping rule), interest paid by a corporation to a related person exempt from tax on such income is currently deductible only to the extent such interest does not exceed the corporation's "excess interest expense."

A. Excess interest expense means, generally, the excess of a corporation's net interest expense, over 50% of the corporation's adjusted taxable income.

B. Adjusted taxable income means taxable income plus:

(1) net interest expense.

(2) depreciation.

(3) net operating loss deduction and under proposed regulations in the case of the disposition of any asset, less the depreciation deductions taken with respect to such asset for years beginning after July 10, 1986. Prop. Reg. § 1.163(j)-2(f)(3).

C. In making the above calculations affiliated companies are treated as one.

D. Interest with respect to which there is a reduced treaty rate is treated as partially exempt. IRC § 163(j)(5)(B).

E. A deduction is not deferred under this section if the debt to equity ratio does not exceed 1.5 to 1. For a special rule under the proposed regulations relating to the computation of the debt to equity ratio see Prop. Reg. § 1.163(j)-5(e).

F. Interest deferred under this section may be carried forward indefinitely.

(iv) Certain interest may be required to be capitalized. See IRC §§ 263 and 263A.

(v) Interest may be deferred under the passive activity loss rules. IRC § 469. See also IRC § 465.

(vi) In the case of a foreign corporation, interest is deductible only to the extent such interest is treated as attributable to income which is effectively connected with a U.S. trade or business. Treas. Reg. § 1.882-5 provides a formula for computing the allowable interest expense of a foreign corporation. To the extent the amount of interest allowable as a deduction under such formula exceeds the amount of interest treated as paid by a U.S. trade or business, such excess is subject to a tax of 30% (or lower rate prescribed by treaty). IRC § 884(f)(1)(B).

(vii) For interest to be deductible the requirements of section 163(f) must be met.

(c) Finally, debts may be specifically written off by a lender as they become worthless in whole or in part. IRC § 166. However, special rules obtain in an affiliated group.

(d) Repayment of the principal balance of a loan is neither deductible by the borrower, nor treated as an income distribution to the lender. However, the repayment of the balance of a loan at less than face or a forgiveness may give rise to cancellation of indebtedness income unless the discharge occurs in a "Chapter 11" case or the debtor is insolvent (see IRC § 108(a)(1)). In such a case certain tax attributes of the debtor are reduced. See IRC § 108(b).

(i) A discharge will be deemed to occur if the debtor or a related party to the debtor acquires debt at less than face. IRC § 108(e)(4).

(ii) Debt which is contributed by a shareholder is considered to have been satisfied at an amount equal to the shareholder's basis in the debt. IRC § 108(e)(6).

(iii) The discharge of a debt by certain entities will require a filing of a return with the I.R.S., IRC § 6050P.

(e) Equity. By contrast, a return on equity or a dividend is not deductible by the payor except for certain special cases. See IRC §§ 535(a), 545(a), 556(a), and 561. However, the recipient of the dividend is required to include such dividend in income.

(i) Subject to a dividends received deduction under section 243 which is generally

applicable only to dividends to and from domestic corporations. But see IRC §§ 243(e) and 245.

(ii) In the case of a foreign recipient of a U.S. source dividend, a 30% tax rate (or lower rate prescribed by treaty) applies. Dividends from U.S. corporations generally are considered from U.S. sources, regardless of the source of the income of the paying corporation. IRC § 861(a)(2)(A). Dividends from a foreign corporation are considered to be from U.S. sources only if for an applicable three year period 25% or more of such corporation's gross income were effectively connected with the conduct of a U.S. trade or business. IRC § 861(a)(2)(B).

A. Where a U.S. dividend withholding tax is applicable under U.S. internal law, no treaty to which the U.S. is a party exempts the dividends paid by a U.S. corporation from U.S. tax. However, as noted previously in (I)(B) (4) (d)), infra, tax treaties generally reduce the rate of tax on U.S. source dividends to either 15%, 10% or in special cases 5%.

B. A dividend paid by a foreign corporation is not subject to the thirty percent tax referred to above if the paying corporation is subject to a branch profits tax under section 884. IRC § 884(e)(3). Furthermore, in certain cases such dividends may be exempt from withholding under an applicable treaty. See U.S.-Netherlands

treaty, Article XII. Cf. IRC § 884(e)(3)(B).

(iii) Redemption of an equity contribution by a corporation may constitute a dividend distribution to the extent of current or accumulated earnings and profits. IRC § 301, 302, and 316; cf. IRC § 304.

(iv) If a stock investment in an affiliate becomes worthless, an ordinary loss deduction may be taken under certain conditions. IRC § 165(g). If the stock is not an affiliate, the loss will be capital in nature.

2. Characteristics of Debt/Thin Capital. While there can be significant differences in the tax consequences of a transaction depending on whether an instrument is properly characterized as debt or equity, there is no hard and fast rule under which one can safely assume that an instrument will be clearly on one side of the debt vs equity line or the other, the IRS will not rule on the issue and it is an issue with respect to which it is difficult to obtain an opinion of counsel because of the inherently factual nature of the issues. The issue often arises in the case of related party debt. See generally IRC § 385.

(a) For an instrument evidencing an obligation to be treated as debt:

(i) The obligation should be evidenced by an unconditional promise to pay either on demand or at a specified date a sum certain (or one which can be ascertainable) together with interest at a specified rate.

(ii) A debt may include contingent interest, provided the formula for determining the amount thereof is ascertainable based on objective criteria.

(iii) It is generally prudent to provide a reasonable "cap" on contingent interest. For example, an instrument may require fixed interest of say 10%,

an additional interest in an amount equal to X percent of [cash flow, adjusted profits, etc.] but not to exceed another, say, 5% of the principal sum.

(iv) Uncapped contingent interest raises questions concerning whether the instrument is equity. See, e.g., Farley Realty Corp. v. Commissioner, 60-2 USTC ¶9525, 279 F.2d 701 (2d Cir. 1960), or a partnership.

(v) Particularly in the case of related taxpayers, the debtor should not be "too thinly" capitalized.

A. In general, it is important to be able to show that the debt can be paid in accordance with its terms based on reasonable cash flow projections.

B. If reasonable cash flow projections indicate repayment is probable in accordance with the terms of the debt, it probably is less important to show a debt equity ratio which does not exceed a certain amount. Nevertheless, debt-equity ratios in excess of 5:1 are generally thought to be aggressive. Cf. IRC § 163(j)(2)(A)(ii) (1.5 to 1).

(vi) Whether the debt is to be subordinated is also a factor. Subordination to senior indebtedness only in the case of default is less troublesome than subordination which precludes any payment until senior indebtedness is repaid even before default.

3. Shareholder Guaranty. Where a loan is made, e.g., by an unrelated party to a domestic subsidiary of a foreign parent and the loan is guaranteed by the foreign parent:

(a) An issue arises as to whether the domestic subsidiary borrower or foreign parent lender is to be treated as the borrower for tax purposes.

(i) If the loan were to be recharacterized as having been made to the foreign parent, the domestic subsidiary would not be entitled to a deduction for interest payments on the loan and all payments on the loan would likely be considered distributions (and to the extent of earnings and profits, dividends) to the foreign parent subject to the applicable withholding tax. Cf. Plantation Patterns, Inc., 29 TCM 817 (1970), aff'd. 462 F.2d 712, 72-2 USTC ¶9494 (5th Cir. 1972), cert. den. 409 U.S. 1076; Rev. Rul. 79-4, 1979-1 C.B. 150.

(ii) A loan with a shareholder guaranty may be recharacterized where under the facts it is clear the lender is relying principally on the credit of the guarantor and not on the credit of the subsidiary borrower. For example, a loan made to a newly-formed domestic subsidiary to be used to make an acquisition may run afoul of this line of authority if the unreasonable to assume that the lender could have relied to any significant extent on the balance sheet of the borrower, e.g., either because reasonable cash flow projections do not indicate that the loan can be repaid in accordance with its terms without credit support under the guaranty or no investigation is made into the ability of the purported borrower to repay the loan, reliance being placed entirely on the credit of the guarantor.

(b) The taxability to the parent of any guaranty fee paid to it by its subsidiary may also give rise to certain issues, including:

(i) The source of income of such fee; and

(ii) The nature of such income for treaty purposes.

4. Back-to-Back Loans. Oftentimes taxpayers attempt to avoid problems by interposing intermediaries between the ultimate provider of finance and the ultimate borrower.

(a) To obtain a treaty benefit. Cf. Aiken Industries; Rev. Ruls. 84-152, 84-153, and 87-89, supra. See also LTR 9133004 which held that a treaty country lender was a conduit for its parent even though it was not thinly capitalized on the basis that all of the income was paid out to parent by way of interest and dividends.

(b) To get around the income stripping rules of section 163(j).

This area are of the law is one which has not yet fully been developed by case law and therefore it is difficult to provide a basis for determining the extent to which the Service's position in this area will be sustained by the courts.

(c) See also new Code sections 163(j)(3)(B) and 163(j)(6)(D), which, under certain circumstances disallow interest deductions on interest paid to third parties on debt guaranteed by a related exempt entity.

B. Withholding

1. U.S. source interest paid to a foreign person is subject to withholding unless:

(a) The interest is exempt from tax under the portfolio interest rules.

(b) The income is exempt from tax under an applicable tax treaty. Treas. Reg. § 1.1441-6.

(c) The income is effectively connected with the conduct by the recipient of a U.S. trade or business. IRC § 1441(c); Treas. Reg. § 1.1441-4.

2. A person required to withhold a tax is made liable for the tax in the event of a failure to withhold. IRC § 1461. However:

   (a) If the recipient of the income pays the tax due in respect of the payment, the withholding agent is relieved of its liability for the tax, but not for interest or penalties attributable to its failure to withhold. IRC § 1463.

   (b) A person otherwise required to deduct and withhold a tax is relieved of its liability therefor if it relies on the receipt:

      (i) of a Form 1001 duly executed by the recipient of the income indicating that the recipient is entitled to an exemption from or reduced rate of tax under an applicable tax convention. Treas. Reg. § 1.1441-6(c); or

      (ii) a Form 4224 duly executed by the recipient of the income indicating that the income is or is expected to be effectively connected with the conduct of a U.S. trade or business and therefore exempt from withholding under IRC section 1441(c).

      (iii) In the absence of receipt of the above forms the person making a payment who doesn't withhold does so at its peril. Thus, if an exemption from withholding were to apply under section 1441(c), or under a treaty, there should be no liability for the failure to withhold merely because of a failure to secure the withholding form. Unfortunately, the Tax Court has held that the failure to receive a Form 4224 prior to payment requires the conclusion that withholding is required on the payment without regard to whether the income is effectively connected and therefore exempt from withholding under

section 1441(c). Casa De La Jolla Park, Inc. 94 TC 384 (1990). The Tax Court has taken a different view in the case of a treaty exemption from withholding, holding that the receipt of a Form 1001 is not a prerequisite to the exemption at least where the form is ultimately received and the Service has acquiesced in that position. Casanova Co. 87 T.C. 214 (1986), acq., 1990-2 C.B. 1.

(iv) The above cases underscore the importance of a closely monitoring the receipt of required withholding forms. Since a Form 4224 must be filed annually and a Form 1001 is valid only for three years, periodic updating is required.

(v) The Tax Court has implied in Aiken Industries, that the timely receipt of a withholding form will not relieve a withholding agent from liability for a failure to withhold where the withholding agent is aware of facts which would indicate that the person providing the form is not entitled to the exemption. However, the Service does not require that the withholding agent inquire into the facts. See Rev. Rul. 70-175, 1970-1 C.B. 184. In a recent case, a District Court required a withholding agent to accept a Form 1001 as a basis for not withholding in the absence of any knowledge that the statements contained in the Form 1001 were incorrect. The International Lottery Fund v. Virginia State Lottery Dept., et al., 800 F. Supp. 337 (E.D. VA. 1992).

(vi) In many large loan transactions there is a participation agreement among the lenders.

The tax effects of such an agreement are not entirely clear.

A. If viewed as a partnership for tax purposes and if the partnership were not created under U.S. law (e.g., because the document is governed by non-U.S. law) (See IRC § 7701(a)(4)) withholding would appear to be required regardless of whether the participants themselves are exempt from withholding. Treas. Reg. § 1.1441-3(f).

B. If viewed as a partnership which is created under U.S. law, i.e., a domestic partnership, then the payer of interest to the "partnership" need not withhold, but the "partnership" must withhold on its non-U.S. partners who are not entitled to an exemption. Significantly, the withholding risk in this case shifts away from the borrowers.

C. If viewed as a co-ownership with the lead participant the agent of the other participants, then withholding would appear to depend on the status of each participant and on each participant filing an appropriate form. Indeed, payment to U.S. agent of foreign income recipient does not relieve payor of withholding obligation. Treas. Reg. § 1.1441-7(a) (1). See Rev. Ruls. 70-468, 1970-2 C.B. 171; 69-655, 1969-2 C.B. 168.

(1) In many cases there are undisclosed participants. It

is less likely the IRS will attempt to impose liability for a failure to withhold on payments to a person thought to be a principal but later turns out to be an agent for an undisclosed principal where withholding would not have been required if the agent were in fact a principal. Nevertheless, a well-represented borrower may wish to protect itself from the risk of an adverse result on this issue by obtaining an indemnity from the lead participant with respect to undisclosed participants.

(2) In all cases a borrower should insist on ownership certificates from all disclosed participants.

IV. Licenses/Intangibles

A. Sale vs. License

1. Tax Significance

(a) In the case of a foreign "seller/licensor," the fixed portion of the purchase price is treated as sales proceeds, sourced under IRC section 865; the contingent portion, if any, is treated as a royalty, sourced under IRC sections 865(d)(1)(B) and 861(a)(4). See also IRC § 865(d)(2).

(i) Under IRC § 861(a)(4), the source of a royalty depends on where the intangible is used, not on the residence of the payor. Thus, a non-U.S. person may pay a U.S. source royalty. Rev. Rul. 80-362, 1980-2 C.B. 208.

(ii) The source of sales income generally depends on the residence of the seller. However, there are exceptions under section 865. In particular, to the extent of any depreciation previously taken in the U.S., gain is treated as U.S. source. IRC § 865(c).

(iii) A non-U.S. person seller will generally not be subject to U.S. tax on the fixed portion of the proceeds of sale, but will be subject to a 30% tax on the contingent portion, if any, attributable to U.S. use, subject, however, to a reduced rate or exemption under an applicable tax treaty.

(b) In the case of a U.S. seller, a sale will generally produce U.S. source income under section 865; whereas a royalty will be sourced depending on place of use. But see section 367(d) providing that the case of a transfer of an intangible in a tax-free rollover, a continuing royalty will be attributed to the seller (in an amount commensurate with the income to be earned thereon).

Such continuing royalty is to be treated as U.S. source income. This result should be compared with a license which could produce foreign source income. Cf. IRC § 482.

2. Sale.

In order for there to be a sale, there must generally be a disposition of substantially all rights to the intangible within a country of use. Cf. IRC § 1235.

(a) A reversion of rights will generally characterize the agreement as one of license.

B. Sale vs. Service.

1. In many instances it is difficult to determine whether a transaction gives rise to sales income, or royalty or compensation for services. See, and compare, Ingram v. Bowers, 3 USTC ¶915, 57 F.2d 65 (2d Cir. 1932); Pierre Boulez, 76 TC 209 (1981), aff'd, 87-1 USTC ¶9177, 810 F.2d 209 (DC Cir. 1987), cert. denied; Cook v. U.S., 79-1 USTC ¶335, 599 F.2d 400 (Ct. Cl. 1979), Mark Tobey, 60 TC 227 (1973).

2. Compensation is sourced at the place where the services giving rise to the payment were rendered. IRC § 861(a)(3); W.N. Dillin 56 TC 228 (1971); Ingram v. Bowers, supra.

3. Where services are rendered in part in the U.S. and in part outside the U.S., an allocation is required. Ordinarily the required allocation may be made on the basis of the relative proportions of time spent in and outside the U.S. performing the relevant services. Treas. Reg. § 1.861-4(b)(1).

C. Tax Credit Issue.

A typical provision in a number of license/distribution agreements permits the licensee to reduce the amount payable to the licensor by

"the appropriate portion" of any non U.S. withholding tax suffered by the licensee.

1. The basis for the deduction is that the licensee is out of pocket for the non U.S. withholding tax. If the licensee obtains a tax credit therefor, it is not out of pocket and, accordingly, well-represented licensors insist at the minimum that such deduction is restored to the extent a credit is obtained by the licensee.

2. The latter point is not entirely satisfactory because it is difficult to determine that the licensee has obtained a credit or should have obtained a credit.

3. If the licensee is a resident of a non foreign tax credit jurisdiction (e.g., the Netherlands), there can be no direct credit, but if owned by a U.S. corporation there can be an indirect credit.

4. Finally, it is also not always clear how one determines the "appropriate portion."

V. Other Issues

A. "Double dip" leases are leases in which because of differing tax rules of two different tax jurisdictions at least two different jurisdictions treat a different party as the owner of the property entitled to depreciation.

1. Illustration: Jurisdiction F treats a transaction as a "true lease," but the U.S. treats the same transaction as a purchase. In such circumstances the tax benefits of ownership are enjoyed twice, once in each jurisdiction.

B. Dual resident companies are companies subject to tax in two jurisdictions on world-wide income.

1. For example, a company resident for tax purposes in the U.S. and the U.K. is generally not entitled to tax treaty benefits in either jurisdiction.

2. The losses of a U.S. company resident in another jurisdiction, such as the U.K., may not be used by another member of a U.S.

affiliated group filing a U.S. consolidated return if such income may offset the income of any foreign corporation. See IRC § 1503(d). Thus, e.g. the loss of a U.S. company managed and controlled in the U.K. may not be used in the U.S. company's consolidated return to offset the income of another member if such income may be used to offset the income of a foreign corporation.

VI. Non-U.S. Persons Operating in U.S.

A. Structural Decisions

1. Whether to operate through branch or subsidiary is a close question if a determination were to be made solely on the basis of tax considerations.

(a) The ability to consolidate in the case of a U.S. group of companies, vs.

(i) The effect of U.S. consolidation may be obtained through foreign corporations but it is difficult and costly to accomplish.

(b) The ability to make distributions in excess of earnings and profits and basis free of U.S. tax relevant in the case of FIRPTA. See generally IRC §§ 897, 316, and 301(c)(3).

(c) Comparison of branch profits and U.S. dividend withholding and accumulated earnings taxes.

(d) Permanent establishment implications of operating through branch.

(e) Consideration of interest deductions under Treas. Reg. § 1.882-5 in the case of a foreign corporation.

2. Ownership of U.S. Target by Foreign Parent.

(a) Ability to pay dividends at reduced treaty withholding rates.

(b) Ability to pay U.S. shareholders dividends directly, avoiding additional layers of tax through special classes of stock. Cf. IRC § 269B.

B. Financing of Investments

1. Interest and issues under:

(a) § 881(c) (portfolio interest).

(b) § 163(j) (income stripping).

C. Licensing

1. Section 482 and transfer pricing.
2. Advance pricing agreement.
3. Withholding.

VII. U.S. Person Operating Abroad

A. Structural Decisions

1. Branch vs Non-U.S. Subsidiary.
2. Transfer of assets and section 367.
3. Transfer pricing and section 482.

B. Controlled Foreign Corporations

1. Avoidance of Subpart F.

(a) Manufacturing and the use of subcontractors.
(b) High tax exception.
(c) Same country exception.

C. Maximizing Foreign Tax Credits