Welcome! Our first class meets on Thursday, August 31, at 9:00 a.m. in Furman Hall room 216. The materials you’ll need for the course are a current copy of the Code and Regulations and my book *International Aspects of U.S. Income Taxation* (6th ed. 2015), which are all available in the NYU Bookstore on Broadway. Any additional materials will be posted in the Course Materials folder of NYU Classes. In particular, you will find in Course Materials a copy of the 2016 U.S. Treasury Model Treaty, which you should print for your reference (print two-sided—it’s long). The appendix of my book includes an older version of the treaty; whenever you see in the book a reading assignment to the Model Treaty, always consult the 2016 Model, not the older one in the book.

You’ll see that the book acts as a syllabus, so there is no separate syllabus. In each subpart of a chapter, you’ll see a reading assignment to the Code and Regulations and treaties (U.S.-Netherlands and U.S. Model), and to cases, rulings, etc. that are set forth in the book. You’ll almost always also see a problem at the end of the subpart. When preparing for class, please read the assigned material and the corresponding Notes in the book and prepare a solution to the problem. For our first class, please prepare Chapter 1.A (which deals with the concept of residence and which does not include a problem).

See you on the 31st.
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I. INVESTMENT AND BUSINESS ACTIVITY IN THE UNITED STATES BY FOREIGN PERSONS

A. Residence and Related Questions

Code: §§ 7701(b), 911(d)(3), 865(g)(1) & (2), 7701(a)(4), (5), (30), (31), 6013(g), (h); 1(a), 2(d), 5(a), 11(a), (d), 871(a)(1), (b), 872(a), 881(a), 882(a), (b).

Regs: §§ 301.7701-5, 301.7701(b)-1, -7, 1.871-13(a) - (c).


Notes—Residence and Related Questions

Residence

A taxpayer’s residence and the source of his income are the critical factors in determining how competing jurisdictions sort out their respective taxing rights under established principles of international taxation. All countries employing income taxation subject their residents to taxation either only on income sourced in the country of residence (a “territorial” or “exemption” system), on worldwide income, or on a combination of each. Where worldwide income is included in the tax base, the residence country grants a credit, subject to limitations, for taxes paid to the country in which the income is sourced (a “credit” system). (The United States stands virtually alone in taxing not only its residents, but also its citizens, on worldwide income.1) Source rules are analyzed in later parts of this chapter.

1 U.S. taxation of nonresident citizens, who are estimated to number six million, has created serious compliance problems and provoked much criticism. FATCA (see chapter I.B.1 below) has exacerbated the problems and resulted in foreign financial institutions refusing to permit U.S citizens to maintain accounts and has been blamed for causing a sharp increase in nonresidents renouncing U.S. citizenship. See Paula N. Singer, U.S. Policy on Taxing Citizens and Residents Abroad: A Closer Look, 42 Tax Notes Int’l 1033 (June 19, 2006); Paula N. Singer, A Common-Sense Solution for Taxing U.S. Citizens and Immigrants Abroad, 52 Tax Notes Int’l 555 (Nov. 17, 2008); Reuven S. Avi-Yonah, The Case Against Taxing Citizens, 58 Tax Notes Int’l 389 (May 3, 2010); American Citizens Abroad, Recommendations for U.S. Tax Law Reform, 66 Tax Notes Int’l 459 (Apr. 30, 2012); American Citizens
Residence must be determined both for purposes of the Code and any relevant treaty. Treaties confer certain benefits on residents of the countries that are party to the treaty and contain their own definition of residence, which typically means a person who is liable to tax in the country in question under its internal law (i.e., the Code in the case of the United States) by reason of the person’s domicile, residence (under internal law), or place of management or incorporation, but excluding a person who is liable to tax only on local-source income. (The exclusion for persons taxed only on local-source income is not intended to automatically preclude residence in a country that has adopted a territorial system of taxation.) Tie-breaker rules apply where the person fits the definition of residence in each country. See Article 4 of the treaties in the Appendix.

Domestic corporations (those organized under U.S. law) are subject to U.S. tax on worldwide income. In effect, without textually using the word “resident,” the operative taxing provisions treat all domestic corporations as U.S. residents and all foreign corporations as nonresidents.

Because countries may utilize divergent criteria to establish residence of a corporation (e.g., place of incorporation or place of management) a company incorporated in one country but managed in another may be a resident of each country party to the treaty. In that situation, Article 4(3) of the OECD Model Convention assigns residence priority to the country where the entity has its “place of effective management.” Commentary to Article 4(3) reasons that “[a]n entity may have more than one place of management, but it can have only one place of effective management at any one time.” However, Article 4 of the U.S. Model Treaty, reflecting the U.S. rule that companies organized under U.S. law are effectively treated as U.S. residents, breaks the tie in favor of the country where the company is organized. If that rule does not resolve the dispute (e.g., the company is organized under the law of both countries (“dual charter company”)), the company is denied treaty benefits in both countries unless the competent authorities resolve the dispute. In a related vein, if a company is resident in more than one country that has a treaty with the United States, Revenue Ruling 2004-76 takes into account the wishes of the company and the countries involved in determining the country of residence for treaty purposes.


2 See OECD, Comm. on Fiscal Affairs, Commentaries on the Articles of the Model Tax Convention, Art. 4, ¶ 8 (2014).

3 See §§ 11(a), (d), 881(a), 882(a), (b). There have been proposals to treat foreign corporations as domestic corporations unless they are managed to a material extent outside of the United States or, in the case of investment companies, if investments are managed in the United States. See New York State Bar Association, Tax Section, Rep. No. 1232, Report on the Management and Control Provision of the International Tax Competitiveness Act of 2011 (Jan. 31, 2011).

4 In an internal memorandum issued in 2005, the Service concluded that a corporation organized under U.S. law but managed in the treaty partner country was not entitled to a credit for foreign tax that allegedly could have been avoided by asking competent authorities to determine that the corporation was not resident in the treaty partner. The transaction involved duplicate foreign tax benefits, which are discussed below in chapter II.E. ILM 200532044.
account how a treaty between the competing residence countries resolves residence in order to determine which country’s treaty with the United States governs.

As to individuals, prior to enactment of Section 7701(b) in the Tax Reform Act of 1984, an alien present in the United States was a resident of the United States, as opposed to a nonresident alien, unless he was a “mere transient or sojourner” based on intent as to the length and nature of his stay. Section 7701(b) was enacted to clear up the ambiguity inherent in such a vague standard and to minimize interruptions in an alien’s status as a resident. Although quite complicated, reduced to its essence Section 7701(b) renders an alien resident of the United States if he is a lawful permanent resident under U.S. immigration law (i.e., holds a “green card”\(^5\)) or maintains a “substantial presence” in the United States. Substantial presence requires (i) 31 days of presence in the year in question and (ii) a weighted rolling average of 183 days of presence over the present and two prior years (with days from the present year weighted as one, days from the prior year weighted one-third, and days from the second preceding year weighted one-sixth). An alien who keeps his U.S. presence below 122 days in all years avoids substantial presence. Time spent in the United States as an employee of a foreign government, e.g., a diplomat,\(^6\) or, subject to time limits, as a student or teacher or during periods when the alien has a closer connection to another country, does not count toward substantial presence.

A noteworthy feature of the regulations is that an individual who is an internal-law resident of both the United States and a treaty partner, and who is treated as a treaty partner resident under the tie-breaker rule, must treat himself as a nonresident for all Code purposes if he elects to take advantage of treaty benefits.\(^7\) (The reason that nonresident status is elective is that a person cannot be forced into taxation under a treaty if internal law resident status is preferable.)

Section 7701(b) determines only whether an alien is a U.S. resident, but the regulations provide that the same standard applies in determining the residence of a U.S. citizen unless the “context indicates otherwise.”\(^8\) Examples of special definitions of residence are Section 865(g), which equates residence with an individual’s “tax home” (i.e., home for purposes of deducting away-from-home business travel expenses) for purposes of sourcing gain from sale of personal property; Section 6013(g) and (h), dealing with nonresident aliens who are married to U.S. citizens or residents for marital

joint return purposes; and Reg. § 1.861-2(a)(2), which treats partnerships (foreign or domestic) as residents of the United States if they are engaged in trade or business there, but only for the purpose of sourcing interest income from partnership debt obligations.9

Closely related, but distinct, are Section 7701(a)(4) and (5), which define a corporation or partnership (except, in the case of a partnership, where regulations provide otherwise—no regulations yet) as “domestic” or “foreign” based on where it is legally organized, and Section 7701(a)(30), which defines “United States Person” as a U.S. citizen or resident or a domestic corporation or partnership. Each of the foregoing definitions has a particular scope and content, which must be carefully studied in order to assure that it is applied only for its express statutory purpose.

**Taxation of Nonresidents at Source**

A basic principle of international taxation is that the source country—the country in which income is earned—reserves the primary right to tax the income. If a taxpayer is resident in the source country, there is no competition between the source and residence states; they are the same. However, if the taxpayer is not resident in the source country, the source country has primary taxing rights over locally sourced income and the residence country has only residual taxing rights. In this instance, the source country may relax its primary taxing rights by internal law or treaty, and the residence country may either forego residual taxing rights by adopting a territorial system or may exercise them tentatively and then ameliorate double taxation through a foreign tax credit. Typically, source countries tax residents and nonresidents under different levies. Nonresidents are generally taxed in the source country on locally sourced income via gross-basis withholding taxes imposed on portfolio income and standard net income taxes imposed on business income if the business meets a required threshold of local activity.10 Only in rare instances does a source country tax income earned by a nonresident outside of the source country.

**Expatriates**

As mentioned above, the United States is virtually alone in taxing not only its residents but also its citizens on worldwide income. In certain circumstances, if, before June 17, 2008, a U.S. citizen lost or abandoned U.S. citizenship and residence or a long-term resident alien lost or abandoned U.S. residence, Section 877, which was significantly amended by the American Jobs Creation Act of 2004, continues for ten

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9 Until T.D. 9153 was promulgated in 2004, Reg. § 301.7701-5 was substantially identical to Reg. § 1.861-2(a)(2), except that the former determined whether a partnership was resident in the United States for all purposes, not just for purposes of sourcing interest paid by the partnership. But the other purposes had become obsolete. See the discussion of dual charter companies in chapter V below. Section 861(a)(1)(C), added by the American Jobs Creation Act of 2004, changed the source rule for interest paid by a foreign partnership in certain circumstances. See part B.1 of this chapter below.

10 In the United States, nonresident aliens are subject to withholding tax under §§ 1441 and 871(a) and to net income tax under § 871(b) (see also §§ 2(d), 5(a)). Foreign corporations are subject to companion rules under §§ 1442, 881(a), and 882(a) and (b) (see also § 11(d)). Importantly, nonresident aliens are not subject to the incremental 3.8 percent tax imposed on net investment income enacted in 2010 to help fund Medicare. § 1411(e)(1).
years thereafter to tax the former citizen or resident as though not all U.S. ties were broken.

More specifically, in the case of former citizens, if their income or net worth exceeded certain thresholds or if they failed to meet certain ongoing certification and notification requirements, for the next ten years they are taxed on a broadened class of U.S. source income (which includes gain from disposition of certain assets that would otherwise be foreign source (and, therefore, free from U.S. tax), including U.S. situs property, stock and debt issued by U.S. persons, and stock of controlled foreign corporations) at the rates applicable to citizens and residents. Long-term (i.e., 8 of the last 15 years) lawful permanent resident aliens (green card holders) who abandoned such status or elected treaty benefits available to foreign persons are subject to the same treatment. This treatment is a middle ground between tax status as a citizen or resident on the one hand and as a nonresident alien on the other, the principal effect of which is to tax gains realized upon disposition of assets that would otherwise escape the U.S. tax net.

Certain dual citizens and minors who became citizens at birth and had minimal historical U.S. ties could lose citizenship and nevertheless avoid this middle ground (i.e., be taxed as nonresident aliens) even though their income or net worth exceeded the threshold, provided they satisfied the certification and notification requirements. At the other end of the spectrum, if in any year within the ten-year period following loss of citizenship or residence the former citizen or resident spends more than 30 days in the United States (other than for employment purposes under narrow conditions), he is taxed as a citizen or resident for that particular year.

In 2008, Congress enacted Section 877A, which replaced Section 877 for expatriations (loss of citizenship or long-term residence) occurring on or after June 17, 2008. The new provision generally applies to the same definition of expatriates covered by Section 877, but the effect is very different. Instead of creating a middle ground affecting future taxation, Section 877A requires immediate recognition of unrealized gain or loss inherent in the expatriate’s assets, with an exemption of the first $600,000 of gain. Special rules impose either immediate tax or deferred withholding tax on interests in deferred compensation and certain other tax-deferred accounts and non-grantor trusts. There is a procedure for electing to defer the tax on particular assets until disposition, subject to an interest charge on the resulting deferral, provided adequate security is given. The exceptions for dual citizens and minors are more lenient than in Section 877.

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Finally, in light of immediate taxation instead of the middle ground approach, Section 877A drops the provision that treats an expatriate as a citizen or resident in a particular future year if he spends more than 30 days in the United States. The only effect of returning to the United States is the risk of re-establishing residence under Section 7701(b).\(^\text{13}\)

The incidence of expatriation has increased in recent years, although the extent to which income taxation is the cause is not clear. As was the case before enactment of Section 877A, expatriation can cause adverse gift and estate tax consequences.\(^\text{14}\)

**U.S. Possessions**

Special rules apply to residents of U.S. possessions and to U.S. residents who earn income in the possessions.\(^\text{15}\) The U.S. possessions are American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands. The special rules differ, and coordinate differently with the “mirror” tax provisions in place in some of the possessions, depending on the particular possession involved, so generalizations are merely that. However, the thrust of the special rules is that residents of a possession pay tax on income earned in (i.e., sourced in or effectively connected to a business conducted in) the possession to the possession, not to the United States.\(^\text{16}\) In some cases, residents of a possession pay tax on all of their income, wherever earned, to the possession. In some cases, U.S. residents pay tax on income earned in a possession to the possession, not to the United States. A short history of how the rules have operated in the various possessions is in the preamble to proposed and temporary regulations issued in the wake of the American Jobs Creation Act of 2004, which made significant amendments to the possessions rules.\(^\text{17}\) Prior to the Act, U.S. residents were taking the questionable position that they were residents of the Virgin Islands pursuant to V.I. law (which granted preferential tax treatment) and therefore subject to tax only there. The Act clamped down, in Section 937, by providing a definition of residence fashioned after Section 7701(b)’s substantial presence test and by clarifying the standards for when income is

\(^{13}\) See § 7701(b)(10) for the treatment of a resident who abandons and re-establishes U.S. residence before three years have elapsed.

\(^{14}\) Relevant provisions pre-dating § 877A are §§ 2101(a), 2103, 2104, 2105, 2107, 2501(a)(2), (3), (5), 2511(a), (b). New § 2801 was enacted with § 877A and has far-reaching, much criticized estate and gift tax effects.

\(^{15}\) §§ 931-935, 937, 876, 881(b).

\(^{16}\) In *Francisco v. Comm'r*, 370 F.3d 1228 (D.C. Cir. 2004), a U.S. citizen resident in Samoa argued that income from fishing in international waters was exempt from U.S. tax under § 931 on the ground that the income was either sourced in Samoa or connected to a business conducted in Samoa. The court rejected both claims, finding that the income was U.S. source under § 863(d) and, by parallel reasoning from § 864(c)(4)(B), not effectively connected to a Samoan business.

earned in a possession.\textsuperscript{18} Some of the possessions argued that the change eroded their economy and tax base and pressed for relief, but Section 937 leaves little leeway.\textsuperscript{19}

\textsuperscript{18} See, \textit{e.g.}, \textit{Cooper v. Comm' r}, T.C. Memo 2015-72.

\textsuperscript{19} T.D. 9391, 2008-1 C.B. 945, mentioned in note 17 \textit{supra}, does offer minor relief but concedes that it will disappoint those hoping for significant help for the territories.