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# Taxation

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## TAXATION

RICHARD S. LEHMAN\*

**EDITOR'S NOTE:** The Taxation Report for this issue consists of two articles written by Mr. Lehman.

### FEDERAL ESTATE TAXATION OF NON-RESIDENT ALIENS\*\*

South Florida is the focal point of increasing interest for South and Central American citizens, both as a vacation resort and investment center.<sup>1</sup> This has resulted in new interest in all aspects of Federal taxation of nonresident aliens. This article is intended to serve as a review of the basic concepts of the Federal estate taxation of nonresident aliens. The review essentially will be devoted to the basic statutory scheme governing the estate taxation of nonresident aliens. However, the reader should be made aware that the general concepts covered by this article may be overridden in the following circumstances:

- (1) The statutory provisions are ignored to the extent they conflict with a Treaty made applicable because of the nonresident alien decedent's country of citizenship.
- (2) The nonresident alien estate tax provisions which are generally more favorable than the estate tax provisions applicable to United States citizens and residents will not apply to a nonresident alien who within ten years prior to his death lost United States citizenship in order to avoid United States income, estate, or gift taxes.<sup>2</sup>

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- (3) The generally more favorable nonresident alien estate tax consequences will not apply to a nonresident alien if the country of which he is a citizen imposes discriminatory death taxes on citizens of the United States resident in that country.<sup>3</sup>

The Foreign Investors Tax Act of 1966 is responsible for the present statutory scheme governing the Federal estate taxation of nonresident aliens. That Act introduced Internal Revenue Code of 1954 Sections 2101 through 2108.<sup>4</sup>

Before considering the basic provisions of the Act, one must answer the threshold question of whether an alien is a resident or nonresident for purposes of the Federal estate tax.

The gross estate of a *resident* alien, like that of a United States citizen, embraces assets wherever located and is subject to the same treatment for estate tax purposes as a United States citizen's estate.<sup>5</sup> The gross estate of the *nonresident* alien, however, includes only property interests with a situs in the United States<sup>6</sup> and is subject to both a different set of rules governing estate tax deductions<sup>7</sup> and estate tax rates.<sup>8</sup>

A nonresident alien decedent, for estate tax purposes, is a decedent who, at the time of his death, is *not domiciled* within the United States.<sup>9</sup> Domicile is established by living in a certain place for even a brief period of time with no definite present intention of later removing therefrom.<sup>10</sup>

Residency for Federal estate tax purposes is a much more permanent concept than residency for Federal income tax purposes. An alien who is a resident for Federal estate tax purposes must be domiciled in the United States, yet, residency for Federal income tax purposes requires only that one be more than a mere transient or sojourner in the United States.<sup>11</sup> It will not be uncommon for an alien individual to be subject to Federal income tax as a resident and subject to Federal estate tax as a nonresident.<sup>12</sup> For example, the Internal Revenue Service has ruled that a one year's presence in the United States by an alien raises a presumption of residency for income tax purposes<sup>13</sup> while accepting a Court decision which held that an alien who had lived in the United States in excess of five years was a nonresident alien for Federal estate tax purposes.<sup>14</sup>

Once it is determined that a decedent is a nonresident alien for purposes of the Federal estate tax, his net estate tax is determined by a four step procedure<sup>15</sup> which will be considered in the balance of this article. That four step procedure is as follows:

- (1) Ascertain the total value of the decedent's gross estate.

- (2) Ascertain the total value of the taxable estate by subtracting from the gross estate the authorized exemptions and deductions.
- (3) Apply the estate tax rates applicable to nonresident aliens to the taxable estate to determine the gross estate tax.
- (4) Subtract from the gross estate tax the authorized credits against the tax.

### I. *THE NONRESIDENT ALIEN'S GROSS ESTATE*

A nonresident alien's gross estate for Federal estate tax purposes is that part of his gross estate (determined as if he was a United States citizen) which at the time of his death is situated in the United States.<sup>16</sup>

As a practical matter this definition can be broken down into two basic parts.

First, the gross estate must include property situated in the United States *at the date of decedent's death* if the decedent had an interest in such at his death,<sup>17</sup> if it is an annuity interest to which another is entitled to benefits after his death,<sup>18</sup> or if the decedent had a general power of appointment over such property.<sup>19</sup> Should the decedent die possessing an interest in United States situated property which he held jointly with another who had survivorship rights, his estate would include such interest minus the value attributable to consideration in money or money's worth furnished by the joint property holder.<sup>20</sup>

Second, the gross estate must include property which was situated in the United States *either at the date of transfer or the date of decedent's death* if the property was transferred during the decedent's lifetime in any of the following types of gratuitous transfers: (1) Lifetime transfer in contemplation of death;<sup>21</sup> (2) Lifetime transfer in which the decedent retained for his life or another proscribed period, income or related interest;<sup>22</sup> (3) Lifetime transfer in such a way as to take effect only after the decedent's death or in which he has retained a proscribed reversionary interest;<sup>23</sup> (4) Lifetime transfer which is subject to change by him alone or with another at death.<sup>24</sup>

It is evident from the foregoing that the elementary question which must be asked for purposes of determining a nonresident alien's gross estate is whether a property is considered situated in the United States for estate tax purposes?

*Code Sections 2104 and 2105* have been designed to provide guidance for answering this elementary question. Basically these Code Sections and the regulations pursuant to them provide specific rules for determining the situs of specific types of property. The situs of those types of property not dealt with specifically is a determination solved by the application of general principles of law.<sup>25</sup>

Specifically, the following properties are considered to be situated *within* the United States for Federal estate tax purposes:

- (1) Real property located in the United States.<sup>26</sup>
- (2) Tangible personal property located in the United States<sup>27</sup> so long as it is here with some degree of permanency<sup>28</sup> and is not a work of art loaned for public exhibition purposes.<sup>29</sup>
- (3) Shares of stock issued by a corporation created or organized in the United States irrespective of the location of the certificates.<sup>30</sup>
- (4) Debt obligations (not including United States currency), the primary obligor of which is a United States citizen or resident; a United States partnership; a United States corporation; a United States trust or estate; the United States; a State or any political subdivision thereof or any agency or instrumentality of any such government. (As to debt obligations there are certain minor exceptions beyond the scope of this article.)<sup>31</sup>
- (5) Bank deposits with a branch in the United States of a foreign corporation if that branch is engaged in the commercial banking business. (Here too there are minor exceptions beyond the scope of this article.)<sup>32</sup>

Specifically, the following properties are considered to be situated *without* the United States for Federal estate tax purposes:

- (1) Real property located outside the United States.<sup>33</sup>
- (2) Tangible personal property located outside the United States.<sup>34</sup>
- (3) Shares of stock issued by a corporation (foreign corporation) not created or organized in the United States, irrespective of the location of the certificates.<sup>35</sup>
- (4) Amounts receivable as insurance on the life of the nonresident alien decedent.<sup>36</sup>

- (5) Amounts deposited in the United States in either a United States Bank; Savings Institution or similar association; or held by an insurance company under an agreement to pay interest thereon so long as the deposit is not effectively connected with a United States trade or business.<sup>37</sup>
- (6) Amounts deposited with a branch outside the United States of a United States domestic corporation or partnership engaged in the commercial banking business.<sup>38</sup>
- (7) Debt obligations, the primary obligor of which is neither a United States citizen or resident; a United States partnership; a United States corporation; a United States trust or estate; the United States; a State or any political subdivision thereof or any agency or instrumentality of any such government. (As to debt obligations there are certain minor exceptions beyond the scope of this article.)<sup>39</sup>

This article is not intended to fulfill any estate planning function, however, before leaving the subject of what constitutes a nonresident alien's gross estate, a note of caution should be given to the concept advanced by a number of noted commentators that a foreign corporation may be used as a holding company for many United States situs assets and thereby isolate the nonresident alien's estate from Federal estate taxation on such assets.<sup>40</sup> While a Pre-Foreign Investor's Tax Act of 1966 General Counsel's Memorandum did indeed sanction such a device,<sup>41</sup> care must be taken that the entity which is used as a foreign holding company is an entity that will be recognized as a separate and distinct entity from the nonresident alien decedent for Federal estate tax purposes.<sup>42</sup>

## II. AUTHORIZED EXEMPTIONS AND DEDUCTIONS FROM THE NONRESIDENT ALIEN'S GROSS ESTATE

A nonresident alien's taxable estate is determined by deducting from his gross estate certain deductions and exemptions.<sup>43</sup> A statutory exemption of \$30,000 is provided for.<sup>44</sup> There is no marital deduction allowed the estate of a nonresident alien. A charitable deduction is allowed but only for transfers to corporations and associations created or organized in the United States, for use within the United States.<sup>45</sup> A deduction is allowed for funeral and administration expenses, claims and charges against the estate and casualty losses incurred during the settlement of the estate.<sup>46</sup> However, these deductions unlike the similar deductions which

are allowed citizens and residents of the United States under *Code Sections* 2053 and 2054 are subject to a limitation. Since a nonresident alien's *entire* gross estate is not subject to United States estate tax and only his gross estate situated in the United States is subject to the tax, only a proportionate amount of the expenses and losses of the entire estate are allowed as a deduction. That proportionate amount is expressed as follows:<sup>47</sup>

$$\text{Deduction allowed} = \frac{\text{Value of estate within U.S.}}{\text{Value of entire gross estate}} \times \text{2053 \& 2054 deductions}$$

Furthermore, this proportionate deduction will not be allowed unless the value of the decedent's entire gross estate is disclosed in the estate tax return.<sup>48</sup> This limitation can be extremely unfair if a large part of the decedent's gross estate is located outside of the United States and property located within the United States is subject to a large mortgage. The full value of the United States situs property will be includible in the nonresident alien's gross estate while the limitation will cause only a small percentage of the mortgage to be allowed as an estate tax deduction. A pre-*Foreign Investors Tax Act* of 1966 Tax Court case offers a suggestion for proper estate tax planning to avoid this inequity. If the mortgage debt can be collected only from the property mortgaged to secure the debt and not from the nonresident alien decedent's estate generally, then only the equity of redemption will be included in the gross estate and the limitation on the deduction for a debt of the estate will be avoided.<sup>49</sup>

### III. TAX RATES APPLICABLE TO THE NONRESIDENT ALIEN'S TAXABLE ESTATE

Once a nonresident alien's net taxable estate is determined by subtracting the allowable exemptions and deductions from the gross estate, that taxable estate is subject to the following tax rates:<sup>50</sup>

<i>Taxable Estate</i>	<i>Tax Due</i>
\$0-100,000	5% of the taxable estate
\$100,000-500,000	\$5,000 plus 10% of the excess over \$100,000
\$500,000-1,000,000	\$45,000 plus 15% of the excess over \$500,000
\$1,000,000-2,000,000	\$120,000 plus 20% of the excess over \$1,000,000
over \$2,000,000	\$320,000 plus 25% of the excess over \$2,000,000

### IV. CALCULATION OF NET TAX DUE

In order to determine the net tax due, the taxable estate is subjected to the estate tax rates set forth above and from that amount there is sub-

tracted estate tax credits attributable to amounts paid for State death taxes, gift taxes and estate taxes paid on prior transfers. In certain instances, these credits are subject to limitations which have the same effect as the limitations applied to deductions allowable to the nonresident alien. That is, since something less than the nonresident alien's entire gross estate has been included for Federal estate tax purposes, the available credits are allocably reduced.<sup>51</sup>

## NOTES

<sup>1</sup>The Miami News July 8th, 1975.

<sup>2</sup>Code Section 2107.

<sup>3</sup>Code Section 2108.

<sup>4</sup>HR 13103 89th Cong. 2d Sess.

<sup>5</sup>Code Section 2031.

<sup>6</sup>Code Section 2103.

<sup>7</sup>Code Section 2106.

<sup>8</sup>Code Section 2101.

<sup>9</sup>Treas. Reg. 20.0-1 (b).

<sup>10</sup>Treas. Reg. 20.0-1 (b).

<sup>11</sup>Treas. Reg. 1.871-2 (b).

<sup>12</sup>*Estate of Jan William Nienhuys*, 17T.C. 1149 (1952).

<sup>13</sup>Rev. Rul. 69-611, 1969-2 C.B. 150.

<sup>14</sup>*Estate of Jan William Nienhuys*, (*supra*) acq. 1952-1 C.B. 3

<sup>15</sup>Treas. Reg. 20.0-2 (b).

<sup>16</sup>Code Section 2103.

<sup>17</sup>*Cf. Estate of Hedwig Zietz* 34 T.C. 351 (1960) and Code Section 2033.

<sup>18</sup>*Chase National Bank, Executor, (HASKELL)* 1933 P.H. B.T.A. Mem. pag. 33, 318 and Code Section 2039.

<sup>19</sup>*Commissioner vs. Nevius* 76 F.2d 109 (2d Cir. 1935) and Code Section 2041.

<sup>20</sup>*Estate of Paul M. Vandenhoeck* 4 T.C.125 (1944) and Code Section 2040.

<sup>21</sup>Treas. Reg. 20.2103-1 and Code Section 2035.

<sup>22</sup>Treas. Reg. 20.2103-1 and Code Section 2036.

<sup>23</sup>Treas. Reg. 20.2103-1 and Code Section 2037.

<sup>24</sup>Treas. Reg. 20.2103-1; Code Section 2038 and *Estate of Oei Tjong Swan* 24 T.C. 829 (1955).

<sup>25</sup>Stephens & Maxfield; *Federal Estate and Gift Taxation* Section 6-10 (1973).

- <sup>26</sup>Treas. Reg. 20.2104-1 (a) (1).  
<sup>27</sup>Treas. Reg. 20.2104-1 (a) (2).  
<sup>28</sup>*Delaney v. Murchie*, 177 F.2d 444 (1st Cir. 1949).  
<sup>29</sup>Treas. Reg. 20.2105-1 (b).  
<sup>30</sup>Treas. Reg. 20.2104-1 (a) (5).  
<sup>31</sup>Treas. Reg. 20.2104-1 (a) (7).  
<sup>32</sup>Treas. Reg. 20.2104-1 (a) (8).  
<sup>33</sup>Treas. Reg. 20.2105-1 (a) (1).  
<sup>34</sup>Treas. Reg. 20.2105-1 (a) (2).  
<sup>35</sup>Treas. Reg. 20.2105-1 (f).  
<sup>36</sup>Treas. Reg. 20.2105-1 (g).  
<sup>37</sup>Treas. Reg. 20.2105-1 (i).  
<sup>38</sup>Treas. Reg. 20.2105-1 (j).  
<sup>39</sup>Treas. Reg. 20.2105-1 (k).  
<sup>40</sup>Ross, *United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments*, 22 Tax Law Review 279 (1967) and Rodman, *Foreign Investors Act of 1966, Estate and Gift Tax Changes 105 Trusts and Estates 1156* (1966).  
<sup>41</sup>G.C.M. 18718, 1937-2 C.B. 476.  
<sup>42</sup>Cf. *Sánchez v. Bowers* 70 F.2d 715 (2d Cir. 1935); *Fillman v. United States*, 355 F.2d (32 Ct. Cl. 1966); and *Estate of Oei Tjong Swan*, 24 T.C. 829 (1955) (all Pre-Foreign Investors Tax Act of 1966 cases).  
<sup>43</sup>Code Section 2106.  
<sup>44</sup>Code Section 2106 (a) (3).  
<sup>45</sup>Treas. Reg. 20.2106-1 (a) (2) (i) and *Estate of John Edgar McAllister* 54 T.C. 1409 (1970).  
<sup>46</sup>Treas. Reg. 20.2106-1 (a) (1).  
<sup>47</sup>Treas. Reg. 20.2106-2 (a).  
<sup>48</sup>Treas. Reg. 20.2106-2 (a) (2).  
<sup>49</sup>*Estate of Harcourt Johnstone* 19 T.C. 44 (1952).  
<sup>50</sup>Code Section 2101.  
<sup>51</sup>Code Section 2102.

## THE UNITED STATES—A TAX FREE WAREHOUSE CENTER FOR FOREIGN SALES CORPORATIONS

The United States has much to offer as a warehousing and distribution center to South and Central America. Southern Florida in particular

offers the multiple advantages of fine seaports, an international airport with daily freight flights to all parts of South and Central America and a very large Spanish-speaking labor force.<sup>1</sup> What is less widely known is that under the right circumstances the United States can be used as a warehousing and distribution center by foreign sales corporations with no Federal income tax liability resulting from the sales made by such foreign corporations.

Let us assume the following set of facts:

- (A) A Bahamian sales corporation which purchases goods manufactured in Western Europe and the Far East for resale in South and Central America.<sup>2</sup>
- (B) The Bahamian Corporation (sometimes hereinafter referred to as the corporation) makes no sales to the United States.
- (C) The Bahamian sales corporation actively solicits orders for the goods and negotiates the contract of sale.
- (D) The actual goods are stored in a South Florida distribution center and shipped in response to telexed orders to the South and Central American purchasers.
- (E) All rights title and interest to the merchandise are transferred to the buyer in the recipient South or Central American countries.

What are the Federal income tax consequences of such sales?

The starting point for understanding the Federal income taxation of foreign corporations is the Foreign Investors Tax Act of 1966.<sup>3</sup> Portions of that Act were designed to curb a certain abuse involving foreign sales corporations. The particular abuse was the use of the United States as a "tax haven" for foreign sales corporations that were established in the United States for the purpose of engaging in the business of selling inventory-type items. The following explanation from the legislative history is descriptive of the problem that existed prior to the Act.<sup>4</sup>

The present scheme for taxing foreigners engaged in business in the United States also is defective in another respect. The interplay between the tax rules of certain foreign countries and the United States has in some cases permitted the use of the United States as a tax haven. The tax avoidance in such a case can be illustrated by a foreign corporation which is organized in a country which does not tax its domestic corporations on income derived from the conduct of

a business outside the country. If such corporation desires to sell products in countries other than the United States or the country of its incorporation, it can in many instances, avoid all or most taxation on the income from these sales by establishing a sales office in the United States. The income from the sales in such cases is not taxed by the United States because (under the title passage rule) it is not derived from sources within the United States. The income may not be taxed by countries where the products are sold because the corporation does not have a permanent establishment there, and the income is not taxed by the country of incorporation because the business is not conducted there. Similar tax avoidance may be practiced in the case of rents and royalties from a licensing business and income from banking, financing, or investment company business. Your committee believes that foreign corporations carrying on substantial activities in the United States, in such cases, should not be able to cast their transaction in such a form as to avoid all U.S. tax and most foreign tax also, it is believed that foreign corporations should pay a U.S. tax on the income generated from U.S. business activities.

To meet both types of problems described above your committee's bill provides for the taxation of nonresident aliens and foreign corporations at the regular U.S. graduated individual rates or corporate rates on their income which is effectively connected with the conduct of a trade or business within the United States. *This effectively connected rule applies to all their income from sources in the United States and to three limited categories of foreign source income.* The U.S. source income of nonresident aliens and foreign corporations which is not effectively connected with the conduct of a trade or business in the United States is taxed at a flat 30 percent rate (or reduced treaty rate). (Emphasis supplied.)

As stated in the legislative history the abuse which concerned Congress was curbed by applying the United States corporate tax rates to all income which is "effectively connected" with the conduct of a trade or business within the United States. The result of this "effectively connected" concept was to subject certain income earned by a foreign corporation to Federal income tax even though the income was considered to be earned from a source outside of the United States.<sup>5</sup>

While this concept in the Act did manage to curb the particular abuse which was the concern of Congress, it will be shown that it did

nothing to subject to Federal income tax those sales profits which in part arise from using the United States as a warehouse and distribution Center for sale outside of the United States.

The Federal income tax laws governing the sales profits made by our hypothetical Bahamian sales corporation are as follows:

A foreign corporation is a corporation which is not created or organized in the United States or under the law of the United States or any state or territory.<sup>6</sup>

For purposes of this article we will assume that the foreign corporation which wishes to warehouse and distribute from the United States has no shareholders that are either United States citizens or residents or any other United States domestic entities (such as trusts, estates, etc.). To assume contrary might require consideration of additional tax consequences which are beyond the scope of this article. See for example *Internal Revenue Code of 1954 Sections* 951 through 964 (hereinafter *Code*) dealing with Controlled Foreign Corporations; *Code Sections* 541 through 547 dealing with Personal Holding Companies and *Code Section* 551 through 558 dealing with Foreign Personal Holding Companies. Furthermore, we will also assume that our hypothetical corporation will not make sales in the United States for that will also require considerations beyond the scope of this article. See *Code Sections* 861(a)(6), 864(c)(3) and *Treas. Reg.* 1.861-7.

The foreign corporation that we will consider is subject only to Federal income tax under either *Code Section* 881 or 882 if it is subject to Federal income taxation at all.

Pursuant to *Code Section* 881, a foreign corporation which at no time during the taxable year is engaged in trade or business in the United States is taxable at a flat 30% tax rate on gross income received from sources within the United States which is fixed or determinable annual or periodical income as enumerated in *Code Section* 881 (a).<sup>7</sup>

Pursuant to *Code Section* 882, a foreign corporation which is engaged in a United States trade or business must segregate its gross income for the taxable year into two categories, namely, one category for income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States and a second category for income which is effectively connected for the taxable year with the conduct of a trade or business in the United States. These two separate categories are then subject to two separate taxes. The income not effectively

connected with a United States trade or business is taxed the same as that of a *Code Section 881* corporation. That is, it is subject to a flat 30% tax rate on the gross income received from sources within the United States which is fixed or determinable annual or periodical income.<sup>8</sup> The category of income which is effectively connected with a United States trade or business is taxable the same as income earned by a domestic corporation, that is, the net taxable income after appropriate deductions is taxable under the rates as provided for by *Code Sections 11* or *1201 (a)*<sup>9</sup>.

The threshold question which must be resolved to determine under which section our hypothetical Bahamian corporation is taxable, is the question of whether the economic function of warehousing and distributing from the United States, goods not manufactured in the United States, is considered a United States trade or business. The answer to this question determines whether we are governed either by the rules of *Code Section 881* or *Code Section 882*.

The question as to what constitutes being engaged in a trade business is one of fact<sup>10</sup> and like many questions of fact it has an elusive quality.<sup>11</sup> Certainly a warehousing business by itself is a trade or business,<sup>12</sup> and certainly if the South Florida operation is considered a sales business there is a United States trade or business involved.<sup>13</sup> However, if we focus only on the warehouse function there is language in a number of cases dealing with foreign corporations which can possibly be construed to hold that the concept of "trade or business" at least for purposes of *Code Sections 881* and *882* does not include an economic function which is not in and of itself a separate business but is instead only an integral part of the larger business of selling merchandise.<sup>14</sup> Be that as it may, we will soon see that in substance the distinction is meaningless if the actual sales are structured properly.

However, assuming for purposes of discussion, that this warehousing and distribution function is considered a United States trade or business, favorable Federal income tax consequences result from the following proper tax planning.

*Code Section 882 (a)* provides that a foreign corporation engaged in a trade or business within the United States during the taxable year shall be subject to tax on that income which is effectively connected with the conduct of that trade or business. What follows is an analysis of how to conduct the foreign corporation's business so that it has no effectively connected income from its Latin American sales.

*Code Section 882* provides that the determination of whether income or gain is effectively connected with the conduct of a United States trade or business shall be made in accordance with Section 864 (c) and Treas. Regs. Sections 1.864-3 through 1.864-7.<sup>15</sup>

*Code Section 864* (c) defines the term "effectively connected".

That *Code Section* has different rules of definition depending on whether the income concerned is from "sources within the United States" or "sources without the United States".<sup>16</sup> Pursuant to that *Code Section* all sales income *from sources within* the United States is considered to be effectively connected income and consequently is all subject to tax under *Code Section 882*. However, income from sources *without* the United States when derived from the sale of inventory property, may be subject to certain exceptions that provide that such income is not effectively connected and is therefore not subject to United States taxation. Before considering those exceptions and their applicability to our Bahamian company we must first turn to the question of whether the company's sales to South and Central America will be considered to result in income from sources *without* the United States.

*Code Section 862* provides the definition for determining whether income is from sources without the United States. *Code Section 862* (a) (6) provides that gain derived from the *purchase* of personal property *within* the United States and its *sale without* the United States results in income from sources *without* the United States. This *Code Section* does not exactly fit the situation our Bahamian company finds itself in because our company both *purchases* and *sells* its inventory items *without* the United States. However, as one noted commentator has stated.

While the statute speaks of purchases without and sales within the United States (or vice versa), it follows a fortiori that income from — (*Purchases without and sales without*) the United States would be assigned a source at the place of sale.<sup>17</sup> (emphasis supplied).

Furthermore, the following example (which is a paraphrased combination of two Treasury Regulations) seems to accept purchase without and sale without as a situation which insures that the resulting income is considered to be from a source without the United States.

Foreign corporation N, which is not a controlled foreign corporation within the meaning of Section 957 and the regulations thereunder, has an office in a foreign country which purchases merchandise and sells it through its sales office in the United States for use in various

foreign countries, such sales being made outside the United States and title to the property passing outside the United States. . . . N has an office in a foreign country which participates materially in the sales which are made through its U.S. office. The taxable income which is allocable to N's U.S. sales office is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the corporation.<sup>18</sup>

The key to establishing that the sales income is from a source without the United States of course is to insure that our Bahamian company's sales to South and Central America will be considered sales *without* the United States so as to qualify under *Code Section 862 (a) (6)* (income from sources without sale of personal property) and not qualify under *Code Section 861 (a) (6)* (income from sources within, sale of personal property). In this regard, there is a specific Treasury Regulation concerning itself with the place of sale of personal property. *Treas. Reg. 1.861-7* provides in general that gains derived from the sale of personal property shall be treated as derived entirely from the country in which the property is sold. *Treas. Reg. 1.861-7 (c)* specifically defines the term country "in which sold" and states:

... (a) sale of personal property is consummated at the time when, and in the place where, the rights, title and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations and the execution of the agreement, the location of the property, and the place of payment, will be considered and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

This definition provides generally that the test of "passage of title" in a foreign country will control unless the transaction was so arranged as to avoid Federal income tax. This author believes that if the Bahamian corporation's sales force, which is outside of the United States, continues to be the center of the selling activity, even if orders are communicated directly to the United States by telex from South and Central America, the Bahamian corporation's South and Central American sales will be

respected as sales within the recipient South or Central American country if title to the property and all other sufficient incidents of ownership pass within that country. Case law and Service position are supportive of this view.<sup>19</sup>

Having determined that our Bahamian corporation's South and Central America sales will be from sources *without* the United States, we now return to the effect of this determination.

As we stated previously, *Code Section 864 (c)* provides certain exceptions which *exclude* income from sources without the United States from the term "effectively connected". The result of such an exclusion is to not subject this not effectively connected income to United States taxation. One of the exceptions of *Code Section 864 (c)* is applicable to our corporation's Latin American Sales. *Code Section 864 (c) (4) (B) (iii)* provides that *income from sources without*, derived from the sale of inventory property is *not* considered effectively connected income if the property is sold for use outside the United States and an office or other fixed place of business of the taxpayer *outside* the United States participated *materially* in such sale.

There is an extremely good policy reason for the exception granted by the *Code*. Congress recognized that a valid jurisdictional argument for taxation existed only when the United States activity was an essential and significant economic element, and not just an incidental factor in the production of the income to be the subject of the Federal income tax.<sup>20</sup>

There is every reason to believe that in the case of our Bahamian sales corporation, it has made such a material participation in the sale of the goods, that none of the sales profits will be considered to be subject to Federal income tax as effectively connected foreign-source income. The corporation's non-United States sales office is clearly the center of the sales organization. Treasury Regulation 1.864-6 (b) (3) (i) outlines what constitutes a material factor and supports the view that the activities of the Bahamian sales corporation are a material factor in the production of the foreign-source income. That regulation states in pertinent part:

... an office or other fixed place of business which the taxpayer has outside the United States shall be considered to have participated materially in a sale made through the office or other fixed place of business in the United States if the office or other fixed place of business outside the United States actively participates in soliciting

the order resulting in the sale, negotiating the contract of sale or performing other significant services necessary for the consummation of the sale . . .

In further support of this view, reference is again made to Treasury Regulation 1.864-6 (b) (3) examples (2) and (3) quoted at pages 181-182, *supra*.

To sum up, if the Bahamian corporation will open a South Florida warehouse as a branch operation and not as a separate domestic corporation, it is this author's opinion that the corporation may be considered to be engaged in a trade or business in the United States. As such, it will be taxable under *Code Section 882* only on that income which will be considered to be effectively connected with its United States trade or business. Since its foreign sales office will contribute materially to all South and Central American sales and since all South and Central American sales can be structured to consummate in the South and Central American countries, no income resulting from its South and Central American sales will be effectively connected with its United States business. Consequently, there will be no Federal income tax resulting from the gain on the South and Central American sales.

In the alternative, let us study the effect of *Code Section 881* in the event that it may be determined that the foreign corporation's warehouse and distribution function is not an activity which rises to the point of being a United States trade or business. It is the opinion of this author, however, that the activity will be considered a United States trade or business.

The reader will recall from the previous discussion that it is possible to structure sales of goods delivered outside of the United States so that the income resulting from the sale will not be considered income from sources within the United States. Under *Code Section 881* we need not be concerned about the "effectively connected" concept because *Code Section 881* imposes its flat 30% tax on specific types of income only from sources within the United States.<sup>21</sup> Since the sale of goods can be structured so as not to be within the United States there is little concern of taxation under *Code Section 881*. Furthermore, gains from the sale of property do not even come within the specified types of income governed by *Code Section 881*.<sup>22</sup>

Before closing the author believes it is in order to point out why a foreign corporation wishing to warehouse and distribute from the United States, should not establish a subsidiary domestic corporation to achieve

its objective. A domestic corporation pursuant to *Code Section 11*, is subject to United States Federal income taxation on all of its taxable income. A domestic corporation which ships most of its products outside the United States may be able to avail itself of the benefits of *Code Section 921*, applicable to Western Hemisphere Trade Corporations. However, *Code Sections 921* and *922* provide only a reduced rate of taxation.

In the case of *Code Sections 882*, the Code specifically provides that a foreign corporation is only taxable on its effectively connected trade or business income and in the case of *Code Section 881* only on its United States source income. However, when a foreign parent corporation forms a domestic subsidiary the specific provisions of *Code Sections 881* and *882* are not applicable to the income of the subsidiary domestic corporation. In that instance there exist two separate incorporated businesses, the foreign parent and the domestic subsidiary and, pursuant to *Code Section 482*, the Commissioner may allocate certain of the sales profits among the two entities. Such an allocation would be extremely detrimental for it may well "create" income for the domestic subsidiary by virtue of fixing the prices the subsidiary must pay its related foreign parent. The *Code Section 482* allocation may well result in taxable income not encompassed by *Code Section 882*.

## NOTES

<sup>1</sup>The Miami News, July 8th, 1975.

<sup>2</sup>The Bahamas has no present income tax treaty with the United States. Keep in mind that in those countries which do have an income tax treaty with the United States, the results could be significantly different.

<sup>3</sup>HR 1303 89th Cong. 2d Sess.

<sup>4</sup>1966-2 C.B. 976-977.

<sup>5</sup>Sitrick, the Effectively Connected Concept in The Foreign Investors Tax Act of 1966, 45 *taxes* 2 (1967).

<sup>6</sup>*Internal Revenue Code of 1954 Section 7701* (a) (4) and (5) (hereinafter referred to as *Code*).

<sup>7</sup>Treas. Regs. 1.881-1 and 1.881-2.

<sup>8</sup>Treas. Reg. 1.882-1 (b) (1).

<sup>9</sup>Treas. Reg. 1.882-1 (b) (2).

<sup>10</sup>*Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953) *aff'd per curiam* 221 F.2d 222 (9th Cir. 1955).

<sup>11</sup>*Alfonso Diaz*, 58 T.C. 560 (1972).

<sup>12</sup>However, *cf.* Treas. Reg. 1.355-1 (c) (3).

- <sup>13</sup>Frank Handfield, 23 T.C. 633 (1955).
- <sup>14</sup>Cf. *Scottish American Investment Co., Ltd.*, 12 T.C. 49 (1949); *Spermacet Whaling & Shipping Co.*, 30 T.C. 618 (1968) *aff'd* 281 F.2d 646 (6th Cir. 1960) and *European Naval Storage Co., S.A.*, 11 T.C. 127 (1968) *acq.* 1948-2 C. B. 2.
- <sup>15</sup>Treas. Reg. 1.882-1(a)
- <sup>16</sup>Code Sections 864 (c) (3) and (4).
- <sup>17</sup>*Bittker & Eustice*, Federal Income Taxation of Corporations and Shareholders Section 17-5.
- <sup>18</sup>Treas. Reg. 1.864-6 (c) (3) examples (2) and (3).
- <sup>19</sup>Rev. Rul. 74-249, 1974-21 I.R.B. 15; *Commissioner v. Pfaudler Inter-American Corp.*, 330 F.2d 471 (2d Cir. 1964); *Commissioner v. Hammond Organ Western Export Corp.*, 327 F.2d (7th Cir. 1964); and *Barber Greene Americas, Inc.*, 37 T.C. 365 (1961) *acq.* 1964-2 C.B. These authorities considered the application of Treas. Reg. 1.861-7 (c) to Code Section 921. This author does not believe there is any distinction, for purposes of interpreting the regulations, between Code Section 921 and other Code Sections governing foreign corporations such as Code Section 882 which we have here. cf. *United States Gypsum Co., v. United States*, 452 F.2d (7th Cir. 1971). Both Code Sections 882 and 921 make similar indirect reference to Treas. Reg. 1.861-7 (c). See Treas. Reg. 1.882-1 (a) and Treas. Reg. 1.921-1 (c).
- <sup>20</sup>S. Rept. 1707, 89th Cong. 2nd. Sess.
- <sup>21</sup>Treas. Reg. 1.881-2 (a).
- <sup>22</sup>Treas. Reg. 1.881-2 (a).