

10-1-1976

U.S. Taxation of Foreign Corporations

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Recommended Citation

U.S. Taxation of Foreign Corporations, 8 U. Miami Inter-Am. L. Rev. 952 (1976)

Available at: <http://repository.law.miami.edu/umialr/vol8/iss3/15>

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- b. Concerning patent applications whose annuities have not been paid within the legal term and which are pending appeal by their holders, the INPI will notify the interested party to prove payment of the annuities and of the appeal charges, both in accordance with the chart presently in effect within 60 days of said notification;
- c. Concerning patent applications whose annuities have not been paid within the legal term, but for which dismissal has not yet been published, the INPI will notify the interested party to effect payment, or prove payment of the annuities owed within 60 days.

MAURO J. G. ARRUDA
Pinheiro Neto & Cia.
São Paulo, June, 1976

U.S. TAXATION OF FOREIGN CORPORATIONS

I. GENERAL RULES FOR FOREIGN CORPORATIONS

Foreign corporations would ordinarily be subject to U.S. federal income tax on two types of income:

1. Income from sources within the U.S. which is effectively connected with the conduct of a trade or business within the U.S.—taxable at ordinary U.S. corporate income tax rates¹ after taking all appropriate business deductions related thereto; and
2. Income from sources within the U.S. which is not effectively connected with the conduct of a trade or business within the U.S. (e.g., interest, dividends, rents, royalties, and other fixed or determinable annual or periodical gains, profits, and income)—taxable on the gross amount thereof at a 30 percent withholding tax rate.

Except in certain cases, a foreign corporation would not be subject to tax by the U.S. on income from sources without the U.S. Similarly, a foreign corporation would not be taxed on capital gains not effectively connected with a U.S. business.

Rules for determining source of income are rather complex and involve, *inter alia*, two basic concepts, to wit: "effectively connected income" and "engaged in a trade or business in the U.S." In general, in order for the income, gain, or loss of a foreign corporation to be considered "effectively connected," the foreign corporation must be "engaged in a trade or business within the U.S." The Internal Revenue Code ("Code") provides that all income, gain, or loss of a foreign corporation engaged in business in the U.S. and derived from sources within the U.S. (other than fixed or determinable annual or periodic gains, profits, and income²) shall be treated as "effectively connected" with the conduct of a trade or business within the U.S. for the purposes of U.S. tax law.

Income of a foreign corporation from sources without the U.S. will in certain cases be considered "effectively connected" with the conduct of a trade or business in the U.S. if such corporation has an office or other fixed place of business in the U.S. to which such income, gain, or loss is attributable, and such income, *inter alia*,—

1. consists of rents or royalties for the use of or for the privilege of using certain types of intangible property in the U.S., including patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property; or
2. is derived from the sale (without the U.S.) through such U.S. office or other fixed place of business of personal property which includes stock in trade of the foreign corporation (i.e., inventory or other property held primarily for sale to customers in the ordinary course of business), irrespective of the destination to which the property is sent for use, consumption, or disposition.

II. EXCEPTIONS TO GENERAL RULES FOR FOREIGN CORPORATIONS

Certain sections of the Code are designed to tax the earnings of a foreign corporation (by taxing the U.S. shareholders thereof) beyond the limits described above on certain types of income³ received by the foreign corporation which is generally characterized as passive in nature, provided certain specific ownership tests are met. The major exceptions in this regard are controlled foreign corporations, personal holding companies, and foreign personal holding companies. In particular, two concepts are of special significance in connection herewith: (1) "U.S. persons" include

U.S. citizens or resident aliens of the U.S.; and (2) the attribution rules for determining stock ownership are extensive and generally prevent the circumvention thereof by use of nominees, trusts, family relatives, or other similar arrangements.

Furthermore, the general rules mentioned herein may also be modified where there is a tax treaty in force.

III. MISCELLANEOUS PROVISIONS RELEVANT TO FOREIGN CORPORATIONS

A. *Accumulated Earnings Tax*

If a foreign corporation is formed or utilized by its shareholders or the shareholders of any other corporation for the purpose of avoiding the U.S. income tax by permitting earnings and profits to accumulate instead of being divided or distributed, it is subject to an additional tax ranging from 27½ percent to 38½ percent of the accumulated taxable income (in addition to the normal corporate income tax). The accumulated earnings tax is applicable with respect to the income of the foreign corporation derived from sources within the U.S. if any of its shareholders are subject to the U.S. income tax on its distributions because they are either citizens or residents of the U.S. or because they are nonresident aliens and more than 50 percent of the gross income of such foreign corporation is effectively connected with the conduct of a trade or business in the U.S.⁴

The accumulated earnings tax is applied to the accumulated taxable income of the foreign corporation, minus dividends paid. In addition, there is allowed an accumulated earnings credit, which is equal to that portion of the corporate earnings retained to meet the "reasonable needs of business." Generally, at least \$150,000 in income can be accumulated by a foreign corporation before the possibility exists that the aforesaid accumulated earnings tax would be applicable thereto.

B. *Allocation of Income Under Section 482 of the Code*

Section 482 of the Code provides that "in the case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the U.S. and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the IRS may distribute, apportion, or allocate gross income, deductions, credits or allowances between or among such organizations, trades or business, if it determines

that such distribution, apportionment or allocation is necessary in order to prevent the evasion of taxes or clearly to reflect the income of any organizations, trades or businesses." For purposes of this test, control between two corporations exists if there are common owners owning 50 percent or more of the two corporations. The same interests would include a group of controlling taxpayers.

C. *U.S. Estate and Gift Taxes*

The U.S. estate tax is not applicable to shares of a foreign corporation held by a nonresident alien, even though the foreign corporation may conduct its entire activities in the U.S. through a branch or other permanent establishment.

A nonresident alien is normally subject to U.S. estate tax (ranging from approximately 5 percent to 25 percent of the nonresident alien's net taxable estate) on any property situated in the U.S. Stock of a corporation incorporated within the U.S. is deemed to be U.S. property for purposes thereof, regardless of where such shares may be physically held.

A resident alien of the U.S. is subject to U.S. estate tax on his worldwide assets, which would, of course, include the stock of a foreign corporation.

Generally, similar rules are also applicable with respect to the impact of the U.S. federal gift tax upon individual shareholders.

GERBER & SKOLA
New York City, April 1976

NOTES

¹Until June 30, 1976: 20 percent on the first \$25,000 of taxable income; 22 percent on the second \$25,000 of taxable income; and 48 percent on taxable income in excess of \$50,000. As of July 1, 1976: 22 percent on the first \$25,000 of taxable income; and 48 percent on taxable income in excess of \$50,000.

²The fixed or determinable annual or periodic gains, profits, and income (such as dividends, interest, rents, and royalties) could also be considered "effectively connected" with the conduct of a trade or business in the U.S. Factors taken into account include whether the income, gain, or loss is derived from assets used or held for the use of such trade or business; or whether the activities of such trade or business were a material factor in the realization of income, gain, or loss. For example, interest on bank accounts that are maintained in the U.S. as necessary cash flow to the business of a foreign corporation could be considered "effectively

connected" with the conduct of such trade or business and therefore subject to U.S. taxation (even though it would otherwise be exempt from U.S. taxation under the provisions of the Code dealing with interest on U.S. bank deposits).

³Such income is commonly referred to as Subpart F Income since it is subject to tax under the provisions of Subpart F of the Code.

⁴A 30 percent U.S. withholding tax would be levied on a foreign corporation paying dividends to nonresident aliens if more than 50 percent of the foreign corporation's income were "effectively connected."