An Overview

Extraterritorial Effects of United States Tax Laws*

**Editor's Note: The material which follows reproduces the papers and comments delivered before a joint session of the Section of International Law and the Section of Taxation at the Annual Meeting of the American Bar Association in Chicago, Illinois in August, 1977.*

Welcoming Remarks by Mr. John Pennell

Welcome to this joint program on international tax law. I am John Pennell, Chairman of the Section of Taxation of the American Bar Association, and as you know, this program is a joint undertaking of the Section of International Law and the Section of Taxation, and it gives us a great deal of pleasure to have that cooperation. I hope we see a lot more of it and I am sure that we will. I think you will find this program to your liking. It has been planned on behalf of the two sections by Bob Cole of the Section of International Law, and Joe Guttentag, who is the Chairman of the Committee on Foreign Tax Problems of the Section of Taxation.

I sincerely urge those of you who are members of the International Law Section who are interested in taxation to also become members of our section, and vice versa. I think that the cross-participation can be helpful to both sections and to the improvement of international tax law.

This program this afternoon has been planned by Joe Guttentag and Bob Cole. Bob Cole is going to be the moderator. Bob has been International Tax Counsel to the Treasury Department and he presently is in the practice of law in Washington, D.C. with the firm of Cole Corette & Bradfield. I will turn this program over to him to introduce the speakers and to explain the format.

Remarks by Mr. Robert T. Cole

Scope of Program

Thank you, John.

The United States tax system inherently involves extraterritorial problems for three different reasons. First, we tax the foreign income of U.S. residents, citizens, and corporations. Second, we tax the U.S. income of foreigners (foreign corporations and foreign residents). Third, the means of communication and transportation in a world of change are such that if you have a completely domestic transaction, you can find that key information for audit purposes, or verification, or the proceeds of transactions are located outside of the United States even though you are dealing with a U.S. person with U.S. income. Not only do we have these three inherent aspects of the U.S. tax system which engender extraterritoriality, but we have seen fit to use the U.S. tax system to accomplish U.S. non-tax goals as to foreign conduct. As Ray Garrett said at lunch today, the SEC is very much involved in the question of foreign bribery. The Congress has seen fit to have U.S. tax consequences flow from foreign bribery and certain other types of foreign "sensitive payments."

We are going to try to conduct this seminar simultaneously on three levels. I don't know whether we will be able to do it. First, we are going to try to impart "bread and butter" information to the non-tax specialist, or to the non-international tax specialist, who wants to find out what our rules are in international taxation. Second, this is going to be an opportunity to discuss tax policy in the international area. Third, international tax law is part of international law and, therefore, it raises the question of what the international legal policy of the U.S. should be generally. If people who are not tax specialists think we are getting too complex, shout out at any time and we will try to clarify and unjargon what we are talking about.

Introduction of Speakers

Now let me just introduce the speakers all at once. The first speaker just arrived from New York and I will recite his biography from memory. RICHARD C. PUGH is a partner in the New York law firm of Cleary, Gottlieb, Steen & Hamilton which also has offices in a lot of places around the world. He was formerly Deputy Assistant Attorney General in the Justice Department, in the Tax Division, has been a Professor of Taxation at Columbia Law School, and still teaches at Columbia Law School on a part-time basis.

The second speaker is DAVID S. FOSTER who will finish, in the next fortnight, an illustrious career with the Treasury Department where he was International Tax Counsel and before that, one of the draftsmen of the pension legislation with which we all are now living. He is moving to San Francisco with the firm of Brobeck, Phleger & Harrison and we all wish him luck in his new career.

The last speaker in the regular part is JOSEPH H. GUTTENTAG, my co-chairman from the Tax Section, who is a partner in the law firm of Surrey, Kafasik and Morse, of Washington, D.C. and other places. Mr. Guttentag also sat in the same office in the Treasury Department, in the job that is now known as the

International Tax Counsel, and was my first boss at the Treasury Department.

The first commentator is MARK R. JOELSON, who is the head of the Antitrust committee of the International Law Section, and is a partner in the law firm of Arent, Fox, Kintner, Plotkin & Kahn of Washington, D.C. He has been with the Justice Department in the Civil Division.

BRUCE VECHERE, a partner in the law firm of Vechere & Gauthier, with offices in Montreal and Toronto, was the second scheduled commentator. However, because of the air-controllers' strike in Canada, he has not been able to leave Montreal. We are very fortunate in having an American lawyer, WILLIAM J. CAVENEY, to replace Mr. Vechere as the other commentator. Mr. Caveney is Group Tax Manager-Planning with Norton Simon, Inc., and is both a lawyer and a CPA. He has worked a great deal on Canadian tax and legal matters. He will give us some thoughts as to how the Canadian system compares with our system.

I will now try to summarize the international aspects . . . in fifteen minutes —which will mean we will be running five minutes late—try to summarize the international aspects of the U.S. tax system, and if you will look at the outline that has been handed out, you will get to page II.

Overview of Extraterritorial Effects of United States Tax Laws

The United States taxes the worldwide income of U.S. persons and there are a number of rules that one has to keep in mind. First of all, who are U.S. persons? Principally U.S. persons are U.S. citizens, individual residents of the United States and U.S. corporations.

U.S. citizens are subject to worldwide taxation, regardless of where they live. Regardless of citizenship, persons who are residents of the United States are taxed on a worldwide basis. There is a limited exclusion for $15,000 of earned income. The other sort of U.S. person of great significance is a U.S. corporation. A U.S. corporation is a corporation incorporated in one of the fifty states or the District of Columbia. If a corporation has that kind of origin it is a U.S. corporation, regardless of who its stockholders are or where it carries on business.

As I said, U.S. persons are subject to worldwide taxation. The way we avoid international double taxation is through something called the "foreign tax credit." I will try to tell you a little bit about the foreign tax credit. First of all, the foreign tax credit is one of two ways of avoiding double taxation. There is an easy way and there is a hard way. The easy way would be to exempt foreign source income, to conclude that it is generally taxed abroad and decide that we are not going to worry about it. But our approach is that we are afraid of foreign source income being undertaxed. Therefore, we tax it and then we give a credit for the foreign taxes that have been paid. One of the things that Dick Pugh will go into is that we give a credit only for something called a foreign *income* tax, and how our characterization has international ramifications. The idea, of course, is that we do recognize that the country of source has primary jurisdiction, and we apply a residual tax to the extent that foreign income has not been fully taxed up to the U.S. level.

Sometimes foreign taxes can exceed the U.S. tax. You can do business in a country where the effective tax rate is, say, 60 percent to prevent the foreign tax credit from offsetting U.S. tax on U.S. source income, the U.S. system includes a foreign tax credit limitation. We determine through a mathematical formula which part of the U.S. tax before credit is imposed on the foreign source income. We do that by the ratio of foreign source taxable income to worldwide taxable income. For this purpose U.S. tax accounting standards are used. We apply the foreign tax credit on a worldwide basis so if you are paying 70 percent tax to, say, Iran, and zero tax to Ireland, that averages out, depending on the amount of income from each foreign country. As long as the effective foreign tax rate averages out to no more than the U.S. rate, you get a full credit. That is called the overall limitation to the foreign tax credit which became virtually mandatory this year. Special rules for oil income, interest and DISC income will not be discussed.

Another important aspect of the foreign tax credit is that it applies not only for taxes that have been paid directly, but for taxes that have been paid by foreign subsidiaries.

Subsidiaries are defined so that they have to be 10 percent owned by the U.S. parent corporation to qualify. We go down three tiers of foreign corporations, and there has to be at least a 5 percent indirect ownership. The U.S. parent corporation is entitled to a foreign tax credit for the income taxes paid by the subsidiary. The credit is generally available at the time the subsidiary distributes dividends to the parent corporation, because until the subsidiary distributes dividends there is no income and there is nothing to tax, except to the extent Dick Pugh will tell you otherwise.

That completes my discussion of the highlights of how we tax foreign income of U.S. shareholders. I will take a few minutes to describe how we tax U.S. income of foreign persons.

First of all, if a foreign person becomes sufficiently present in the U.S., he is no longer foreign. If somebody comes to the United States and rents an apartment in Miami, and lives there and conducts business, after a certain time, he or she will become a resident of the United States. One of the subcommittees of the International Law Section is considering at what point a foreigner becomes a resident.

Another way a foreigner becomes a resident of the United States is by forming a U.S. corporation. Instead of conducting business directly, a foreign corporation could form a United States corporation and then that U.S. corporation is a U.S. person taxable on its worldwide income. Of course the foreign owner of the U.S. corporation remains a nonresident.

Considering the foreign corporation or the foreign individual, there are three types of income with which the U.S. might be concerned. The first category is passive income, such as interest, dividends, royalties and passive rents. Passive income, for the foreigner who is not engaged in trade or business in the United States, or whose passive income is not connected with a trade or business in the United States, is taxed on a gross basis at a flat withholding rate of 30 percent. However, we don't really mean to collect 30 percent; if you are a foreigner from a country with which we have a tax treaty, we will reduce the rates on interest, royalties, and dividends down to zero, 15 or 5 percent, depending on the type of income, and conditioned on reciprocity. On interest and royalties, 0 to 15 percent is typical. On dividends, 15 percent is typical, often with a 5 percent rate for dividends paid to a corporate direct investor. On compensation, we either tax it or we don't tax it; but if you come from the right country and do the right things, we will let you stay here 183 days in a taxable year without taxing you.

The second category of income of a foreign person is occasional business-type income, mainly sales income and services income of corporations. If the foreign corporation is not engaged in a trade or business in the United States (this is obviously a term of art), the U.S. does not tax that income at all. If there is a treaty in effect, you are tax-free as long as your trade or business is not carried on through a U.S. permanent establishment.

The third category of income which a foreigner can have is income from being engaged in a trade or business in the United States. As I said, if you are a foreigner from a treaty country, the trade or business has to be through a permanent establishment to fall in the third category. In 90 percent of the cases, a "permanent establishment" is a permanent establishment. The policy makers have figured out exceptions: Where permanent establishments are not "permanent establishments" and where business carried out without a permanent establishment is taxed as if it were. But I will not get into that detail now.

Once you have a trade or business here (carried on through a permanent establishment in a treaty case), then you must consider the "effectively connected" concept. The rule is that such foreign persons are subject to tax on "effectively connected" income. Passive income connected with your business is considered "effectively connected" and taxed as part of the business at normal rates. All of your U.S. source business income, even though not connected